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Oversea Listing and State-Owned-Enterprise Governance in China: the Role of the State

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Abstract: There are both considerate horizontal and vertical governance problems in the Chinese state-owned-enterprises (SOEs). Due to their privileged positions in the political economy, traditional institutions of corporate governance are far from perfect. Thus the value of oversea listing as a governance mechanism is highlighted, and that could be better revealed by a deeper analysis of the benefit-and-cost balance by the government which controls the SOEs. However, effective as it is, oversea listing could not be a marvelous antidote to all governance ills. Further, as the two major governance disasters of oversea listed SOEs shows, if the government lacks a proper self-positioning, nontrivial negative implications will be brought to SOEs governance via oversea listing. The ultimate function of corporate governance in SOEs thus relies heavily on public governance.

Key words: state-owned-enterprises, oversea listing, corporate governance, China

Table of contents

I. Introduction

P.R. China perhaps has the largest group of state-owned-enterprises (SOEs) in the world. As of 2008, total assets of the SOEs were $6 trillion (133% the size of China's economy). [1] As of 2010, total assets of the 120 central controlled SOEs equaled 62% of China's GDP, total revenues 42% of it. [2]

Though not as viable and active as the emerging private-owned enterprises, they dominated the capital-intensive sectors such as power, steel, chemicals and machinery. SOEs also account for approximately 70% of China's listed companies [3] in a nominally leading stock market by capitalization.[4] After nearly twenty years of reform, most of SOEs have been corporatized and many even become listed companies. However, corporate governance remains a big challenge for these firms. [5]

This paper discusses the effects of oversea listing on the SOEs in China where the corporate governance is ineffective, the government and SOEs are powerful. I would try to demonstrate that on the one hand, ordinary corporate governance mechanisms would not be very useful, highlighting the unique value of oversea listing for SOEs. On the other hand, constraints from oversea listing remain limited on SOEs, as

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[1] Jason Dean et al., *China's 'State Capitalism' Sparks a Global Backlash*, Wall St. Journal, Nov. 16, 2010. It also pointed out though France is famous for extensive state involvement, the relevant numbers were $686 billion and 28%.

[2] Lin, Li-Wen and Milhaupt, Curtis J., *We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China* (November 1, 2011). Columbia Law and Economics Working Paper No. 409, *available* at SSRN: http://ssrn.com/abstract=1952623 or http://dx.doi.org/10.2139/ssrn.1952623, n11.

[3] In 2006 the head of the national State-Owned Assets Supervision and Administration Commission stated that 56% of listed companies were controlled by the Commission or the equivalent local-level state assets departments. Guowuyuan guoyou zichan jiandu guanli weiyuanhui guanyu yinfa Li Rongrong tongzhi zai quanguo guoyou zichan jiandu guanli gongzuo huiyi shang de jianghua de tongzhi [Notice Regarding the Printing and Circulation of the Speech Given by Mr. Li Rongrong in the National State Assets Supervision Working Meeting], Mar. 6, 2007, available at http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=90735.

[4] The market overtook Japan as the world's second-largest stock in January 2008 and July 2009, *China's Market Value Overtakes Japan as World's No. 2*, Bloomberg News, July 16, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a_84o9PPPGqk. But due to the bulk of de facto non-negotiable state-owned shares, a calculation of capitalization by multiply the shares with market price will be overestimating.

[5] Surely, what is a proper role for the SOEs is highly debatable. I agree with the claim that SOEs should retreat from competitive industries and profit maximization should not be its goal. However, in the medium term the Chinese government as the owners of SOEs seemingly would not to go in this direction. Numerous or even the majority of SOEs operate like ordinary business firms. So for the simplicity, this paper just treats SOEs as firms with a special kind of controlling shareholder, without exploring whether there is a non profit maximization social role for them.

compared with other kinds of enterprises. Both effects can be attributed to the fact that SOEs are deeply embedded in a political economy system where they enjoy special position.

A series of paper have addressed the issue of oversea/cross listing from the governance perspective, [6] nevertheless, U.S. scholars naturally would not pay special attention to the particularities of (Chinese) SOEs group. Some Chinese researchers have touched this topic as well, but they adopt an approach regarding general *entrepreneurs* [7] or place an emphasis on private owned firms.[8] This paper will focus the influential and distinctive cluster of Chinese SOEs, which are important and complex enough to deserve more academic efforts.

The article is structured in seven parts: Part 2 surveys the general governance background in Chinese SOEs, where both horizontal and vertical governance problems exist. I will show the ineffectiveness of various kinds of normal governance institutions. This highlights unique merits of oversea listing. It serves as a kind of constraints imposed by external law enforcers, and is considered more credible and more easily observed by outsider investors.

Part 3 examines the meaningfulness of oversea listing for SOE governance and more importantly the reason that why SOEs and their controllers will voluntarily elect to be oversea listed. I will explore costs-benefits done by government controllers of SOEs, the real decisions makers. This could well cast lights on the subtle relationship between SOEs and their government controllers and how oversea listing could change the landscape of SOEs governance in China. Also I will discuss more specifically

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6 E.g., Craig Doidge et al., Why Are Foreign Firms Listed in the U.S. Worth More?, 71 J. Fin. Econ. 205, (2004). G. Andrew Karolyi, *The World of Cross-Listings and Cross-Listings of the World: Challenging Conventional Wisdom*, 10 Rev. Fin. 99 (2006). Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Georgetown Law Journal 439(2001). John C. Coffee, Jr., "*The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*", 93 Nw. U. L. Rev. 641 (1999). John C. Coffee, Jr., Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, 102 Colum. L. Rev. 1757 (2002). John C. Coffee, Jr., Law and The Market: The Impact of Enforcement, 156 U. Pa. L. Rev. 229 (2007). Stephen Choi, Law, Finance, and Path Dependence: Developing Strong Securities Markets, 80 Texas. L. Rev. 1657(2002). Reese Jr., William A. and Weisbach, Michael S., *Protection of Minority Shareholder Interests, Cross-listings in the United States, and Subsequent Equity Offerings*, Journal of Financial Economics 66 (2002) 65–104.

7 Hua Cai, *Bonding, Law Enforcement And Corporate Governance In China*, 13 STAN. J.L. BUS. & FIN. 82, Fall, 2007.

8 Ding et al, Foreign vs. domestic listing: An entrepreneurial decision, Journal of Business Venturing 25 (2010) 175-191.

about what the change in the oversea listing destination reflects the balance of benefits and costs done by the decision makers, as well as more generally about its implications in the context of the outsourcing and decentralization of law enforcement in China.

While the theoretical analysis of the effects of oversea listing presents a relatively optimistic picture, Part 4 will turn to some concrete case studies to examine the dark sides. First a positive case study done by other researchers will be critically reexamined. In addition, two shocking negative cases which may well expose the potential governance problems of oversea listed SOEs will be probed deeply. These couple of once star firms that experienced major losses is China Aviation Oil in Singapore and CITIC Pacific in Hong Kong. I will show that the pathologies of these enterprises include: (1) loose internal control and management dominance; (2) management's deliberate illegal covering up activities after the losses arose. Both could largely be attributed to SOEs' leaders' lack of respect for market discipline as a result of SOEs' privileged positions.

The Chinese governments' behaviors in this process would also be carefully checked since they have profound impact on SOEs' governance. There are two phenomena worth noting: (1) moral hazard problems arise from the dubious economic and legal justifications proffered in relation to the eventual bailouts of these two corporations by their parent companies and the government. (2) It seems that oversea regulators may impose less severe punishments on the liable SOEs and their managers. It is not without possibility that regulators in international/regional financial hubs are paying attention not to annoy the formidable entity behind the companies: the Chinese government which had the final word in the allocation of future oversea listing resources and other economic resources.

Part 5 analyzes three intertwined perspectives concerning oversea listed SOEs: state, enterprise and foreign regulators, as well as how their interaction affects the governance of oversea listed SOEs. First I will summarize the striking similarities of the two major governance failures which may indicate system-specific vulnerabilities. Next, I will address a number of problems brought about by state ownership and control in these firms, namely: a more severe agency problem which may lead to bad things, implicit bailout guarantees from the government which reduce the incentive of ex ante market monitoring, lax ex post market discipline which fails to punish the wrongdoers, and an inactive oversea regulator. Such observations could help answer questions like: how far-reaching could a government impact the governance of oversea listed SOEs? How much will the oversea regulators care the attitude of the governments which control the companies? How much would oversea investors expect from those governments?

In other words, oversea listed SOEs may not be as market-oriented as it may appear to be if the role of the state acts in other way. When the government fails to treat SOEs as separate commercial firms, the high visibility created by oversea listing may cause the government to be more concerned with the fate of a single firm and tend to regard oversea listed SOEs as a whole. So it would endeavor to rescue anyone in trouble, thinking it is good for the integrity of the whole group or even of the state. Similarly, foreign regulators may also be cautious to avoid punishing violators seriously and upsetting the Chinese government. All these point to a fact that while oversea listing might bring some incremental improvement to SOEs' governance, this is likely to be overshadowed by the political factor and the government's acts, which may exert more profound effects on the future of SOEs' governance. Though oversea courts may be willing to characterize SOEs as ordinary business companies, such a status will become meaningful only when the government loose its hands and reorient a proper role of itself in managing and regulating the SOEs.

The conclusion part will explore that to what extent the corporate governance of SOEs will be determined by the factors of public governance and the role of the state in determining the governance impact of oversea listing for SOEs. Improper government acts may constrain the function of oversea listing (like market discipline) and bring about negative effects (like bailout). Maybe the Chinese government should try hard to adjust the role of itself, enhance the independence and accountability of SOEs first if it wants to make full use of the potential of oversea listing mechanism.

II. The Governance Problems of Chinese SOEs and the Limitations of Traditional governance problems

A. The Governance problems of Chinese SOEs

Vertical governance (between shareholder and managers) and horizontal governance (between a controlling shareholder and distant shareholders) are two fundamental themes core corporate governance institutions should respond to. [9] Both problems could be found in any jurisdiction, but "the centrality of each differs" across the country. Normally the former dominates in countries with diffuse ownership, where maybe "controller machinations are resolved well", while the latter tends to be the focus in jurisdictions with concentrated shareholding.[10] In the case of SOEs where a controlling shareholder exists by definition, the horizontal problem is not negligible. However, due to the special character of state as a shareholder, the vertical problem is also severe. So the overall governance problem for SOEs is big, while the function of almost all traditional ways of governance is constrained to a great extent when applied for SOEs.

1. Vertical Problems: Manager Control in Chinese SOEs

The most fundamental way of mitigating vertical problem is large block holder actions which could replace irresponsible or incompetent directors by voting rights. In SOEs, there of course is a government or government-affiliated entity holding a majority stake of shares. Some SOEs' nominal ultimate shareholders are explicitly government agencies like central or local State-owned Assets Supervision and Administration Commission, bureaus of finance, some are holding companies whose ultimate controllers are still the government.

However, such control may be weak in practice, since they are not true shareholders in the ultimate sense. A government stockholder suffers badly from an agency problem itself and does not bear the consequence of firm efficiency.[11] In

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9 Mark J. Roe, *The Institutions of Corporate Governance*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371,372-5 (Claude Menard and Mary M. Shirley ed., Dordrecht: Springer, 2005).

10 Id,372.

11 More general theory, see Shleifer, A., and Vishny, R., 1986, *Large shareholders and corporate contro*l, Journal

theory, the ultimate owner of SOEs is assumed to be the people, which represent an extremely diffuse ownership which discourage monitoring and induce free ride problem. [12] Further, between that subject and managers of a specific SOE, there are a number of chains: the state/the government, a particular government organ in charge of SOEs affairs, some particular officials (ministers and their subordinates), people in the holding company (maybe more than one level) of SOEs. The majority of these subjects (some are not natural persons) lack the abilities to make sound business judgments (because they are bureaucrats) and are not well informed to guarantee the efficiency of such attempts. Even when they have the competence, there is a "free rider" problem among the bureaucrats to decline to seriously question the operation of SOEs under their supervision.

Hence abundant authorities are delegated to the board of SOE companies. For example, Article 67 of the Company Law of P. R. China stipulates that wholly state-owned companies do not have shareholder meetings. The state-owned assets supervision and administration authority may authorize the company's board to exercise some of the functions of the shareholder meeting and decide on the important matters of the company.[13]

In non-wholly-state-owned companies, boards still have free rein to determine much things as the governmental shareholders would give much deference to them. Two factors are worthy of special notes. The first is that SOEs leaders are de facto treated as government officials, their appointments are normally determined by the Organization/Personnel Department of the Communist party, so the nominal shareholder could not easily remove managers not up to running the firm. The other is that many offspring of political leaders of the Party take a career as the heads of SOEs (partly because they could gain more economic benefits than being placed as public servants), thus reinforces the leverage of SOEs against the control of the government.

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of Political Economy 94, 461-88.

[12] A. Alchian, 1965, *Some Economics of property rights*, Il Politico 30, 816-829. (Originally published in 1961 by the Rand Corporation), reprinted in Alchian, A., 1977. ECONOMIC FORCES AT WORK, Liberty Press, Indianapolis, IN. Karpoff, J.M., and Rice, E.M., 1989, *Organizational form, share transferability, and firm performance*, Journal of Financial Economics 24, 69-105.

[13] An English version of the Company Law of P. R. China could be seen at http://www.lawinfochina.com/display.aspx?lib=law&id=4685.

All this contribute to the value dissipation as a result of weak governance. In fact, the SOEs run by managers with extremely little holdings are like the case in managerial capitalism, or could be illustrated as an exaggerated version of the failure of financial capitalism. Though in theory the government retains the power to displace any director or executives and push a decision if it wishes, this is not the normal case, in generally the board and managers steer the SOEs.

When such principals fail to rein the agents, two phenomena arise and demonstrate that mangers are not working primarily in shareholders' interest. The first is *empire building* in the SOEs. Growing out of production factories in the old order-oriented economy, the SOEs often have a relative core business. The government also emphasizes that the SOEs should focus on their main sectors. But the truth is major SOEs frequently aggressively expand and launch diversification program. For example, real estate market has been really hot in the recent years, and induced most of major SOEs, including those with other types of designated main industries, to put (loaned) money into it.

The other phenomenon which displays manager dominance is high *consumption of perquisites*. Managers take excessive compensation (to some extent boost salaries to compete with foreign multinationals)[14] even when the stock prices decline, enjoy excessive perks ("a whole bunch of hidden benefits and allowances which are very often more than the final salary, such as housing, car and driver, expense accounts and club memberships"[15]), pursue pet projects, elevate cronies and so forth, just like things used to be regarded as only happening in diffuse ownership firms.

"[A]gency costs will be incurred only if the benefits to the owner-manger from their creation are great enough"[16]. Unfortunately, normally SOEs are not established as a result of economic calculation and balance, hence such cost may be rather big even at the early stages, and become even bigger as the managers gain more

[14] In China "the pay gap between executives and the rank and file is widening". After compiling annual reports of about 1,400 Chinese publicly traded companies, most of which are SOEs, an analyst found that the highest-paid executive enjoyed, on average, a 20% pay hike in 2006. In the finance and insurance industry, the average increase was 80%. Don Lee, *In China, Disparity takes a great leap*, Los Angeles Times, Jun 10, 2007.

[15] Id.

[16] Michael C. Jensen, A Theory of the Firm: Governance, Residual claims, and organizational forms, Harvard University press, 2000, 106.

autonomy and political economy influence.

2. Horizontal problems: exploited minority shareholders

One reason for the government's tolerance for SOEs's de facto autonomy in the business is that they could cooperate to shift value from the minority shareholders to the government controller. Initially, instead of standard rationales like fund promising investment opportunities in the economy and facilitating secondary trading, exchanges in China were built under the background of the costly restructure of SOE, with a key purpose of tapping private savings to supplement or replace fiscal revenue desired by SOEs. [17]On these national platforms, the government controllers have been driven by non-financial goals to utilize the listed firms for the purposes like promoting employment and fund other social and political tasks. In addition to suboptimal practices that may jeopardize efficiency, more severe problems include controlling shareholders directly borrowed money from listed companies or let the latter stand guarantee for the former in a loan. The controllers often had no intention to return the money to the "cash cows" at the very start. Unfair related transactions are also common despite the fact that the law prohibits them.

B. The Limitation of Traditional Governance Institutions in the Case of Chinese SOEs

The institutions to tame SOEs are weak. Let me explore them as follows. First I will touch on mechanisms geared primarily to prevent managers from stealing and diverting interests to themselves, then I will probe those primed to channel managers toward pro-shareholder decision making and those handle the diligence and competence problem. But these two kinds of institutions aim at both types of governance problem at the same time, though they do not uniformly address the couple.[18]

Suits. The text of China's securities law seems to be at an acceptable level, but its enforcement is found wanting. In an environment where class action mechanisms to

[17]Kenneth W. Dam, The Law-Growth Nexus: The Rule of Law and Economic Development 260 (2006).
[18] See Mark Roe, *The Institutions of Corporate Governance*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371,373 (Claude Menard and Mary M. Shirley ed., Dordrecht: Springer, 2005).

aggregate claims are unavailable, the prospect of suits institution is unsurprisingly constrained by a collective action problem and rational apathy. Nonetheless, what makes suits even more difficult in China is the judiciary. In general, they lack independence and suffer from corruption, and are unsophisticated in dealing with complicated matters. [19] In particular, they lack willingness to handle sensitive cases like securities lawsuits. For example, when the serious market decline exposed a string of underlying securities scandals and set in motion numerous lawsuits filed against listed companies in 2001, the Supreme People's Court (SPC) instructed that in light of the legal and regulatory uncertainties surrounding these cases lower courts were not to hear such civil compensation suits for the reason of unpreparedness and incompetence.[20] Only in 2002 and 2003, after much criticism for such a denial of access to the courts, the SPC partly reversed the position and issued guidelines agreeing that investor suits for false or misleading disclosure could be brought, provided the defendant had been administratively sanctioned by the regulatory authority, China Securities and Exchange Regulatory Commission [21](CSRC)[22] or other administrative agencies or had been found liable in a criminal proceeding. [23] What should be noted here is that currently civil suits related with other market abuses such as inside trading, manipulation will not be accepted by courts.

However, even in the cases of CSRC-sanctioned companies with actual factual findings of wrongdoing and "would appear to be easy targets for investor lawsuits,

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[19] *See, e.g.*, Stanley B. Lubman, BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO 120-21 (1999); RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 326-28 (2002); Donald Clarke, Power and Politics in the Chinese Court System: The Enforcement of Civil Judgment, 10 COLUM. J. ASIAN L. 1 (1996).

[20] Zuigao Renmin Fayuan guanyu she zhengquan minshi peichang anjian zan buyu shouli de tongzhi [Notice of the Supreme People's Court on Refusing to Accept Civil Compensation Cases Involving Securities for the Time Being] (promulgated by Sup. People's Ct., Sept. 21, 2001, effective Sept. 21, 2001) (P.R.C), available at http://www.law- lib.com/law/law view1.asp?id=16373. Also see Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 China Econ. Rev. 451 (2003).

[21] The 2005 Securities Law states that this agency is to "carry out supervision and administration of the securities market" and is responsible for investigating and punishing any violations of the securities laws. Zhengquan fa [Securities Law] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), arts. 178-179.

[22] Zuigao Renmin Fayuan guanyu shouli zhengquan shichang yin xujia chenshu yingfa de minshi qinquan jiufen anjian youguan wenti de tongzhi [Supreme People's Court's Notice Regarding Accepting Tort Cases Arising from Stock Market False Disclosure] (promulgated by the Sup. People's Ct., Jan. 15, 2002, effective Jan. 15, 2002),

[23] Zuigao Renmin Fayuan guanyu shenli zhengquan shichang yin xujia chenshu yingfa de minshi peichang anjian de ruogan guiding [Several Regulations of the Supreme People's Court Regarding Trying Civil Compensation Cases Arising from Stock Market False Disclosure] (promulgated by the Sup. People's Ct., Jan. 9, 2003, effective Jan. 9, 2003) (P.R.C), available at http://www. court.gov.cn/lawdata/explain/civil/200312220011.htm.

approximately 85% of the eligible target companies have not been sued", according to a study eyeing on a period of 2001-2006.[24]

The reasons for this situation are numerous, and one of the most important is that the majority of implicated potential defendants are SOEs. Moreover, frequently the corporate misdeeds are implicitly permitted by their governmental controllers. For example, transfers of wealth to SOEs parents are rooted in the government controllers' desire to exploit the listed companies to serve local economy, relieving the local budget of the burden of financing investments and facilitating economic development. Local bureaucrats' own career prospects are also tightly linked with their regions' performance [25] and political images of their governing. Judicial judgments against SOEs under their jurisdiction apparently would impact not only the economic resources ultimately controlled by the government, but cast shadows on their ruling abilities. Thus bureaucrats may act to influence courts and cause problem like local favoritism, reduced enforcement rates against local firms. The court may decline and choose to apply rigid causation standard to reject the plaintiff's claim, so that themselves need not to confront the behind-the-scenes players: the government. All these finally render the prospect of recovery "simply too small to justify the expense, time, and effort required to bring suit".[26]

Indeed, as some investors have fearlessly tried to challenge misbehaviors of SOE listed companies, courts may utilize various kinds of reasons to avoid beginning a proceeding, "use strict causation requirements to deny plaintiff recovery",[27] or let the cases languishing in the courts with no apparent progress toward a judgment. And even if there is a judgment, it is not very likely that it could hold the SOE defendants adequately accountable. In short, civil liability is "not yet a major concern" for most listed companies,[28] shareholder lawsuit is "simply not yet a viable means" of investor

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24 Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 COLUM. L. REV. 929, 944 (2008).
25 See, e.g. Huang Yasheng, Inflation and Investment Controls in China, Cambridge University Press, 1996.
26 Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*,943.
27 Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, Chicago and London: The University of Chicago Press. 2008,143.
28 Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*,956.

protection in China.[29]

State-supplied Regulation. In a country with concentrated shareholding structure, the focus of regulation should be to prevent controlling shareholder from exploiting minority shareholders. The CSRC may be of well intention and "perhaps as aggressive as it can be", but it is ill equipped, overworked, subject to restricted resource and "limited political breathing room", [30] often "comes under extensive external pressure not to take actions."[31] Consequently, the law enforcement record basically is weak. [32] The number of sanctions issued by the CSRC "seems rather modest given the ubiquity and severity of the problems" in China's capital markets. "The institutional and political constraints within which the CSRC operates seem apparent in these rather small numbers"[33]. Besides, the punishments come later, often "two or more years after the wrongdoing occurred".[34]

In particular it is also understandable that CSRC is especially reluctant to toughly discipline politically connected SOEs, whose controllers are government organs or super SOEs groups which may have as high official rank as CSRC in P.R. China's political economy system.

In short, there appears to be "widespread agreement that, at least as of yet, the legal approach has failed to address the widespread problems" in this markets.[35]

Stock Exchange. Stock exchange may play a fundamental regulatory role in improving corporate governance, but this is premised on "the assumption that the exchanges are private, member-run organizations" [36], otherwise, its function will be severely harmed by state intervention.[37] Unfortunately, China's two stock exchanges are just extensions of the state without independence and autonomy from the

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[29] Id,977.
[30] Id,977.
[31] Id,955-6.
[32] Katharina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184, 185 (2005).
[33] Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 COLUM. L. REV. 929, 942 (2008).
[34] Id,955.
[35] Id,945.
[36] Id,945.
[37] John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 34-39 (2001). Another important literatures advocating exchanges' role as regulator is Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453 (1997).

government.[38] Their possible self-regulatory function was deeply overshadowed by the paramount influence of the CSRC's “interventionist role” [39] even the exchanges are to some degree empowered by the Securities Law. This is a kind of tight administrative subordination relationship, unlike that between the SEC and NYSE.

It should be acknowledged that some scholars have dug out a “fascinating” practice of public criticism performed by stock exchanges as an aspect of regulation.[40] However, such disciplines often focus on conduct not serious enough to lead to CSRC action.[41] Useful as it may be on numerous occasions, some companies still did not effectively responded to it and indeed have received two or more rounds of sanctions. [42] Also, both Chinese exchanges sanctioned private companies more often than state-owned ones, notwithstanding the former make up a minority of all listed firms and are not definitely more law-abiding.[43] Some Chinese empirical literatures focusing on share price effects also cast doubts on its effects.[44] Finally, given its “procedural vagueness” and the absence of “a formal appeal mechanism”, erroneous criticisms and those with motives irrelevant with investor protections will have the society incur costs. [45]

Media/press (Reputation). It has been noticed recently the role of the media in transition economies corporate governance. [46] When the law is weak, norms may matter more [47] and give more rewards to firms abiding by good corporate governance.[48] Some concluded that "alternative ... corporate governance mechanisms, such as those based on reputation and relationships ... support the growth of the

[38] Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 Colum. L. Rev. 929, 931 (2008).
[39] Chenxia Shi, *Protecting Investors in China through Multiple Regulatory Mechanisms and Effective Enforcement*, 24 ARIZ. J. INT'L & COMP. L. 451, 471 (2007).
[40] Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 COLUM. L. REV. 929, (2008).
[41] Id,954.
[42] Id,951.
[43] Id, 957, also see Gongmeng Chen et al., *Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions,* 24 J. Acct. & Pub. Pol'y 451, 469 (2005).
[44] Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 COLUM. L. REV. 964 (2008).
[45] Id,979.
[46] E.g. Alexander Dyck & Natalya Volchkova & Luigi Zingales, *The Corporate Governance Role of the Media: Evidence from Russia*, Journal of Finance, American Finance Association, vol. 63(3), 1093-1135, (2008) 06.
[47] John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. Pa. L. Rev. 2151, 2175 (2001).
[48] Bernard Black, Does Corporate Governance Matter? A Crude Test Using Russian Data, 149 U. PA. L. REV. 2131, 2133 (2001) (as reflected in those firms' value ratios).

Private Sector" in China. [49]

Acclaimed by many as a fourth branch of government, media promotes corporate information disclosure in China,[50] and enjoy particularly significant autonomy in uncovering and reporting on pure financial misconduct as well as abuses of investor rights, enabling it to be an effective regulator of corporate wrongdoing, in sharp contrast to their weakness in the monitoring of political issues.

But it certainly is insufficient to prevent significant levels of misdeeds. No society can rely on the media as a fundamental check against abuse. It only has an ancillary function. Especially, its unchanged status as "arms of the party-state, state mouthpiece and intelligence-gathering institution for political leaders"[51] severely undermines its independence and determines its vulnerability to state intervention.

Gate-keeper. Lawyers, accountants, securities analysts, underwriters help verify or warrant corporate information. As repeated market players, they contributed a lot to produce accurate information flow by working as reputation intermediaries. [52] But gatekeepers may face pressures from powerful companies and the government. In a country not ruled by law, when a government agency says it is OK, the legal risk of noncompliance is reduced and it is likely that a gatekeeper would no longer insist professional principles. As mentioned before, government controllers will benefit from the listing of companies under their jurisdictions economically and politically, hence they have incentives to cover up negative information and even commit severe frauds like producing faked documents like what happened in the Daqing Lianyi IPO, making the job extremely hard for gatekeepers. This is why basically Chinese gate-keepers do not earn a very high creditworthiness and a number of law firms and accountant firms have been punished or even had their licenses rescinded for being involved in securities fraud.

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[49] Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 59 (2005)

[50] Benjamin Liebman, *Watchdog or Demagogue? The Media in the Chinese Legal System*, 105 COLUM. L. REV. 1, 31 n.119 (2005).

[51] Id, 1.

[52] See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 619 (1984); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001); John C. Coffee, Jr., The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting (Columbia L. Sch. Ctr. for L. & Econ. Stud., Working Paper No. 191, 2001).

In December 2001, the CSRC demanded that all IPO and SPO companies have their annual reports audited by a "world renowned accounting firm". [53] At the time firms of this category contemplated and authorized by the CSRC to provide the service were the *Big Five* (Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and PricewaterhouseCoopers). Unfortunately, the shameful fall of Anderson early in the next year killed this round of reform attempt. However, this may not be that pitiful, since some research indicates that the Big Four seemed to fail to offer better, conservative auditing quality. [54]

Institutional Investors. The role of institutional investors is still at a nascent stage of development in China. In one hand, the fund managers suffer all the problems faced by American counterparts, such as limited time and attention, risk of displeasing incumbents. On the other, the pervasive concentrated shareholding structure reduce the chance of institutional investors to obtain a board seat, the power of state-background controllers significantly add difficulty for any outside challenges.

Besides, because of the political economy favoring SOEs including weak judiciary and regulators, complaints from unrest minority shareholders usually could be safely neglected too.

Nonprofit Organization watchdogs. In some East Asia economies, nonprofit organizations have been playing an increasingly noteworthy role in proclaiming a firm commitment to enhance shareholder value, monitoring behaviors of public companies and sometimes initiating suits against them, such as Securities investor association of Singapore [55] and its counterparts in Japan, Korea and Republic of China (Taiwan). These financial market watchdogs, with a leverage of combined organizational force like lobbying efforts, could help ensure transparent and fair treatment of investors in

[53] China Securities Regulatory Commission, *Gongkai faxing zhengquan de gongsi pilubianbao guizhe di 16 gao—A gu gonsi shixing buchong shengji de zhanxinguiding* [*Temporary Regulation Regarding Additional Auditing Requirement for A-Share Listed Companies*], (December 31, 2001).

[54] Liu Feng & Zhou Fuyuan, GuojisiDa yiweizhe gao shenji zhiliang ma? — Laizi woguo A gu shichang de chubu zhengju [Does the Big Four Mean Higher Auditing Quality: Preliminary Evidence from China's A Share Market] 3, (2006 Asia and China Corporate Governance International Conference, Group C Working Paper), *available* at http://www.baf.cuhk.edu.hk/research/cig/pdf_ download/GroupC.pdf.

[55] For instance, in the below discussed CAO case, it responded vocally, though no further actions (perhaps because the settlement plan was satisfying).

an environment lacking effective class action mechanisms. [56]

However, the communist regime in China strictly restricted the operation of all kinds of nonprofit organizations, in fear of that they might be employed as a leverage against the one-party ruling system.

The Market for Corporate control/Takeover. The legal barriers for acquire a Chinese listed company are lower than the case in the United States. However, the state-owned block is not de facto subject to tender. Before 2006, they were legally not tradable except among state-controlled entities. Then after a major reform, [57] they became legally transferable but in fact the sale is still subject to strict regulations which aim at maintaining a state control for these enterprises. Mere buying up non-state-owned shares would not guarantee a control block in most companies.

For the same reason, proxy contest is not a much reliable choice, though it did happen occasionally.

The Market for Capital. Many SOEs may face difficulty when they try to go back to the market for additional capital because of their bad performances. But the effect of this source of discipline is limited.

First, China is a country where the flow of capital is restricted, ordinary investors lack ample options, for example, the bond market is small. So the new issued shares earn an exceedingly high opportunity to rise rapidly. (For the same reason, price/earning ratio and turnover rate in this market is unusually high, many investors were obsessed with gambling and paid little attention to the underlying value of stocks, underperforming companies do not always suffer low prices). Hence the Wall Street rule could not be very effectively used and investors' requirements on listed company performance are lowered.

Second, when needed, government will subsidize listed companies to maintain their viability. For example, in November 2008, China Eastern Air Holding Co. and

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[56] See Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 Yale J. Int'l L. 169 (2004). Wallace Wen-Yeu Wang & Chen Jian-Lin, *Reforming China's Securities Civil Actions: Lessons from PSLRA reform in the U.S. and Government-Sanctioned Non-Profit Enforcement in Taiwan*, 21 COLUM. J. ASIAN L. 115 (2008).

[57] See Sandra Kister, *China's Share-Structure Reform: An Opportunity to Move beyond Practical Solutions to Practical Problems*, 45 COLUM. J. TRANSNAT'L L. 312-363 (2006).

China Southern Air Holding Co. separately obtained governmental subsidies of 9 and 3 billion yuan, and before long, the state additionally offered the former 3 billion yuan. In early 2010, China National Aviation Holding Co. gained a 1.5 billion yuan state-owned capital operation budget from the Ministry of Finance (MOF) for the sake of its listed subsidiary Air China. [58]

The Product Market. Though SOEs may not have an advantage in competitive product market, this is not a big problem for them. First, many of them especially the biggest ones enjoy monopolized privileges and policy preferences. Oligopolistic and monopolistic product markets give slack to managers who "can lose for shareholders some of the monopoly profit". [59] Second, the subsidies from the government could be sufficient enough to compensate such loss. For instance, in December 2010, Asia's top refiner China Petroleum & Chemical Corporation (Sinopec) "received a government subsidy of 12.3 billion yuan ($1.74 billion) to cover refining losses", which constituted "the third consecutive year for getting a huge "cash infusion in state compensation". [60] Hence for SOEs without strong market competitiveness, their substantial vested capital (added by continual subsidies), which constitutes sunk cost, is sufficient enough to fritter away. It is OK for impotent managers to escape from disciplinary actions for an extended period of time as long as they could recover the enterprise's "variable costs to survive for the life of that capital (which may be longer than their own working lives)". [61] After the turbulent waves of SOE restructures and reforms mainly transpiring pre-2003, those survival ones are safe to enjoy a long run of peaceful lives before possible withering because of inefficiency or underperformance.

The Managerial Labor market. In China there is hardly such a market for

[58] *Air China to Win CNY 1.5bn Governmental Subsidy*, Jan 18, 2010, http://www.sinocast.com/readbeatarticle.do?id=39404. SinoCast is a business information provider with a focus on China.

[59] Mark Roe, *The Institutions of Corporate Governance*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371,378 (Claude Menard and Mary M. Shirley ed., Dordrecht: Springer, 2005). As Professor Roe stressed "monopoly profits may or may not be good for society", id, though the monopoly profits by SOEs may not be something worth applauding, the point here is managers, incompletely constrained by the market, do not serve the firm well.

[60] Fu Chenghao, *Sinopec confirms state subsidy for third year*, Shanghai Daily News, 21 March 2008.

[61] Mark Roe, *The Institutions of Corporate Governance*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371,378 (Claude Menard and Mary M. Shirley ed., Dordrecht: Springer, 2005).

SOEs. The managers enjoy quasi-government-official status and are usually party appointed. Though the people in charge may sometimes think carefully to choose the talented, in general this is not a highly competitive process. The vast number of SOEs makes the recruitment task very difficult, so most are get promoted from lower positions within the firms. And if a SOE manager is removed, due to his quasi-official status, he would be placed to an equivalent position instead of being swept to the street, as long as his oust is not a result of the violation of the law.

Another issue significantly undermines such a market is that the outstanding SOEs managers could not contract freely with other SOEs. To the contrary, the Personnel Departments of the communist party of various levels take firm control of all the senior executives of SOEs and may rearrange their positions in a way that would astonish people from liberal market economies.

The first of such is reshuffling and rotating heads of major SOEs, which could be done merely by pieces of notices, for example, chiefs of the three biggest telecoms companies in 2004, the three biggest airlines in 2009, three biggest oil companies (each is a Fortune 500 company) in 2010. [62]

The second is even more surprising. To some extent, the more managerial capacity a SOE executive demonstrates, the more likely his company career would be terminated, since he would be "awarded" a government official office. And the process may happen suddenly and without much omen. For example, Wei Liucheng was general manager/president of China National Offshore Oil Corporation from 1998 to 2003, then he was order to work as the an governor of a province not famous for oil resources. In 2009, Xiao Yaqing, General Manager of Aluminum Corporation of China was named as the Vice Secretary-general of the State Council. [63] This happened amidst the process of the firm's negotiation with a block investing of Rio Tinto Group and less than a week after a strategic cooperation agreement was signed. Expectedly, such an unexpected key personnel movement confused many international investors, partly contributed to the failure of the deal months later. But

[62] *Special Report for State capitalism: A Choice of models: Theme and variations,* Economist, Jan 21st 2012.
[63] Xiao Yaqing, *CHINALCO 's General Manager promoted to State Council's Vice Secretary-general,* China Business Focus, March 2009

this successfully cultivates a notion in these managerial talents' minds that they are "cadres first and company men second" [64]. Their future as entrepreneurs depends on whether they have pleased the party boss rather than whether they have offered superior corporate performance and governance.

Executive Compensation. A common way of tying managers with shareholders in the United States is stock-based compensation. However, since the government controllers would retain the blocks, they are not sensitive to stock price. In fact, due to this reason, the adopting of such practices may be more duly regarded as a manipulation of mangers seeking to enrich. Also, quasi official status of SOEs leaders somewhat shore them of becoming too rich by such arrangements. Finally, the abovementioned slack given by product market etc. makes managers not very worried about their missteps and inaction even there is performance based compensation arrangements.

A more Responsive Board. Directors in SOEs tend to be bureaucrats or senior managers and the board is easy to be captive to executives rather than to foster the professionalism of managers. Following the trend in the United States, Chinese regulators pushed to bring on special committees and increase the proportion of independent directors. But effectiveness of such reform "planks" is mixed at best, like in America. The inherent information control by managers and the conflict and balance of proximity and objectivity of the board[65] remains a problem.

Besides, it is apparent that this institution would not effectively cure the horizontal problem.

Management Leveraged buyout. This is neither allowed in big SOEs due to political consideration nor feasible due to the scale of fund required.

Capital structure/loan. A large amount of debt could reduce the manager slack. But in China, the major lenders are SOE banks which would not breathe down the neck of SOE industrial companies, not to mention force them to bankruptcy, a drastic decision in practice be made by the government. Since both are offspring of the

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64 *Special report for state capitalism: A choice of models: Theme and variations*, Economist, Jan 21st 2012.

65 See Jonathan Macey, Corporate Governance, Promise Kept, Promise Broken, Princeton University Press, 2008, ch. 4-6.

government, and the fund transfer between them is not pure commercial transaction but usually at the will of the state, so when the debt faces a great chance of not being paid off, the former would just complain to the state and ask for subsidies for the souring loans. Managers do not sense repeated pressures to come up with lots of cash like those felt by Japanese managers who are after by banks. The incidence and magnitude of errors would be increased since there is not sufficient stick from banks. In fact, one of the incentives of the state to establish the securities market is that the banks and the governments could no longer bear the financial burden to support inefficient SOEs, a new way of collecting fund is needed.

The above analysis depicts the drawbacks to various institutions of corporate governance in the case of Chinese SOEs. A result is Chinese stock market is marginal in the financing and real economy [66] and inefficient in pricing capital.[67] It “remains underdeveloped in view of its economic heft and potential”, incommensurate with the country’s huge size along various economic measures such as foreign reserves, trade surplus and private savings. The average size of Chinese listed companies is smaller than comparable transition economies like Brazil, India and Mexico too.[68]

But this paper does not intend to argue that above mechanism of corporate governance are of no avail. It just tries to show they may be far from effective enough for alleviating the particular governance problem faced by Chinese SOEs, thus the merit of another mechanism for enhanced corporate governance (which surely has its own weakness) should be adequately noted, even though in some countries it may be an untypical and marginal governance institution. Also, I neither aim to imply oversea listing is a remedy for all ills nor it is necessarily better than any other institution. In fact, they could interact as complements and substitutes to collectively improve the quality of management and corporate governance in Chinese SOEs.

[66] Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 73 (2005). Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 China Econ. Rev. 451, 453 (2003).

[67] Dongwei Su, CHINESE STOCK MARKETS: A RESEARCH HANDBOOK 88 (2003).

[68] Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 COLUM. L. REV. 929, 937-8 (2008).

III. The Meaningfulness of Oversea listing as a Governance Institution in the Case of Chinese SOEs

A. Oversea listing as a Corporate Governance Institution and why it could be chosen

Oversea listing means putting a domestic company be listed in a foreign exchange, normally one located in an international financial center. In the Western literatures, the word "cross listing" is more common, which refers to the situation an already domestically listed company gets an oversea listing. However, since many Chinese major SOEs did not finish their modern style of corporatization restructure not before long (they used to be regulated by Law on Industrial Enterprises Owned by the Whole People, without corporate organs like the board), it is not uncommon for them to get oversea listing first immediately after the corporatization, then a domestic listing at an appropriate time. Hence I use the term "oversea listing" rather than "cross listing" here, but I may employ the claims about cross listing in other literatures directly as long as they fit.

An oversea listing in a more renowned exchange normally subjects firms to a more robust law regime. This includes more stringent listing and disclosure standard, reduced informational asymmetry, stricter regulation and other enhanced scrutiny. The listing may be a form of bonding or signal that assures investors that agency costs will be lowered, behaviors of managers and controllers will be constrained by the conformity. In short, the advantages for corporate governance in the sense of investor protection are apparent.[69]

But in contrast to externally-imposed mechanisms like regulation, suits, media, this option only functions when the firms voluntarily opt it in. So the key point is *why the firms would select to be oversea listed at first*? What are their incentives? Obviously, the benefits of oversea listing should not only *outweigh* the cost thus

[69] See John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757(2002). Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, The American Journal of Comparative Law, Vol. 49, No. 2 (Spring, 2001), pp. 329-357.

incurred by the company, but more important, the cost borne by those doing the real decision of oversea listing. [70]

Current literatures focus mainly on the *economic gains* brought about by oversea listing, including (1) higher securities valuation/price premium; (2) a lower cost of capital (and more capital). [71] Are these the main reasons here?

Re Chinese firms, some researchers did argue from the perspective of a voluntarily bonding by "entrepreneurs".[72] But for a fateful decision like listing, the say is held by controlling shareholders, rather than entrepreneurs or managers. How will the real decision makers view such advantages?

The first economic benefit abovementioned may not be that crucial to the controller of Chinese SOEs. Since the transfer of state-owned shares is subject to strict administrative regulations so as to maintain the state control, the direct gain of share value increase is very limited. [73] The second factor carries a relatively greater weight. The controllers and companies need development funds, the government officials and managers would be glad to see the corporations be able to expand with the help of more money, and enhance their opportunities for promotion. Besides, the domestic stock market indicia, perhaps due to limited market sizes, usually suffer when a large IPO is launched, indicating their vulnerabilities to sustain major SOEs' public offering, so oversea market is indispensable in many cases.

But I want to emphasize that *a conscious effort of improving corporate governance from the controller may matter too.* As depicted above, Chinese SOEs have both vertical and horizontal dimension problems. In firms with better financial shapes, the vertical problems may be more severe. Government controllers do not as

[70] Usually, a significant SOE activity like oversea listing should get an approval from not only its nominal corporate controlling shareholder, but relevant government agencies like state-owned assets supervision and administration authorities, local governments. In the case of biggest SOEs, it may even involve discussion among top leaders.

[71] E.g. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007), 231.

[72] For example, Hua Cai, *Bonding, Law Enforcement And Corporate Governance In China*, 13 STAN. J.L. BUS. & FIN. 82, Fall, 2007, this paper explores from the general viewpoint of firms about how they could lure investment in a weak law enforcement environment.

[73] The general analysis of the impact of non-transferability of property rights on organization and incentive, see A. Alchian, 1965, *Some Economics of property rights*, Il Politico 30, 816-829. (Originally published in 1961 by the Rand Corporation), reprinted in Alchian, A., 1977. ECONOMIC FORCES AT WORK, Liberty Press, Indianapolis, IN. Karpoff, J.M., and Rice, E.M., 1989, *Organizational form, share transferability, and firm performance*, Journal of Financial Economics 24, 69-105.

effectively control the management as private controllers. Hence they have incentives to *seek alternative ways to keep the management loyal and diligent*. However, not only are ordinary institutions are imperfect as displayed above, but also the government is not willing or able to enhance the mechanisms:

First, some universal mechanisms, such as more independent courts or medias, may bring on uncontrollable consequences that could shake the basis of the whole current ruling system. For example, the extent of press influence may be out of the policymakers' domain,[74] decentralized litigations brought by non-state agents are difficult to monitor and control. So the state is reluctant to enhance them.

Second, some mechanisms like state-supplied or exchange-supplied regulation are subject to basic political economy constraints of this country. The regulators and the SOEs are within the same “inner circle” and form a kind of coexistence relationship. [75] They may not be willing to fight hard against one another if not for their own sakes.[76] Even if the top leaders delegate more power to the regulators, it remains a problem that whether they will use it against SOEs aggressively.

In fact, a typical oversea listed SOE owns such features:

(1) has stable revenue, often a result of monopolies or privileged positions in key sectors of the economy, so they could stand firmly in an international exchange without worrying about the disgrace of the risk of delisting.

(2) has significant positions in the domestic political economies, usually are giant companies which will not easily be tamed by ordinary mechanisms like court, regulator, exchange, gate-keepers, media, market competition, etc.

Hence their governmental controllers try to rein in them by exposing them to a relatively robust outside discipline which is more capable of assessing (by more efficient price finding mechanism, etc), monitoring the firm performance, and giving

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[74] Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media* (Ctr. for Research in Sec. Prices, Working Paper No. 543, 2002), available at http://ssrn.com/abstract=335602, 31.

[75] For example, a corrupt guy who was sentenced to death reprieved for two years, Xiao Shiqing, rotated between the positions of China’s Securities Regulatory Commission’s high level officials and head of state-owned securities companies for several rounds, and such appointments are common scenes since officials and SOEs leaders are all communist cadres that could be “allocated” by senior party leaders to different positions at will.

[76] Surely, too extravagant illegal activities would tarnish the image of securities regulator and bring some enforcement actions.

needed punishments.

B. The Advantages of Oversea Listing as a Corporate Governance Institution for Chinese SOEs

Oversea listing may be more effective where the surrounding institutional environment is relatively devoid of alternative deterrence and punishment mechanisms. Normally, in China domestic SOE listings were more regarded from a predominantly developmental perspective with the aims of financing local industries, raising fiscal revenues, fueling the ambitions of local officials, [77] and stimulating investment sentiment among the public.[78] But oversea listing dose not seem to coincidence with these goals and could not merely be viewed as an extended version of domestic listing. It has particular forces to make managers better stewards of the resources they control and improve investor protection, given the underdevelopment of legal institutions.

First, the constraints imposed by foreign regulators from rule-of-law jurisdictions are not only of high standard, but strict and "real" since they are much less vulnerable to domestic relationship, lobby efforts and other forms of pressure. For major SOEs, product market and domestic capital market in which they are privileged blue chips exert comparatively little pressure. Regulator and courts also bring little pressure on them. But in an international environment, they will be treated more fairly and less favorably, the slack may be picked up.

Second, the ongoing discipline function of oversea listing relies on the efforts and resources of extraterritorial institutions. It does not require much domestic resources and reform attempts. As a separate institution, an enhanced protection could be achieved without disturbing the older, established firms. [79]

Third, in a country struggling hard to catching up with the leading counterparts,

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[77] Stephen Green, THE DEVELOPMENT OF CHINA'S STOCK MARKET, 1984-2002: EQUITY POLITICS AND MARKET INSTITUTIONS 10-12 (2004).

[78] Id,,207.

[79] More about the theory of corporate legitimacy, see Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law,* 89 GEORGETOWN L. JOURNAL 439,464(2001). Ronald J. Gilson, Henry Hansmann and Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union,* 63 STAN. L. REV. 475(2011).

“complying with international level” is a kind of *legitimacy* by itself, it is an acclaimed “fashionable” social norm which could earn praise and reputation for SOEs and government leaders pushing it. In the corporate context, this dimension could be a “governance goal” and “corporate legitimacy” like the social considerations called for in Europe continental. [80]

Fourth, for this reason, the prospect of oversea listing became a good push for *one-shot micro reform efforts.* Old-styled SOEs usually have a long way to go before looking and acting like a modern or westernized company. Undergoing such a restructure is of even more significance for their long term governance goal. However, normally such painful activities are not easy to be carried out and the reform paces in many SOEs are slow. But oversea listing gives a boost to them.

The first wave of SOE listing occurred in the second half of 1990s, when some major SOEs were directly converted from a non-company enterprise without shares to an oversea company in accordance with Special Provisions of the State Council Concerning the Floatation and Listing Abroad of Stocks by Limited Stock Companies of 1994[81], which provides more flexibility for SOEs than Company Law. These firms typically conducted IPOs soon after the incorporation, a practice not allowed for ordinary companies under law. For instance, China Mobile Limited was incorporated in Hong Kong in September 1997 and listed in New York and Hong Kong in the next month. [82] PetroChina Company Limited was established in October 1999 and listed half a year later.[83]

The next wave came after China’s entry into World Trade Organization in 2001, the government was anxious about how to ensure the big SOEs be able to stand on their feet when facing the incoming fierce competition in the more open market. Four of five biggest SOEs commercial banks accomplished the listing goal after drastic restructure actions before 2006, the deadline when the financial market is promised to be substantially opened. Similarly, China Life Insurance (Group) Company was

[80] See Mark Roe, *The Institutions of Corporate Governance*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371,375 (Claude Menard and Mary M. Shirley ed., Dordrecht: Springer, 2005).
[81] An English version is available at http://www.lawinfochina.com/display.aspx?lib=law&id=707.
[82] http://www.chinamobileltd.com/about.php?lang=gb
[83] http://www.cnpc.com.cn/en/aboutcnpc/companyprofile/history/

restructured in 2003, in the same year its main subsidiary China Life Insurance Company Limited was oversea listed. [84]

In the both stages, a clear and glorious goal of "meeting the requirement of an international standard" could be technically useful to encourage the firms to proceed more actively. This kind of legitimacy more easily marshals the energies and coordinates things.

Moreover, in second stage of the overhaul when the society is more open, big foreign companies are invited to participate to increase the attractiveness and credibility of later IPOs because it could "introduce advanced business concepts and management skills so as to further improve the corporate governance" [85]of these SOEs. For example, world-class financial institutions joined as strategic investors of major commercial banks, Bank of America purchase about 10% equity of China Construction Bank and Royal Bank of Scotland acquired 10% in Bank of China's stocks. Owners other than agents of the state injected new viability into the firms. [86] As stockholders, they will be really concerned with the governance of the new entities they help restructure, and the prospect of international listing made their fund contribution possible in the first place.

Fifth, the effects of oversea listing look more *manageable* in the eyes of governmental decision makers. Since it is a voluntary and contract-based mechanism, in theory the government could more freely choose to halt the process, switch the target market or even delist the company without raising much criticism or backlash. After all, the effects of such measures are not so obvious or direct to domestic investors.

Sixth, after oversea listing, domestic investors of the company could automatically enjoy the improved governance and reduced illegal activities to a great extent. Their domestic peers would be exerted pressures since investors now have

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[84] http://www.chinalife.com.cn/publish/English/356/index.html

[85] Wu Xiaoling (Deputy Governor of the People's Bank of China*), Speech: Strengthen China's Financial Industry in the Process of Opening up* (Feb. 14, 2006) (transcript *available at* http://www.pbc.gov.cn/english/detail.asp?col=6500&id=106).

[86] See Donald Clarke, *Corporate Governance in China: An Overview*, China Economic Review, 14:451-472, 2003.

seemingly better choices available (this is the source of price premium for cross listing firms). Hence they may react to charge up their governance even if they do not select to oversea listing themselves.

Thus in summary three types of advantages could be attributed to oversea listing:

1. Economic advantages: mainly include price premium and more capital.
2. Technical or operative advantages such as accessible high-quality regulation at relative low cost, i.e., making use of extraterritorial regulatory resources, etc.
3. Governance advantages which are especially relevant for Chinese SOEs. These are composed of two subtypes:

(1) Formal benefits which refer to achieving a status of “internationally recognized good firm”, a kind of legitimacy for the firm and for the government.

(2) Substantive benefits as mandated by the demands from the listing places, including:

1) Pre-listing restructure arrangements as required by the exchanges, such as more independent directors;

2) Ongoing monitoring by the exchanges and compliance requirements.

True, in such a process, the controller should forego some private benefits,[87] mainly composed of the reduction of exploitation of minority shareholders. This may not be a big problem for the type of SOEs seeking listing in an oversea exchange, because they are mainly major privileged or monopolized firms controlled by the central government and with relatively stable revenues. The government controllers do not have much incentive to extract monetary private benefits of control in these companies. Reducing the incidence of shirking and stealing of managers and making the SOEs more viable are important goals. Hence the decision makers in the government will not mind such cost.

It is also worthy noting that since SOEs managers definitely incur substantial

[87] See Craig Doidge, *U.S. Cross-Listings and the Private Benefits of Control: Evidence from Dual-Class Firms,* 72 J. Fin. Econ. 519, 550 (2004) (providing empirical evidence of this impact).

constraints after the listing, why don't they resist? One reason is that with the establishment of a general trend of oversea listing for major SOEs and the recognition of the legitimacy arising from the discipline of oversea listing, it is hard for one particular firm to demand an exception. The second reason is that with the avoidance of the annoying U.S. risk of "frivolous" class action which could be circumvented by simply listing in Hong Kong (see more below), there is not much potential harm incurred by them. Compliance costs are not directly imposed on senior corporate leaders. Normally they also do not have some specific ill behaviors in mind that will be deterred by foreign regulators. Third, making the firm "better", by getting oversea listed, will enhance the promotion chance of senior executives. Fourth, quite a few companies bargained in this process a plan for stock options as executive compensations, said to be a feature of "international practice".

To this extent, it is not impossible that managers are actually inclined toward the listing. But their attitude would not be the primary factor, since new stock issuance is not only an owners' issue, but relates to the strict regulating system of state-owned shares (and its dilution). Such a plan could only be determined by the government, not even the parent company,.

C. The Choice of Oversea Listing Destination: a Refined Calculation of Benefits and Costs

The assessment of benefits and costs when making decision concerning oversea listing, especially whether concerns with governance advantages outweigh those with economic advantages, could be more insightfully revealed by the evolution of the selecting of the listing destination.

At first glance, A U.S. exchange seems to be the best choice for an oversea listing destination.

First, it is no doubt the fore-runner of international capital markets, which promises the largest potential for the amount of capital to be raised (especially for big enterprises) and reduced cost of capital; Second, according to some scholars, major

U.S. exchanges are the sole places that will make the cross listing firms reap extraordinary benefits like noticeable valuation premium, which may not be available elsewhere, including London. [88]

But such gains come with pains. Lower cost of capital should be exchanged for of stronger regulation and more extensive disclosure requirement. [89] And sometimes the companies may be reluctant to reap such gains. Indeed, Sarbanes-Oxley Act was blamed by many as the reason for numerous foreign firms declined to be listed in the America,[90] since it significant raised compliance cost and increased risks faced by company leaders.

Though many Chinese commentators underscore the importance of SOX, heightened cost is not that influential for the oversea-listing-seeking major SOEs. [91]They are big enough to assimilate the incremental governance cost of paperwork which is carried out by ordinary staff instead of high level executives. For these big privileged enterprises, irregularities like flawed accounting practices are also not common, shirking and lack of an international brand, instead of stealing, is of more concern for their superiors. So the certifying requirement is not a potential hazard.

However, an unexpected “frivolous” class action significantly drove Chinese major SOEs away from New York after 2004. Before 2004, a good number of leading SOEs, including the biggest three oil companies, the biggest four telecom companies and the biggest insurance company all chose to be dual listed in New York and Hong Kong roughly simultaneously. In spring 2004, senior executives of Chinese banks were still paying visit to NYSE to discuss about listing plans, but when the wave of bank listing preparation unfolded in the second half of 2004, none of them selected

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88 See Craig Doidge et al., Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time 4 (Charles A. Dice Ctr. for Research in Fin. Econ., Working Paper No. 2007-9, 2007), available at http://ssrn.com/abstract=982193, at 32-33. Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. Fin. Econ. 205, 206 (2004).

89 Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCT. RES. 485, 524 tbl.1 (2006) (finding that countries with "more extensive disclosure requirements and stronger securities regulation" exhibit a lower cost of capital).

90 Comm. on Capital Mkts. Regulation, Interim Report of the Committee on Capital Markets Regulation 2-6 (2006), http://www.capmktsreg.org/pdfs/11.30Committee Interim ReportREV2.pdf.

91 In general, big foreign firms continue the trend to cross-list in the United States following the enactment, Joseph D. Piotroski & Suraj Srinivasan, *The Sarbanes-Oxley Act and the Flow of International Listings*, Journal of Accounting Research, Vol. 46 No. 2 May 2008. Hence there should be other reasons for the retreat of Chinese big SOEs.

New York. Hong Kong became the sole place for giant SOEs oversea listing since then. Obviously, this could not be explained by economic factors of either the listing place or the listing corporations. See the chart.

Chart: The Oversea Listing of some Biggest SOEs in key industries

This chart illustrates oversea listing of biggest SOEs in several key industries. All of them are ultimately controlled by the Chinese state. In the cases of non-financial firms, the final controller is the State-owned Assets Supervision and Administration Commission.[92] *Things in these industries are typical and could be representative of major SOEs in almost all industries.*

One can learn from this chart that: (1) oversea listing is a rule for SOEs, largely eliminating the possible listing explanations regarding the fiscal conditions and CEOs preferences of individual companies; (2) 2004 is the year of watershed for NYSE as or not as a choice; (3) the first wave of listing took place in the initial corporatization movement of major SOEs after mid 1990s, not long after when these corporations are formed, the second wave is after 2001, when China entered World Trade Organization.

Name	**Listing place and year**	**Industry**
China United Network Communications Group Co., Ltd. ("China Unicom")	New York Stock Exchange ("NYSE") and Stock Exchange of Hong Kong Limited ("HKEx") 2000, Shanghai Stock Exchange(SSE), 2002	the three biggest telecom operators in China
China Mobile Limited (subsidiary of China Mobile Communications Corporation)	HKEx and NYSE 1997, incorporated in 1997	

[92] A English list of all the biggest non-financial SOEs finally controlled by the state-Owned Assets Supervision and Administration Commission, is available at the website of the commission, http://www.sasac.gov.cn/n2963340/n2971121/n4956567/index.html

China Telecom Corporation Limited (subsidiary of China Telecommunications Corporation (China Telecom))	NYSE HKEx 2002	
China Communications Services Corporation Limited (subsidiary of China Telecom)	HKEx 2006	
Industrial and Commercial Bank of China	HKEx 2006, the biggest commercial bank	the biggest five commercial banks
Agricultural Bank of China	HKEx 2010, it is the last listed because its asset is worst.	
Bank of China	HKEx 2006	
China Construction Bank	HKEx 2005	
Bank of Communication	HKEx 2005	
PetroChina Company Limited (subsidiary of China National Petroleum Corporation, CNPC)	HKEx NYSE 2000, SSE 2007, established in 1999	the three largest oil and gas producers and suppliers
China Petroleum & Chemical Company (Sinopec Corp.), (subsidiary of China Petrochemical Corporation (Sinopec Group))	HKEx 2000, NYSE 2001, the group established in 1998	
China National Offshore Oil Corporation	HKEx NYSE 2001	
Huaneng Power International, Inc.	NYSE ADR 1994 HKEx 1998, SSE 2001	one of the largest power producers
Air China	HKEx 2004	

China Eastern	HKEx, NYSE, SSE 1997	the three biggest airlines
China Southern	HKEx, NYSE1997 SSE 2003	
The People's Insurance Company(Group) Of China	HKEx, expected in 2012	the biggest four insurance companies
China Life Insurance Company Limited (subsidiary of China Life Insurance (Group) Company)	HKEx NYSE 2003 SSE 2007	
Ping An Insurance (Group) Company of China, Ltd	HKEx 2008	
New China Life Insurance Company	HKEx 2011	

Sources: compiled by the author according to their official websites

In spite of the absence of an official explanation, it should be noted that in spring 2004, an class action against China Life Insurance Company Limited ("China Life") and its five directors shook the Chinese. The suit was brought by 9 investors for violations of Section 10(b) of the Securities Exchange Act. In June 2006, the SEC finally announced that it would take no action to the firm and in September 2008 U.S. District Court, S.D. New York dismissed the complaint,[93] but the proud company's image was badly tainted in China's public opinion as early as the time it was involved in the suit. In the perception of the ordinary Chinese, the reactively implication of law proceeding seems to be disgraceful enough, especially if one have faith in the presumed disciplining function of the more advanced U.S. securities market. Gee, the muscular unabashed SOE was beaten by brave Uncle Sam.

While this may be perceived as ordinary commercial risks in the litigation abundant United States, this is considered as too annoying and humiliating for SOEs which usually operate in the logic of government entity whose high level executives

[93] In re China Life Securities Litigation, No. 04 Civ. 2112 (TPG),. 2008 BL 199112 (S.D.N.Y. Sept. 03, 2008) United States District Court, S.D. New York.

and directors own quasi-official status, and for Chinese leaders in charge of SOEs affairs. This sense may be especially strong when taking into account that China Life's innocence was at last proved years-long later. The risk of a U.S. listing suddenly was found to be unacceptably high.

Let me put it more clearly. For the decision makers which are government controller, the real major benefits of SOEs oversea listing are: (1) more capital, (2) more discipline for managers (share value increase is not very important). The major costs are: (1) reduced private benefits of control (not so important for the government controller), (2) discipline effects which may be (indirectly) extended to the controllers.

Hence Chinese *lingdao* (leaders) may want a foreign force to help monitor managers, but they do not intend to get themselves involved in a high profile shameful event. Bad publicity caused by easy-to-be-brought class litigations and correspondingly potential legal punishment aiming at board members and high level executives with official status are something too much.[94] In other words, for these major SOEs, money is not a big problem, but "face" is significant（this largely explains after the disgraceful beginning why China Life did not settle the case like an American giant, but choose to fight for a declaration of the innocence and endure the costly and aggressive adversarial questioning of a long deposition）. For that sake, SOE controllers will be willing to forego the monetary superiority of a New York listing and make do with a second best choice.[95] So it is no wonder that the whole group of government and SOEs were alerted and found it necessary to reconsider the option of being listed in the United States.

At the same time, the existence of Hong Kong offers a highly practical alternative. It is obviously an international/regional financial center. In general, London and Hong Kong are where transactions, listings, and trading volume are migrating to from the

[94] A subtle aspect is that the cause of the China Life suit was that the National Audit Office of China found certain accounting irregularities in the predecessor of the new founded China Life (the punishment would not be borne by China Life), and such an auditing itself constituted a kind of reformist action by the new administration. Hence the Chinese leaders would feel upset that a progressive attempt has been exploited by foreign investors to baselessly attack a renowned SOE. The American market thus seems so uncomforting and unreliable.

[95] For example, when Bank of China changed its listing destination from New York to Hong Kong, its anticipated amount of money raising was reduced by one third.

U.S. [96] Its regulatory environment is much better than mainland China. Contrary to some studies claiming that nowhere else other than the U.S. offers a cross listing value premium, [97] empirical studies found "bonding premium" in the Hong Kong listed Chinese firms against those domestically listed. [98] Hence a "retreat" to the island is not disgraceful. This allows the corporations to turn their heads away from the American market without much concern about commercial losses.

The more important superiority is Hong Kong's great understanding and respect for practices with Chinese characteristics, offering unparalleled operation convenience unavailable anywhere else. When Beijing intends to enhances Hong Kong's status of an international center to show the advantage of its indirect ruling, such "infusion" of SOEs became a more robust trend.

But a retreat from New York to Hong Kong is not a complete backward move. First, due to the multiple links between China mainland and Hong Kong, pressures faced by the city-jurisdiction which should foster its market-oriented appeal to ensure economically competitiveness are not neglected by the Chinese government. Beijing may not recklessly press them hard to degrade their standards too much.

Second, after all the oversea listing is a reform effort caused by the strong incentive of those in power to deliver sustained economic growth. Possessing a fast-growing continent-wide economy and a huge potential market, China has become frequently able to functions as a price setter rather than taker in the international economic arena. But due to its flawed political regime that bears declining political legitimacy, Beijing needs to stick to the economic goals. Though it may not always be enthusiastic about marching ahead, sometimes it even steps back, but just as presented by the area of corporate governance, the basic direction is market oriented and consistent with the logic of better investor protection. The Party may not willingly sacrifice too much or change a lot merely for abiding by international rules, but it

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[96] Committee on Capital Mkts. Regulation, Interim Report of the Committee on Capital Markets Regulation 2-6 (2006), http://www.capmktsreg.org/pdfs/11.30Committee Interim ReportREV2.pdf.

[97] (Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time* 4 (Charles A. Dice Ctr. for Research in Fin. Econ., Working Paper No. 2007-9, 2007), available at http://ssrn.com/abstract=982193, at 32-33).

[98] Qian Su et al., *Bonding Premium as a General Phenomenon* 13-27, 32 (Hong Kong Polytechnic Univ., Working Paper, 2006), *available at* http:// ssrn.com/abstract=890962.

would give in and discard the traditional model occasionally when economically needed. From this view of point, a less tough but still tough enough Hong Kong market may prepare SOEs better for a solid, though not big or fast, progress. And in the same vein, we could draw some lessons for the general law and growth in P.R. China.

D. Law and Growth in China from the Perspective of Oversea Listing

The attempt of oversea listing is a way of outsourcing and decentralizing the law enforcement concerning corporate governance. The profoundness of such a step is not only that it grants authorities to parties other than the powerful (central) government, which is unusual itself, but that it further *subjects the government to external rules*. Though delisting theoretically remains a possible option to escape a tough governance environment, it is easier said than done, so far it seems unlikely in the medium term. The corporations and the government choose to painfully adapt to them instead of to move away from them. Also, oversea listing will work as a form of "regulatory competition" [99] to drive the domestic authorities to learn and improve its own regulation.

To a great degree, this is neither a wonder nor an exception against the broad picture of institutional evolutions in China. *Within* the diversified arms of the Chinese political authorities, there are really numerous individuals, including some leaders, who have fought to form a check on the vast bureaucratic machinery, constraint the untrammeled authority of officials, bring corruption under control and push the state and the society forward. There have been a series of laws promulgated and substantially enforced, directly confining the once unbridled state power in the past three decades (surely not as well as in a rule-of-law country). Hence it is not very surprising to witness a purposely injected reform which imposes some constraints on the SOEs. While the government as a whole keeps firmly its unabashedly dominant or even above-the-law position, some parties within the ruling system may be subjected

[99] John Coffee, Jr., *Racing towards the Top: the Impact of Cross-listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1757 (2002).

more to a commitment to strict legal scrutiny for the sake of economic growth as a fundamental ruling legitimacy of P.R. China. Even if the law may be initially employed as a mere means in this sense, it could also work to enhance a right-based system in specific situations.

Additionally, unintended consequences always take place as law begins to take on an enduring *life of its own* and walk according to its inherent logic in an imperfect setting. Constrains on power could be brought to bear on official behaviors by law, by oversight personnel within the government system as well as by external parties, who are impressed by the new opportunities afforded by the institutional reforms, eager to advance their own interests through exploring the possibility of invoking more individual protection under various circumstances.

As far as oversea listing is concerned, with the aid of the systematic support of the platform of international exchanges, ordinary investors could exert their individual rights against the SOEs, pushing the giants to form a habit of being more concerned with investor welfare even in the domestic context. For example, people around Jia in CAO may have more consideration for the risk of inside trading next time when contemplating a share sale before the bad news is disclosed (See below).

Since the Chinese government clearly identifies its goal as “market economy” (though “with Chinese characteristics”), basic rules of economy operation (such as “investors need protection”) will compel it to act within the invisible boundaries and even sparingly allocate some control rights to the market participants to help rein in the established interests. After having a taste of the magical flavor of the market, *those in power* could realize that other than the traditional approach of instrumentally making use of the law to coordinate the economy and the society, occasionally it is for the sake of the leadership to have a check on the untrammeled interests like SOEs with the assistance of reform-oriented constituencies within the system, and even permit the implanting of a “Trojan horse” which may ultimately turn against the whole old system and undermine those outpaced’s hold on power.

Indeed, *outsider players*, with raised courage and expectation about the protective capacity of law, will less hesitantly seize the opportunities to move the bureaucratic machinery to a favorable direction. One of the most active parties pushing oversea listing of SOEs is investment banks within and outside China. They were motivated by the prospect of obtaining profits from such businesses, but their efforts lead the Chinese SOEs to be more on the market tracks.

In short, a gradual but steady reform instead of one rapidly altering the existing framework was the basic theme of China's last thirty years' endeavoring in the market and law building. Notwithstanding a soil of suboptimal nutrients, the implanted tree of law slowly bears its intended fruit for future generations. Overall a comparatively more decentralized approach to legal governance and a more investor-protective atmosphere are achieved.

IV. The Real Effects of Oversea listing on SOEs Governance: Case studies

An oversea listing in a more renowned exchange normally means better law, more stringent listing and disclosure standard, reduced informational asymmetry, stricter regulation and other enhanced scrutiny. A listing may constitute a form of bonding that assures investors that agency costs will be lowered, the behaviors of managers and controllers will be constrained. But it is by no means a remedy to all ills. Sometimes, the high visibility brought by oversea listing may even have negative effects on the SOE governance. To illustrate that, we need to put more touchable flesh on the theoretical analysis.

A. Advantages of Case studies as a Methodology

This part explores what effects oversea listing will have on the SOEs in the respect of corporate governance. The focus will not be the observation of price premium but comprehensive performance of the operation and governance of companies. To achieve that end, this paper utilizes case studies as a vehicle to examine the reality and vulnerabilities of the governance in oversea listed SOEs. By portraying close descriptions of firm-level extraordinary events, I hope readers could better appreciate the characters and complexness of the targets. The unique significance and representativeness of the episodes could justify the discarding of a sampling method. [100] Further, when I try to situate the informed stories within a broader examination of the role of the state in the political economy, let the cases cast light on generic issues related to this topic, assist spot key systematic features. These probes would afford a deeper comprehending of the system's structure since the response it generated involve other big players including the state, thus the inner operation logic of the system may be exposed, aiding us speculate the likely direction of institutional development. [101]

The focus of case researches will be the dark sides of governance in the discussed enterprises. Since I would try to identify possible pathologies, rankings, indices and other coding methods are relatively less useful. Negative events carry more weight because bad things that happened could function like a stress test, vividly expose the challenges the targets face and uncover their vulnerabilities and potential hazards caused by structural flaws which used to be beneath the radar as long as the system operates smoothly. Out-of-equilibrium stories offer problems needed to be addressed, urges one to generalize from the breakdowns of the operation, thus more likely to afford a more instructive intellectual roadmap for comprehending the reality and locating a guide for the future. While conceding the necessarily impressionistic nature of some of my analysis, this process could be viewed like an autopsy which always reveals more information than regular checkups. [102]

Surely, it should be admitted that due to the short history and limited number of oversea listed Chinese SOEs, there is hardly direct case of major governance failure. Many of them are not without domestic governance troubles after the oversea listing, nevertheless the connection with the foreign exchange is not strong, and we cannot effectively assess the impact of extraterrestrial law and regulation on them. Hence I

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[100] K. M. Eisenhardt, *Building Theories from case study research*, Academy of Management Review, 14 (4): 532-550 (1989).

[101] See Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World, 9.

[102] See Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World, 10-11.

will only brief explore in the Sinopec case, as a typical example, about the scenario that oversea listing did not deter some significant problematic behaviors within the company. More attention would be devoted to two colorful episodes involving two star oversea subsidiaries of key Chinese SOEs which suffered dramatic governance failures after being oversea listed. And in their stories, the oversea listed status may contain unique governance implications.

The two firms are oversea incorporated, which make them different from Beijing-based companies. It is not without possibility that the really fatal chain is the oversea existence. But the exploration of why oversea chartered SOEs which may have been of a higher level compliance still failed miserably could be more instinctive. This paper will show that their operation, their rise, fall and rebirth is dramatically influenced by their SOEs identity. Were they not (Chinese) SOEs, the whole stories might unfold in considerably divergent ways. Their oversea incorporations and possible stronger market orientation seemed to be outweighed by the inner SOE blood. When we look at a bigger picture of how its parent company in Beijing and the Chinese government dealt with the issues and created some ex ante effects for future, the mark of SOEs in these stories are also highlighted. For example, after the transpiring of tragedies, the Chinese government unambiguously regarded it as events concerning SOEs rather than “foreign listed companies”.

Besides, since they are oversea registered companies, oversea legal authorities could exert more substantial power in routine monitoring and crises handling. Hence the (maximum) potential of such advanced legal regimes in disciplining Chinese SOEs could be better tested. In such cases it could be even more illuminating about evaluating how effectively the outsourced law and regulation on the SOEs works.

Without denying positive governance changes brought to oversea listed companies, I will keep in mind aspects that may be hard to be cured by oversea listing alone, with the questions like: will the status of SOEs make difference from other kinds of oversea listed firms when it comes to the issue of governance? Since SOEs’ governance problem is generally harder to address in the first place, will oversea listing be a little less functional for such kind of entity than for other kinds of firms?

B. Case study: Is Sinopec a Governance Model?

Available studies concerning major oversea listed Chinese SOEs are limited, but three Chinese scholars have done a case study on the governance improvement they found in Sinopec after its oversea listing. [103]

China Petrochemical Corporation (Sinopec Group) is a super-large petroleum and petrochemical enterprise group established in 1998. As the Asia's biggest oil refiner by volume, it is solely invested by the State with a rank of the 5th in Fortune Global 500 in 2011(climbed from 16th in 2007). China Petroleum & Chemical Company (Sinopec Corp.) is controlled by Sinopec Group and listed on stock markets in Hong Kong, New York, London and Shanghai. The total number of shares was 86.7 billion in which Sinopec Group owns 75.84%, international investors own 19.35% and domestic investors own 4.81%.[104]

These authors focus on Sinopec's efforts of enhancing investors' "information rights" by establishing a mechanism of "investor relations management", including special departments and staffs, an information disclosure system, internal regulations, explanation meetings, etc. [105] They argued that the significance of information for the firm's global competitiveness, saying that with the change of environmental exogenous rules, Sinopec has conducted self-enforcing institutional arrangements which are superior to China's legal requirements. Such qualitative changes enable it to have access to lower cost of financing and better performance.

They claimed about a disequilibrium caused by the shock of oversea listing may bring an internal and voluntarily evolution, this is correct. However, such strategic choices may be not as great as the authors advocated. Indeed, one aspect could not be illustrated as a catching-all proxy for the assumed significant improvements in governance.

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[103] Ma Lianfu, Chen Deqiu, Gao Li, *Overseas Listing, Voluntary Corporate Governance and performance: A case study of Sinopec*, Front. Bus. Res. China 2008, 2(3): 440-457, DOI 10.1007/s11782-008-0026-3, Beijing: Higher Education Press and Springer-Verlag 2008.

[104] http://www.sinopecgroup.com/english/Pages/guanyu_gsjs.aspx.

[105] MA Lianfu, Chen Deqiu, GAO Li, *Overseas Listing, Voluntary corporate governance and performance : A case study of Sinopec*, 448-451.

Here I do not intend to substantially undervalue the overall positive effects of oversea listing which also have been well analyzed by the proceeding parts of this paper. I just want to cast doubts on how great the market demand may impulse new policy on the firm level. Accurate, timely and forward-looking information provided to investors is crucial, but it would not fundamentally affect the governance structure. Specifically, the Sinopec paper may have such problems as follows.

First, by illustrating outperforming-the-market data of earnings and financial indicators of Sinopec from 2001 to 2006, the paper tried to display steadily-improving performance and "sustainable development" supported by enhanced governance. [106] However, they could not rule out the influence of "strong government support and unique advantages in resources" [107] (in fact, it frequently demand the state raise gasoline prices to meet rising production cost), so to what extent the "voluntary governance" they highlighted contribute to the leading position of the monopoly firm is suspicious.

Second, inconsistent with their story that Sinopec values the investors feeling, there were abundant events about the extravagance of China's biggest supplier of petrol. In 2009, it was alleged by an online post that Sinopec purchased a 12-million-yuan ($1.8 million) chandelier to adorn the entrance hall of its new headquarters. This sparked public outrage, generating incredulous postings on the Internet. Though a Sinopec official later said the crystal and copper-steel-plate decoration object cost much less, splashing out 1.56 million yuan was still too exorbitant to comfort the public who were fretting over rising prices, [108] especially taking into account that the giant was spending 240 million yuan to renovate an already impressive building.[109]

After this wave of public criticism Sinopec obviously did not refrain from engaging in extravagance. In 2011, massive alcohol bills of a provincial subsidiary of it were revealed online along with photographs of the said invoices. The high-end

[106] Id, 452-453.
[107] Id, 453.
[108] *Sinopec Chandelier Fuels public anger*, China Daily, July 21, 2009, at 9.
[109] Zhao Hongyi, *Sinopec Chandelier fuels public anger*, Beijing Today, July 24, 2009.

liquors costs were rumored to be 2.59 million yuan. [110] Later sources within the company contested the sum of expenditures, but admitted a spending of 1.59 million yuan on booze. Finally the subsidiary head was demoted and ordered to pay 131,100 yuan ($20,100) for the liquor bills he had consumed.[111] Consider that these two exposures happened almost accidently, the iceberg below the water may be much larger.

Third, an ironic issue is that exactly during the period examined by the three researchers, Sinopec was in the charge of a corrupt guy who was eventually sentenced to death with a two-year reprieve in a bribery case believed to be one of the country's biggest one. Chen Tonghai, a former deputy commissioner of the State Planning Commission, joined in 1998 as deputy general manger of Sinopec Group, then general manager of Sinopec Group and chairman of Sinopec Corp from 2003-2007. Chen was convicted of illegally receiving 195.73 million yuan ($28.66 million) between a long period of 1999 and 2007 to help others "seeking illegal interests" in company operations, land transfers and contracts by taking advantage of his top positions, according to the verdict.[112] One basic reason for the striking scale of his unlawful activities was his unconstrained power within the fully international listed firm. In spite of all the nominal corporate governance arrangements like the board, Chen was a “dictator” in “his enterprise”.[113] Though apparently what Chen did may not have hurt the giant much, this is definitely a governance scandal. The market also reacted fiercely to the news.

One thing also worth mentioning is that Sinopec is a typical company whose top leaders are subject to arbitrary reshuffling by the Communist party even after oversea listing. After the downfall of Chen, the chief of Party Organization/personnel department in Liaoning Province Su Shulin was appointed as General Manager of Sinopec Group. This turnover triggered market worries. According to Ma et al., the investor relations management department of Sinopec vigorously worked to

[110] Yan Jie, *Netizens slam Sinopec's drinks bill*, China Daily, April 15, 2011.
[111] Qiu Quanlin, *Sinopec demotion over liquor bills*, China Daily, 2011-04-26.
[112] Zhu Zhe and Cui Xiaohuo, *Corrupt Sino pec ex-chairman convicted*, China Daily, July 16, 2009.
[113] Zhao Hongyi, Sinopec Chandelier fuels public anger, Beijing Today, July 24, 2009.

communicate with the outside world, telling them Su was an experienced oil leader, since he owned nearly 30 years of working experiences in the industry and was deputy president of China National Petroleum Corporation before taking his pure party affair job in 2006. [114] However, years after that the oil talent was again moved out of Sinopec to the position of a governor. And his office was given to former General Manager of China National Offshore Oil Corporation,[115]the second principal competitor of Sinopec in China and also with a NYSE-listed subsidiary. Such a rotation which would surprise Westerner investors continued after their oversea listings.

Hence, a bigger picture about Sinopec reflects that though it basically could be viewed as a healthy corporation whose investors gain juicy profits and without big governance failure, the presumed advanced market monitoring and discipline may fail to restrain excessive executive consumptions or to constrain top leaders, thus the magnitude of the positive effects of oversea listing is ambiguous or limited.

Surely, to a great extent, no news is good news. The market bonding may have already well worked as invisible discipline mechanisms to make the firm cautious, like the paper of Ma et al, indicated. But some other cases showed that it could not prevent the taking place of big disasters, and that is what I will explore next.

C. Case Study: China Aviation Oil (Singapore) Corp

The first episode happened in the most reputable performer of the more than 60 China-related listed companies in Singapore, China Aviation Oil (Singapore) Corp (CAO). By 2000 the SOE had been in charge of one-third of China's jet fuel needs and possessed a 92% market share for imports on such product to China. In 2001, the lucrative company was listed on the main board of the Singapore exchange in 2001 and .[116] The big fuel trader rocked the island in December 2004 by announcing it had

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[114] Ma et al., *Overseas Listing, Voluntary corporate governance and performance : A case study of Sinopec*,545-455.
[115] http://english.sinopec.com/about_sinopec/our_company/leadership/board_of_directors/20080327/3096.shtml
[116] Kevin T. Jackson, *The China Aviation Oil Scandal*, in HANDBOOK OF FRAUDS, SCAMS, AND SWINDLES: FAILURES OF ETHICS IN LEADERSHIP, 152 (Serge Matulich, David M. Currie, Boca Raton ed., FL: CRC Press, 2009).

lost US$550 million, exceeding its registered capital by 1 million dollars, in oil derivatives trading, forcing it to seek court protection from creditors. It then became the focus of attention from both the domestic and international media, since people were reminded by the city state's biggest trading scandal in nearly a decade after the downfall of Barings Bank in 1995 by a Singapore-based trader. [117]

1. The Incurring of Trading Losses as Governance Failures in CAO

Since 2001 the Chinese government has gradually started allowing a few overseas-based companies to engage in some kinds of overseas commodity futures to hedge global price fluctuation risk. But they were strictly barred from speculative derivatives trading. [118] However, since 2003, CAO had embarked upon diversifying from the core business of oil trading and commenced a string of risky derivative trading, betting on oil option. What’s more, the move of the main supplier of airline fuel trader was done without board approval,[119] and the trades seemed more simply aiming at bolstering speculation profits rather than hedging risks.

Like the all-to-familiar stories of gambling, initial forays went with the bet, but later bets on the wrong direction were made. Instead of writing off a loss of approximate 5 million dollars and leaving according to good risk-management procedure, the company raised its bets and increased the risk exposure with the hope of recouping until the deployment of more options against the unfavorable market direction made it infeasible to cope with the mounting due margin calls. This resembled the acts of Nicholas Leeson who brought down Barings Bank barely ten years ago in the same city state. [120]

However, though the firm was finally faced with losses close to its market value and the brink of bankruptcy, CAO did not admit it until investors seemed perceptive of something bad, its market value plummeted. Four days after its share trading was suspended, CAO announced that it was seeking protection from creditors with a total loss of 550 million $.[121]

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[117] Cao Desheng, *Costly lessons from the CAO scandal*, China Daily, 2004-12-23.
[118] Cao Desheng, *Costly lessons from the CAO scandal*, China Daily, December 23, 2004.
[119] John Burton, CAO’s risky gamble made losses worse, Financial Times, 30 March 2005, 27.
[120] Kevin T. Jackson, *The China Aviation Oil Scandal*, 155.
[121] Kevin T. Jackson, *The China Aviation Oil Scandal*, 156.

Indeed, the tremendous losses racked up as it were, there had been a formal corporate multi-layer risk control system designed by Ernst & Young in 2002, composed of numerous safeguards to ensure that nothing goes wrong: senior traders, division heads, independent risk-control committee, internal audit division, audit committee and the board. [122] However, *prudent investing and internal control seems to fail at virtually every level of management.*

First, the traders retained by the company to engage in such activities with significant consequences lacked adequate expertise. Options, more complex than swaps and futures, are beyond what the system was designed to handle. Not to mention CAO participated in compound options. [123] There were structural drawbacks in CAO's mark-to-market valuation methodology which only considers the intrinsic value of the financial instrument, while the weigh of time value component, volatility, option maturity, interest rates, etc have been wrongly neglected. [124] It turns out to be a fatal mistake to overlook the "irrational" price turbulence in the international marketplace that may deviate drastically from the "true value" at least in the short medium. This knowledge is not hard to understand and constitutes one premise for the institution of loss limit. But its absence led to an unreliable anticipation which brought the disaster as well as drove Chen to desperately dumped money in a losing batter, hoping the market could reverse to "normal" condition soon. Also, the difference of valuing model of CAO and its counterparties which kept asking for margin calls deepened the crisis. [125] Finally, the traders even failed to correctly tally the option trades. Otherwise, a pretax loss resulting from the ensuing damage would have forced CAO to cease concealing it months earlier. [126]

Second, personally insensible as the traders may be, an institutional stop-loss trading limit could have been of help. Deals were supposed to be shut down if any trader assumed a loss exceeding $500,000.[127] But the loss restriction on option

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[122] Kevin T. Jackson, *The China Aviation Oil Scandal*, 158.
[123] Kevin T. Jackson, *The China Aviation Oil Scandal*, 154.
[124] Kevin T. Jackson, *The China Aviation Oil Scandal*, 159.
[125] Kevin T. Jackson, *The China Aviation Oil Scandal*, 159.
[126] Kevin T. Jackson, *The China Aviation Oil Scandal*, 159.
[127] Kosuke Takahashi, *Jet Fuel Scandal deals China a body blow*, Asia Time, Dec 7, 2004.

portfolio was not set by risk management committee until the paper loss had been larger than it. [128] Even so, the limit was put aside intentionally. Chen overrode internal controls so as to postpone the crystallization of paper loss. Hence instead of dropping his bearish view, he restructured the call options for three times, sold even larger ones with longer expirations, while the internal audit division failed to periodically and correctly report to the audit committee the possible checking deficiencies. [129] Both its directors and controlling shareholders lacked the capacity to closely monitor the actions taking place oversea. The new generation of more capable and ambitious management team gained trust and autonomy, run beyond of the overseeing ability of Beijing-based bureaucrats who also did not have passion to intervene. Even when the exposure was being built up by millions of dollars, the fact was still hidden from the parent company.

2. The Initial Rescue Attempt from the Parent Company: an Insider Trading

Graver than the commercial fiasco was a blatant deception by the troubled supplier. After they first noticed the potential hazard, Chen, the finance head (later sentenced to two years in prison by Singapore) and three Beijing-based directors "*persistently engage[d] in a series of elaborate and illegal practices*", as commented by the Singapore Judge later in his ruling.[130]

The core one is that in earlier October when the state-owned controlling shareholder China Aviation Oil Holdings Corp (CAOHC), after aware of the whopping losses arranged to sell a 15% stake from its 75% holding in CAO so as to lend the proceeds to the money-seeking subsidiary. It failed to disclose any information about the known losses during the sell-off process and deceived about the true purpose [131] when the placement was managed. It probably did not think about the disclosing since its aim seemed to be selling at a still good price so as to collect rescue money. What’s more, Chen forged documents to defraud the underwriter Deutsche Bank's Singapore branch and compromised its due diligence efforts. [132]

[128] Kevin T. Jackson, *The China Aviation Oil Scanda*l, 158, 160.
[129] Kevin T. Jackson, *The China Aviation Oil Scanda*l, 160.
[130] *Ex-CEO of China Aviation Oil sentenced*, China Daily, March 22.
[131] Kevin T. Jackson, The China Aviation Oil Scandal, 159.
[132] *China Aviation Oil’s Suspended Chief Executive Freed on Bail: Reports*, Agene France Presse, 11 June 2005.

This act of covering major financial conditions in a securities sale unsurprisingly qualified as insider trading under Singaporean law, and probably the law of most jurisdictions including China.[133] Chen became the first person sent to prison in Singapore for insider trading.[134] For a guy having earned an EMBA degree and possessed long time working experiences in Singapore, Chen's failure to notice the obvious illegality seems a little wired, but as two scholars harshly criticized, he has never "operated in an environment where legal constraints were more important than bureaucratic controls or where shareholder concerns played a significant role in managerial decision making".[135]

Thus it would be more natural for people in Beijing to neglect that issue. According to Chinese system of state-owned assets management, such a significant sale of shares for 108 millions $ is beyond the power of CAOHC. It should have been approved by some high level officials. Its character of a government decision partly explained why years later Chen, the only guy thrown into the cell and finished his jail term, was granted a position of vice general manager of a big SOE in 2010.

Back to 2004. The Chinese bureaucrats in charge of SOEs affairs, enjoying long time privileged positions, habitually neglect reactions and interests of other market participants. Now when faced with the risk of the fallout a major firm and perhaps bent on avoiding disgraceful recording loss, their attention may focus more on the pain of forging a large stake, rather than whether the price was fair to buyers.

In fact, it may be more desirable for them to exploit outsiders. During roughly the same period, Beijing employed a tactic to save numerous technically insolvent Chinese securities broker-dealers which, due to the severe years-long bear market and lousy business practices, were in need of bailouts. To exchange for the chance to get a foothold in the burgeoning, potentially lucrative but highly regulated Chinese

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133 The current Chinese securities law stipulates that the listed company shall immediately submit a temporary report and make an announcement regarding the incurrence of any major deficit or a major loss in the company (art.67); any insider who has access to insider information may not sell the securities.(art.76), these and other relevant provisions are also in the valid version of securities law in 2004, an English version of the statute, see http://www.lawinfochina.com/display.aspx?lib=law&id=4693.

134 *Ex-CEO of China Aviation Oil Sentenced*, China Daily, 2006-03-22.

135 Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World, Chicago and London: The University of Chicago Press. 2008,131. An ironic fact was that most of Chen's advanced education in China relates to law. He was also proud of his "Chinese wisdom". See Kevin T. Jackson, *The China Aviation Oil Scandal*, 153.

financial market, international financial institutions were asked to offer their fund to buy substantial shares of those troubled firms. For example, in 2006 UBS invested 1.7 billion yuan ($212.3 million) in a state-owned broker-dealer in return for a 20 percent stake and de facto management control of day-to-day business and operations. At that time, the target company owned only a net asset of less than 500 million yuan, compared to its registration of 1.5 billion yuan. [136] Wasn't such a "market" solution excellent? Hence it was no wonder the sale of CAO shares might be viewed as a wit design of solving the grave economic problems in the eyes of Beijing bureaucrats.

Hence, the bet reflected usual recklessness, but bold cover-up activities in the aftermath of it tell us more about governance reality and political economy with the characteristics of Chinese SOEs.

3. Singapore's Response and China's Cooperation: the Law Seemed to Matter here

Singapore has long been widely recognized as a jurisdiction with strong investor protection. [137] Before the debacle, CAO was not only honored for having "outstanding risk-management structure and procedures" by the Chinese, but named Singapore's most transparent company by the local securities investors association. [138] Months before the bankruptcy filing, Chen was praised by a Singaporean newspaper for exceeding entrepreneurship [139] The meltdown of the elite firm was a blow to the Singapore Stock Exchange (SGX) which had been actively courting listings by mainland Chinese companies as well as intending to press the world by one of the best financial regulation and corporate governance standards in Asia.

Unsurprisingly, the debacle set in motion questions about Singaporean financial authorities. People raised considerable concern on the creditability of Singapore concerning issues such as "whether China's lax corporate governance standards are being papered over in the rush".[140] Singapore's reputation as a financial center was

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[136] *UBS Securities may open in March*, Shenzhen Daily, February 13, 2007.

[137] E.g., see La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 J. Pol. Econ. 1113-55 (1998).

[138] Kevin T. Jackson, *The China Aviation Oil Scandal*, 152-3.

[139] E.g,, *CAO's Shine All due to one man*, Business Times (Singapore), August 19, 2004.

[140] Hamish McDonald，*China Deep in Jet fuel scandal*, Sydney Morning Herald, December 4, 2004.

shaken by one brilliant company which acts as spearhead of a specific group constituting one-eighth members of the SGX.

Specifically, many wonder why the SGX and the central bank Monetary Authority of Singapore (MAS) had not noticed the losses of this magnitude were accumulating earlier. Traders complained about their negligence, saying the entire SGX trading system and the MAS's supervisory role deserve an examination. [141]

Thus the regulators and criminal enforcement agents moved quickly and took a series of swift steps to recoup the market's credibility. They directed CAO to appoint a special auditor, PricewaterhouseCoopers, to investigate the circumstances that led to the losses. A criminal investigation was been launched to look into the possibility of white-collar crime at the firm. [142] In a country without robust private law enforcement, public enforcement actions and the actual level of sanctions are essential and would be the focus of following paragraphs.

A high profile act was to retain at the airport and accuse three board members of CAO, including a politically connected guy Jia Changbin, CAO's Chairman and President of CAOHC, and Gu Yanfei, general manager of CAOHC. They were coming to meet with creditors for proposals about debt writing off and paying back. The directors were in custody for a while and finally as a sentence, Jia was fined in the amount of $247,000, the other fined two $ 92,600 each. [143] Judging by normal income levels of Chinese SOEs leaders, these are substantial and may exceed their personal wealth. (So it is likely the CAOHC ultimately bore the fines.)

Such a first ever attempt to penalize a Chinese SOE and its executives by Singapore authorities surely gave the Chinese businessmen a good lesson, it confirmed the decisiveness and political will of the city state regulators and earned it the fame of rule-of-law. A small state squarely hits Beijing in the face by formal convictions of communist officials.

This is exceptional. Unlike a professional entrepreneur like Chen who began his career in Singapore, Jia was actually an important bureaucrat in the Chinese

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[141] Kosuke Takahashi, *Jet Fuel Scandal deals China a body blow*, Hong Kong: Asia Time, Dec 7, 2004.
[142] Kosuke Takahashi, *Jet Fuel Scandal deals China a body blow,* Hong Kong: Asia Time, Dec 7, 2004.
[143] *Oil firm officials ordered to pay fines*, China Daily, 3 March 2006.

governmental aviation system. Though the reform of commercialization appoint people like him to positions in corporations (firmly and ultimately controlled by the government), they were quasi-officials whose promotions and appointments are not decided in the formality of shareholder meetings but by party personnel department. To fine him is to throw the books at Beijing.

In fact, this punishment stood in contrast to numerous prior oversea SOE subsidiaries governance scandals in which front-line protagonists like managers and local representatives bore the burnt, while high-level executives back in China's parent companies got no foreign prosecution. [144] For instance, in the 2004 fraud scandal of Bank of China's New York Branch, everyone in Beijing was shielded from enforcement actions. [145] Also, please remember the significant consequence of China Life Insurance suit.

4. Politics Trades behind Law Enforcements? Is There Something Special in the Handling of a Major Chinese SOE?

However, under closer examination, one may figure out the contour of an implicit cooperation and exchange-of-interests between the Chinese government and the Singapore authority exists, adding much complexness to an evaluation of governance and law enforcement in this area.

As mentioned before, Singapore found it was in a deep crisis for rebuilding its valued reputation as an international financial hub. For a small economy, this fame is of essence. At the same time, if there is one country whose aspiration to adhere to a Western model of regulation would obtain assistance from Beijing, it would be Singapore.

Singapore is a country with nearly three quarters ethnic Chinese. [146]Among the developed world, it has an undemocratic political regime, non-Western ideology like "Asia Values", state capitalism practices which make it resemble P.R. China to a great extent. Both governments have some sympathy or understanding toward each other.

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[144] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 132.

[145] *Three Chinese indicted in New York for BOC fraud*, China Daily, February 15, 2005.

[146] http://en.wikipedia.org/wiki/Singapore#Demographics

When the Chinese government is engaging in a transition to market economy but no enthusiasm for democracy, Singapore is an appealing, perhaps the best model and even a justification for its choice of a road of strong government coordination. [147]

So the Chinese government could be willing to cooperate with the Singaporean government, understanding the latter's eagerness and aspiration to adhere to the Western model and maintain a good name for tough law enforcement when the troubles were caused by its own offspring.

But this favor was not done without return. The Chinese may get punishment as well as mercy because of the SOE identity of the perpetrator. One should note that China is not very reactive in this process and just be a good man offering help for his little brother.

On the one hand, this was a pure business disaster which must have annoyed the Chinese government too. Someone should accept responsibilities. A penalty imposed by foreign authorities, though not tasteful, impressively reinforces a real warning for other oversea listed SOEs managers. After all, one of the main causes that drive oversea listing is such a harsh discipline, though an ex ante deterrence would be more desirable than an ex post penalty. Also, since Singapore is a special friend or even "kin" nation enjoying a cooperating climate with China, playing by Singapore's rule would not make the Chinese authority feel too humiliated.

On the other, behind the publicized legal action, one may percept "tacit approval" [148] or a willing sacrifice[149] from Beijing. This may be reflected by what Singapore gave in a seemingly grand compromise.

First, the accused were not beaten as hard as may be expected. Initially Jia was accused of three offences, and two of the charges he faced carry a maximum penalty of 7 years jail. [150] But later they three were just fined a total of $433,000.[151] (Of

[147] See more in Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asia Industrialization,* Princeton University Press, 2003.
[148] Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World, 133.
[149] Tom Grimer, *China's taking Notes on Corporate Justice, Singapore-Style*, Globe and Mail (Toronto), June 15, 2005, at 2.
[150] *Arrests in China Aviation oil scandal*, Vietnam Investment Review, June13, 2005.
[151] See Cris Prystay, Executives On Trial: Three CAO Singapore Officials Are Fined In Derivatives Case, Wall Street Journal, 3 March 2006, at C4.

course if he was put into jail, there would be disastrous for Sino-Singapore governmental relationship.) Besides, the civil penalty of CAOHC paid was just $ 8 million. "[M]ost commentators" judged these as "rather mild". [152] The legal justification was that the Monetary Authority of Singapore seemed to buy the claim that acts driven by the desire to save a once extremely successful company as an acceptable "mitigating circumstance". [153]

A less harsh treatment also applied to Chen. At first, he was prosecuted with a total of 15 counts, including forgery, insider trading and failure to disclose losses. [154] Each of the 10 charges of making false statements and insider trading carries a maximum sentence of seven years in jail or a fine of $S 250,000 ($150,000) or both, [155] finally he was sentenced to a prison term of four and a quarter years and fined $S 335,000 ($ 207,500) after pleading guilty to *six* charges, including failing to disclose a trading loss and deceiving adviser Deutsche Bank AG. The conviction of insider trading only cost him several months' life time.

Second, the investment vehicle of the Singaporean government Temasek played a key role in the orchestra of rehabilitation of CAO by taking a 15 percent stake and, more important, expressed the confidence and determination of the Singaporean government to ensure the revival of CAO. Though Temasek happened to the largest cheated investor in the proceeding private placement, this victim did not take any apparently opposing action toward CAO. [156] Instead, the business agent of the Singaporean government finally made a great leap forward in its proclaimed strategic goal of an expansion into China business and promoting closer links with the country.

Such a submission is not unique. As the underwriter, Deutsche Bank was engaged in placing out the private placement of CAO but was kept dark. However, the bank eager to substantially participate in Asia market declined to initiate a legal proceeding.

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[152] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 133.
[153] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 128.
[154] China Aviation Oil ex-CEO charged with 15 counts, *China Daily,* Jun 10, 2005.
[155] Hamish McDonald, *China Deep in jet fuel scandal*, Sydney Morning Herald, December 4, 2004.
[156] Even none of the bank creditors controlled by it filed suit against CAO, standing in contrast to other international banks, Lloyd-Smith and Yeh, *CAO Head was kept in the dark*, Financial Times, 2 February 2005, at 17.

To some degree, Temasek was a larger Deutsche Bank with more resources at control and more at stake. Unlike the China Life case, the outcome here saved the face of the Chinese, and consequently the future investing interest of Temasek and the strong national economic interest deriving from maintaining a good relation.

The tight relation of Temasek with the Singaporean government could make Beijing well accept the enforcement actions from virtually the same party which helped with a large sum of money to keep a major SOE from falling. The interaction, mutual-understanding and cooperation among the Chinese and Singaporean authorities via their agencies like CAOHC, Temasek, MAS, SGX fundamentally determine the way of resolving crisis at the biggest jet-fuel trader in China. Though in this case the legal proceedings are far more than formalities and the goal of investor protection was largely accomplished, politicians and their agents played a greater role than pure law mechanisms. If there is no such implicit relationship between the two states, law may be more influential here since Singapore is a country with substantial rule of law, and the actual result may or probably may not be more satisfying for the investors. Nevertheless, that kind of relationship has been truly in existence and had and would be impactful. Chinese SOEs are likely to be treated in a somewhat different way.

In short, with such a careful balance, Singapore both solidify its reputation for robust rule-of-law while keep the negative impact on its relationship with China to the least extent. [157] This result was also probably sweeter for investors. But the effects of "outsourcing law enforcement" which subject Chinese SOEs to extraterrestrial regulators was mitigated, since pathologies in the weak corporate governance environment of home country were "exported" to the listing place which is assumed to have tougher law enforcement. [158] When the scale of Chinese IPO increases year by year, the expanding stake may incentivize more than one exchange and underwriter to adapt to the uncomfortable Chinese features. When giants like the SEC and NYSE

[157] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 134.
[158] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 134.

are somewhat worried about not being able to attract many Chinese clients and contemplated the possibility of more legal exemptions, [159] no wonder smaller players more dependent on the opportunities from China may be more inclined to be soft.

5. The Final Bailout Efforts by China: the Effects of SOE identity for foreign and domestic investors

Surprised by the unpredictable turbulence of the international market, the "official reaction from China was measured and cautious, they first summoned Chen to Beijing, trying to comprehend what had happened. Initially, they attempted to handle the novel challenge behind the door. An official at CAOHC even denied that Chen's presence.[160] However, when Chen's departure appeared to spark outrage and indignation from oversea investors and put pressures on the Singaporean authorities, Chen was asked to fly back. The Chinese government started to sense that the showing a responsible attitude was essential to preserving its international image.

CAOHC assembled a group of major SOEs including the biggest airline and two biggest oil companies to collect restructure capital. Such a horizontal coordination appeared to be beyond the ability of the relatively weak CAOHC, reflecting the Chinese government's role in it.

At the same time, following the lapses in controls exposed by the high-profile debacle, China did some heavy-duty fire firefighting by stressing that the scandal at CAO was an exception and that no other Chinese companies are flouting rules, [161] "downplaying the crisis as a one-off event" and trying to avoid "the impression of a systemic governance failure that would implicate a breakdown of the Chinese model of company transformation". [162] Also, the chair of State-owned Assets Supervision and Administration Commission (SASAC) said the avoidable incident highlighted the necessity of sound internal auditing and effective risk management, pledging to tighten internal controls on SOEs and work on a system to track liabilities after

[159] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 135.
[160] Hamish McDonald，*China Deep in jet fuel scandal*, Sydney Morning Herald, December 4, 2004.
[161] Kosuke Takahashi, *Jet Fuel Scandal deals China a body blow*, Hong Kong: Asia Time, Dec 7, 2004.
[162] Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World, 135.

investment blunders. [163] In April 2005 the government declared intention to step up supervisions of overseas SOEs operations.[164]

The Chinese government's financial efforts in the final bailout were enormous. Authorities confirmed continual supports for CAO in the respect of policy-related benefits. Since CAO is basically a trading company, its most valuable assets are trading relationships with big SOE airlines via its parent company. Government assurances with huge economic implications proved to be crucial factors to appease investors and make them agree to write off part of the debts to facilitate the reorganization. Also, it was obviously that Temasek's high ended interests would only be satisfied by government level contacts.

Finally, CAO averted bankruptcy in June 2005 when creditors approved its debt-payment plan. BP Plc, Temasek Holdings and CAHOC agreed to inject $130 million to keep it afloat. [165]. Minority shareholders were indemnified in kind in accordance with a penalty decree that demand CAOHC hand over to them shares as a component of debt restructuring plan, [166]creditors got paid substantially too.

Hence, while some Western observers criticized that minority shareholders were "victimized by a distant parent company" which engaged in exploiting placement,[167] I want to stress that though psychologically stunned as they were at the initial stage, investors overall were not hit as terribly as it seemed or could have been. When CAHOC and the Chinese government were anxious to save the image of Chinese SOEs, they did not severely take advantage of investors economically. The price of being of grace was high. The more noteworthy point perhaps is that active bailout activity may "overpay" the victims to some extent and thus cast more shadow on the governance of oversea SOEs in the future.

True, ordinary investors are innocent. Nevertheless, in the real world of the risky

[163] Cao Desheng, *Costly lessons from the CAO scandal*, China Daily, December 23, 2004..
[164] Wayne Arnold, *After Crash, China Aviation Oil Offers creditors sweeter repayment deal*, N.Y. Times, May 13, 2005.
[165] *Ex-CEO of China Aviation Oil sentenced*, China Daily.2006-03-22.
[166] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 133.
[167] Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*, 134.

market, all victims of business scandals have not been adequately compensated. CAO and Chen were blameful, and the possible ill impact of the SOE character could be harshly criticized. However, while a state-owned background alone may not constitute the whole reason for this fallout (since numerous non-SOEs also have lousy internal control), such an identity did push the government to bail it out.

Of course, the Chinese government was not running a charity. It was under heat. The nearly toppling of CAO drew investors' attention and let them have deepened concerns about the risks of investing in Chinese companies (not merely SOEs) for their lack of internal control, risk management, transparency, accountability and fairness. [168] Some Western observers also related it to a string of high-profile corporate scandals inside China. [169] These criticisms drove Chinese authorities to respond to recoup the safety and soundness of investing in Chinese firms.

Nevertheless, one might still argue that this is not the only option owned by the enterprise controllers, especially from an economic perspective. They could consider "treating the company as a company" and let it fall down. More significant than the operation of such a particular subsidiary is the strong persistent market demand. After abandoning the old failed one, the booming business of oil procurement via Singapore to China could be rebuilt by another entity without insurmountable difficulties. Profit-driven trading counterparts would still come. This is the basic rationale of limited liability of the company as a species of business organization. Besides, the controlling shareholder needs not to feel morally guilty since the reckless risk taking was not owed to the influence of it. Negligent as the parent company may be, they paid their high cost of losing all a shareholder has.

During the negotiation, the restructure team once threatened withdrawing financial support for CAO and leaving the company worthless if investors insisted a suit (and made it lose face) or declined the offer payment of $100 million immediately and $120 million over eight years. [170] But such a threat was not really convincing,

[168] See Kosuke Takahashi, *Jet Fuel Scandal Deals China a body blow*, Asia Time, Dec 7, 2004. Kevin T. Jackson, *The China Aviation Oil Scandal*, 151, 160.
[169] Wayne Arnold, *After Crash, China Aviation Oil offers creditors sweeter repayment deal*, N.Y. Times, May 13, 2005.
[170] Wayne Arnold, *After Crash, China Aviation Oil Offers Creditors Sweeter Repayment Deal*, N.Y. Times, May

since shutting down the failed entity would cause an even larger image problem than a suit. In fact the payment was increased four moths later to roughly $275 million over five years. [171] The controller forwent more real money for a low profile process.

D. Case Study: CITIC Pacific Ltd. in Hong Kong

CITIC Pacific Ltd. is a Hong Kong based and listed steel-to-property conglomerate controlled by China's biggest state-owned investment company CITIC Group. The Beijing-based SOE CITIC Group held 29 percent of the shares in CITIC Pacific before October 20, 2008 when CITIC Pacific suddenly warned of that it had realized losses of 808 million HK$ ($104 million) on ill-timed currency transactions and would lose an additional crippling $1.9 billion if it were to mark the transactions to market at the end of 2008.

This earned a place in financial history as the largest loss ever for a Hong Kong-listed blue chip,[172] causing the stock price of the biggest Chinese firm in the Hong Kong capital market to plummet more than 50% on its first trading day after the announcement. The debt of the corporation lurched into junk bond status.

The losses began when the firm entered into foreign exchange contracts stemming from its enormous Australia iron ore mining project. Since equipments were purchased in Australian dollars (AUD), the company attempted to hedge the risks associated with the currency appreciation and committed itself to large purchases derivatives contracts. [173]

Though AUD nearly reached parity with the U.S. dollar(USD) in summer 2008, when the global financial crisis hit, prices of iron ore and other natural resources fell, so that the currencies of major producers went south and plummeted fast. Money fled emerging markets for the security of the greenback which had strengthened dramatically since the onset of the crisis. Counterparts who had long positions in

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13, 2005.

[171] Wayne Arnold, *After crash, China Aviation Oil Offers Creditors Sweeter Repayment Deal*, N.Y. Times, May 13, 2005.

[172] Chen Huiyin, Xu Ke and Wang Duan, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, 2008-10-31. Justine Lau and Xi Chen, *CITIC Pacific To Weed Out Non-Core Assets*, Financial Times, May 26, 2009.

[173] Keith Bradsher, *CITIC Pacific Could lose $2 billion from foreign exchange trading*, N.Y. Times, 2008/10/20.

AUD trading dumped them to close their positions. Thus during the record high currency volatility, the bungled attempt of CITIC Pacific turned out to be a huge loss crater, as under the agreement the company was compelled to purchase AUD at a price of 0.87 USD when it traded around 0.6 USD or even lower.

1. The Losses as a Result of Governance Failure: a lousy investment choice

By a close examination, we may find that such a debacle was not merely a result of bad luck.

First, the contracts were exotic products. Under the complex names “dual currency target redemption forward contracts”, they cap potential gains for the buyer but allow for unlimited losses. Specifically, the accumulator was constructed in such a way that in each transaction gains from a renewed slide are limited to the ratio of a weighted average strike price of 1 AUD to 0.87 USD. Further, each AUD target redemption forward contract may be knocked out after the buyer gets some gains. (As a later lengthy profit warning for its misadventure by the conglomerate put, “[Our counterparties’] obligation to deliver outstanding Australian dollar installments will automatically cease when [our] stipulated maximum profit is reached for that contract”). [174]

However, there was no similar knock-out feature for losses. [175] Instead, if the bet goes bad as the price of AUD falls, the buyer is obliged to keep absorbing double amount at the negotiated price at a continued loss in this one-way bet. [176]

Such an unbalanced arrangement is especially noteworthy in the respect that CITIC Pacific adopted it when AUD was soaring “in the middle of a steady, two-year ascent against the dollar (that finally ended in July)” [177] and “trading close to its 25-year high”, [178] a time the potential for a slump was obviously large.

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[174] Justine Lau and Tom Mitchell, *CITIC Pacific Faces $2bn in forex losses*, Financial Times, October 21, 2008.

[175] Chen Huiyin, Xu Ke and Wang Duan, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.

[176] Bob Chen and Theresa Tang, *CITIC Pacific Tied to Australian Dollar After Losses*, October 23, http://2008www.bloomberg.com/apps/news?pid=newsarchive&sid=a8EeDNgYH8.g.

[177] Tom Mitchell and Justine Lau, *CITIC Pacific scarred by currency bet*, Financial Times, Oct 22, 2008.

[178] Bob Chen and Theresa Tang, CITIC Pacific Tied to Australian Dollar After Losses, October 23, http://2008www.bloomberg.com/apps/news?pid=newsarchive&sid=a8EeDNgYH8.g.

The fact that the corporation failed to be advised on the virtually unconstrained downside risk of the transaction they were entering into and finally got stuck at the losing price surprised many analysts. [179] They bluntly put huge money at stake at wrong time for wrong target. After finding the contract's pricing model was complex and risks difficult to estimate, its CEO Larry Yung admitted that "the potential maximum exposure under these contracts was not evaluated correctly", maybe they simply could not.

Second, though ostensibly the owner of steel and infrastructure assets said it had placed the currency contracts to hedge against anticipated exchange rate changes that may hike costs, it played with a far too large bet. The contracts committed CITIC Pacific to buy AUD 9.44 billion ($6.3 billion), while its 2007 net income/revenues was only HK$10.8 billion ($1.4 billion) and HK$ 64.7 billion ($8.4 billion) in net assets. It was estimated that at the most AUD 1.6 billion were actually needed for its real modest exposure to AUD. Later when CITIC Group took up most of CITIC Pacific's leveraged forward contracts as yet unsettled onto its own books, it only left a small proportion with it to be used for ore business.[180]

In other words, the accumulation of appalling exposure was not really for the purpose of offsetting risks, fixing the cost of the mine expenditure, but the result of a hope for profit by betting on the foreign currency, or speculation. In fact, in that summer, numerous investors were lured to bet on the seemingly attractive AUD. The continent then was experiencing a commodities boom as the interest rate had been prompted to rise continually thanks to rising robust exports of energy and natural resources, particularly to China. [181] However, greed and gambling mentality cannot compensate for the lack of foreign exchange derivatives knowledge when the firm forwent buying less risky futures, stepped in a trap of structured investment products excessively complex for unwary players.

[179] Tina Wang, *CITIC Pacific Slammed By Poor Currency Bet*, Forbes, October 21, 2008.
[180] Vivian Wai-yin Kwok, *CITIC Pacific's $1.5 Billion Bailout: The Tarnish Remains*, Forbes 2008/11/13.
[181] Keith Bradsher, *CITIC Pacific could Lose $2 billion from foreign exchange trading*, N.Y. Times, October 20, 2008.

Third, after the event, the company said that the bets, made by the financial director Leslie Chang Li-hsien and overseen by the financial controller Chau Chi-yin, were unauthorized as the director neither follow hedging policy nor seek the chairman's approval before conducting transactions, while the controller failed to bring to the attention of the chairman of the unusual transactions.

Even if this attempt to pin the blame revealed the whole truth, the fact that someone could effectively conduct such huge transactions without getting all the necessary approval is already shocking and reflects weak internal control. But the reality appeared to be more obscure in the firm Yung kept a tight grip on. The two culpable turned in their resignations quickly over the losses from the misguided bet. However, the company did not accuse them of any misconduct. Later, it appeared that they didn't suffer from tattered reputations. For example, the former who was said to simply "omit to assess the downside risk" [182] later became the CEO of a Hong Kong-listed major property developer and alternative energy player in China. [183] It was rather unimaginable that ordinary executives, especially those two particular guys who do not have an imprudent fame, [184] would dare to make such unauthorized huge risky bets. Who pushed the grand gamble? Some Chinese media reports pointed a finger at Yung's daughter Frances, head of the finance department, and son Carl, both finally were demoted, pay cut and left the company.

2. Background: CITIC Pacific as a privileged SOE

CITIC Pacific is "supposed to be a jewel in China's overseas corporate crown, with a management pedigree that approaches royalty in communist China."[185] It is an especially privileged SOE that has more chance to be nurtured by the economic resources of the state.

[182] Tom Mitchell and Justine Lau, *CITIC Pacific scarred by currency bet*, Financial Times, Oct 22, 2008.
[183] See his profile in http://investing.businessweek.com/research/stocks/people/person.asp?personId=8097029&ticker=190:HK&previousCapId=9709409&previousTitle=CHINA%20EVERBRIGHT%20INTL%20LTD.
[184] Tom Mitchell and Justine Lau, *Former CITIC Pacific Chairman Larry Yung Was Never Master Of His Own Fate*, Financial Times, April 10, 2009.
[185] *CITIC Pacific Emerges badly scarred by its currency speculation*, Financial Times, Oct 22, 2008.

The “Chinese government conglomerate” [186] was initially established by the fund of the government and the management skills of one family. The family of Rong ran one of the biggest family firm groups in pre-communist China. After P.R. China turned to reform and opening up after 1978, the main member of the family Rong Yiren was picked up by the state to found the China International Trust & Investment Corporation (CITIC) Group, which was P.R. China's first and largest state-owned investment company and served as a model to pioneer reforms in the financial sector, lure foreign investment and technology and develop international business. As a major economic adviser and a symbol of red capitalist, Rong was even promoted to the honorary position of vice president of China from 1993-1998.

Larry Yung, scion of this storied family and son of the red tycoon, was dispatched to Hong Kong and helped build the local CITIC arm in 1990. He took in charge of its operation ever since and personally bought 19 per cent of the company shares by a very controversial personal approval from the chairman of CITIC Group, Wang Jun. Though Wang is the son of vice president of China Wang Zhen (who happened to be the predecessor of his old friend Rong on that position), he admitted such a bold action put him under tremendous pressure. But finally both “princelings” were fine, and Yung later was hailed by Forbes as China's richest person in 2005.

Financial Times thought that unlike most Hong Kong tycoons, Yung “served at the pleasure of the Chinese state”, [187] nevertheless in my eyes this is only a nominal relationship. Having “cultivated a deep relationship with the Communist Party leadership” [188], Yung owned a uniquely privileged position in the political economy of China, and was more influential than most SOE managers. The controlling shareholder somewhat suffers a bigger horizontal problem in this case. They may not be able to exert much influence on the Hong Kong-based subsidiary, but unsurprisingly when the arm encounters problems, the parent SOE is still bound to cover the losses.

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[186] Justine Lau and Tom Mitchell, *CITIC Pacific Faces $2bn in forex losses*, Financial Times, October 21, 2008.
[187] Tom Mitchell and Justine Lau, *Former CITIC Pacific Chairman Larry Yung Was Never Master Of His Own Fate*, Financial Times, April 10, 2009.
[188] Chen Huiyin, Xu Ke and Wang Duan, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.

Consistent with the prominent position of the company, other leaders of CITIC Pacific were also tycoons in this metropolis. For instance, Managing Director Henry Fan is a member of Hong Kong's Executive council (cabinet equivalent) and a director of HKEx. Hence the failure of directors to abide by the exchange rule of prompt disclosure was surprising, raising doubts that whether they dared to neglect such plain requirements partly because of the privileged position of the firm.

3. Bigger Governance Trouble Causing Legal Liability: Failure to timely disclose and Inside trading

It deserves attention that at that time numerous companies around the world posted losses on foreign-exchange hedge, such as in Brazil and Korea.[189] Such a disaster could at least be partly owed to bad luck. However, the problem in the CITIC Pacific is more than betting the wrong way, fraud and conscious illegal activities played a nontrivial role and were more blameful.

Shortly after the humiliating announcement, Yung stressed that an audit concluded that fraud or other illegal activities had not occurred. [190] Nevertheless, in the Oct. 20 announcement, CITIC Pacific admitted that it learned of the currency exposure on Sep. 7 though it had stated in a stock exchange filing on Sept. 12 which cited information current until Sept. 9 that its directors were "not aware of any *material adverse change in the financial or trading position* of the group".

Besides, notwithstanding the Sept. 12 circular, the company's shares fell 42 percent between Sept 7 and Oct 20 while in the same period the benchmark Hang Seng Index dropped 23 percent and the Australian dollar kept slipped the covering up, which may cost investors much wealth before they were finally aware of the hazards in their investment of CITIC Pacific stocks.

When explaining the delay, Managing director Fan stressed that they “were seeking to wind up those contracts once we learnt of the exposure on Sept 7, but the outbreak of the financial turmoil made it impossible to do it as the Australian dollar

[189] Bob Chen and Theresa Tang, CITIC Pacific Tied to Australian Dollar after Losses, October 23, 2008, http://2008www.bloomberg.com/apps/news?pid=newsarchive&sid=a8EeDNgYH8.g.
[190] Tina Wang, *CITIC Pacific Slammed By Poor Currency Bet*, Forbes, October 21, 2008.

was falling sharply",[191] and Fan said the company took legal advice over the timing of its disclosure. However, being unable to unload appeared to be a different issue from not informing investors. Hence Hong Kong's Department of Justice held the view that seeking financing without disclosing losses and keeping investors waiting six weeks before the informing of their losses constituted a defraud. But this problem has not been legally determined in the procedure aspect. [192] In March 2011 the Department won a High Court rule to access to records of legal advice the company received before disclosing the bets. But at least until December 2011, the police were still fighting to ask CITIC Pacific to turn over the privileged documents. A lawyer for the steelmaker and property developer argued that officers didn't comprehend the implications of currency exposure, so they failed to disclose earlier. In other words, the attorney placed an emphasis on the complexness of the contract which prevented the board deciding within two days that they are going to sustain huge losses. [193] Anyway, it is highly suspicious that the firm had adopted a proper or normal protocol to inform shareholders, and that is why Yung finally resigned.

Along with the delay in disclosure is the secret selling of shares by executives. For instance, in August 2011 the Securities and Futures Commission (SFC) of Hong Kong declared that it had commenced criminal proceedings against a former Assistant Director and deputy head of the Finance Department of CITIC Pacific, for insider dealing whilst in possession of price sensitive information about the profit warning and avoided losses.[194]

4. The Law of Hong Kong Matters?

A formal investigation from the Hong Kong SFC began soon after the company admitted the losses. In April 4, 2009 Hong Kong police force's commercial crime bureau raided the company's offices and removed documents for further investigation into alleged false statements and fraud. Later the company announced that the police

[191] *CITIC Pacific under investigation after currency loss,* China Daily, October 23, 2008.
[192] See CITIC Pacific Ltd. and Secretary of Justice, Commissioner of Police, CACV60/2011 in Hong Kong's Court of Appeal.
[193] Debra Mao, *CITIC Pacific Didn't Know Currency Exposure Impact,* Court Told, Business week, December 7,2011.
[194] Enforcement news of the Securities and Futures Commission (SFC) of Hong Kong on 25 August 2011, http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=11PR100.

"executed a search warrant requiring the company and its directors to provide certain information". [195] The police probe triggered "great impact in society" and forced prominent businessmen chairman Yung and his long serving ally Fan to face the harsh reality and step down ingloriously five days later for "the best interests of the company", even he had said he "haven't thought about retiring" in March 25 when the first-ever corporate annual loss was released.[196]

Here it was noted that it was not the shareholder pressure that cause Yung's departure, though CITIC Pacific shares had lost around half of value since October and its image badly damaged. It was the move of Hong Kong law enforcer indirectly brought the inglorious exit for the tycoon. Suddenly the strong public criticism in the Hong Kong markets which had long prompted public agencies to take actions realized its potential, compelling Yung to end his career in the company he built.

This may be a conspicuous victory of market discipline and law from the perspective of one in the mainland China, where SOE leaders are subject to less effective market and public pressure after huge losses. It is safe to say that were CITIC Pacific not oversea listed, Yung could remain in his office as long as he retained trust from high-level political leaders who would not be sensitive to pure market failures, and this seemed not to be difficult when taking into account his family background.

However, the climax appeared to be an end. When the Hong Kong securities regulator initially launched a probe into possible insider trading in October 2008, it was widely believed that the target was CITIC Pacific's two largest individual shareholders – one of whom Yung – who frequently raised their stakes before the losses occurred and suddenly stopped in early September.[197] The police also aimed at "false statements by company directors and/or conspiracy to defraud under the common law." [198]

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[195] Tom Mitchell and Justine Lau, *HK police raid CITIC Pacific in fraud probe*, Financial Times, April 4, 2009.

[196] Tom Mitchell and Justine Lau, *Former CITIC Pacific Chairman Larry Yung Was Never Master Of His Own Fate*, Financial Times, April 10, 2009. Tina Wang, *Inglorious Exit for Yung at CITIC Pacific*, Forbes, April 9, 2009.

[197] Chen Huiyin, Xu Ke and Wang Duan, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.

[198] Tom Mitchell and Justine Lau, *HK Police raid CITIC Pacific in fraud probe*, Financial Times, April 4, 2009.

Nevertheless, more than three and a half years after the event, it seems almost certain top guys could stay at large without being implicated in any personal criminal investigation. Taking into consideration of their positions in the political economy of China, a cynical person may think this is not very surprising and thought it casted shadow on the reputation of Hong Kong's image as a rule-of-law international financial center.

5. The Implication of the Case: What are the bigger problems for Chinese SOEs

(1) A wider financial problem in SOEs?

The venerable CITIC Pacific should not happen to be the only stupid to be burned. Rapid industrialization and an acute shortage of natural resources at home have turned the Middle Kingdom into a voracious acquirer of overseas mines. Because of its abundance of minerals and its welcoming attitude for foreign investments, Australia has appeared as a favorite destination for Chinese investors, particularly in the mining sector. [199]

Notwithstanding the great number of Chinese companies that expanded in Australia, they universally lack experience in managing the currency risks tied to their new international ventures, quite a few fund-abundant SOEs were lured into speculation. Due to the inherent loose internal control in the SOEs, the same banks which trapped CITIC Pacific probably sold the same products to other Chinese companies.[200] For example, two Hong Kong listed principal SOEs, China Steel Construction and China Railway Construction Corp. reported foreign exchange associated losses in the same moth. [201] The leading blue chips' losses deepened market concerns about the soundness of the Chinese financial system. [202]

Maybe because of the unparalleled volume involved, CITIC Pacific emerged as the eye-catching tip of the iceberg. SOEs are rich in money, ambitious but armed by

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[199] Keith Bradsher, *CITIC Pacific Could lose $2 Billion from Foreign exchange trading*, N.Y. Times, October 20, 2008.
[200] Keith Bradsher, *CITIC Pacific Could lose $2 billion from foreign exchange trading*.
[201] Chen Huiyin, Xu Ke and Wang Duan, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.
[202] Chen Huiyin et al, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.

clumsy skills of risk management. During the short period when the market looks promising, they will easily be tempted by the quick profit from speculation, recklessly gamble on their analyses of market trends without resorting to the cautious measures of hedging. And finally a big number of Chinese firms repeated the similar botched attempts, suffering multiplied losses as a result of high leverage and market volatility. [203] This is perhaps a result of the fact that to a great extent SOEs are playing with "other people's money", which could be illustrated by the fact that though wealthy private investors also lost money due to the Australian dollar depreciation, but apparently none were seriously hurt. For example, the Hong Kong developer Hutchison Whampoa Property traded simpler and safer future contracts to lock in forward risks for operations in need of foreign currencies. [204]

(2) A Bigger Governance Problem for CITIC Pacific in related areas

CITIC Pacific's bulged attempt in hedging foreign exchange risks is not isolated. The developer seemed to understand even less about mining than about finance. For example, it granted a construction contract along with a 20 per cent equity interest to China Metallurgical Group Corporation (MCC) - a SOE with experience neither in developed countries nor this specie of construction. MCC repeatedly lashed Australia's regulatory environment in avail, in particular for its failure of importing cheaper Chinese laborers. What is worse, the incompetent couple has been at feud with each other ever since the marriage.[205]

Why these behemoths bravely enlarge their presences oversea without adequate preparation was partly due to Beijing's official investment strategy of "going out" declared in 1999. Around 2007 when China's build-up of foreign exchange reserves began to break records, the money became easier to be squandered by the big actions of SOEs.[206] Leaders these flagships were excited about the opportunities to grow with the aid of the state, even though they were not so sure about investing efficiency. A typical swelling investment coffer like iron ore mines is easily transformed into a

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[203] Chen Huiyin et al, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.
[204] Chen Huiyin et al, *CITIC Pacific Stung by 'Cowboy' Investment*, Caijing Magazine, October 31, 2008.
[205] John Garnaut, *The Ties that bind us to China*, The Age (Melbourne), September 10, 2011.
[206] John Garnaut, *The Ties that bind us to China*, The Age (Melbourne), September 10, 2011.

fiscal black hole. The 2008 tragedy and replacement of its leadership is not the end of CITIC Pacific's Australian ore troubles, its stock price plunged again in 2011 after disclosing the development of the mine may cost 35 percent more than expected and also that would be delayed. [207] Ironically, this time the problem derived from the now-strong Australian dollar, which means the old costly foreign exchange arrangements it adopted did not do the job.[208]

Like 2008, in 2001 after serial travails CITIC Pacific anticipated that the local debt and equity markets would not be happy to source further capital to tide it over, again the parent SOE is the party it chose to selling assets to when an added infusion of cash was to be find. [209]

6. The Bailout by the parent company and a Recoup of control by the principal

On October 21, CITIC Pacific's shares fell 55 per cent to HK$6.52, causing the estimated forex losses to exceed its market capitalization. After the painful revelation of the dismaying collapse, Yung flew to Beijing, asking the CITIC Group for help. Though it was also facing a tough fiscal reality amid the global turmoil, the latter, "backed by China's cabinet" [210], soon pledged a $1.5 billion standby loan available to the affiliate for the bailout to be executed, intending to cover most of CITIC Pacific's losses.

Since other kinds of financing supports were tough to find in the market environment where CITIC Pacific was downgraded and posted "negative outlook", a significant bridge loans to provide flexibility and time from the parent SOE substantially stabilized its finance, strengthened its liquidity, made the share price surged and changed its destiny. Notably, CITIC Pacific stressed its connection to "Beijing" when disclosing its calamity to terrified investors. Though in the past, Yung liked to emphasize his personal role in the Hong Kong-based company.

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[207] Marco Lui, *CITIC Pacific shares plummet in HK*, China Daily, July 19, 2011.
[208] Peter Lee, *CITIC Pacific Hit by an Iron bullet, Asia Times*, July 23, 2011.
[209] Peter Lee, *CITIC Pacific Hit by an Iron bullet*, Asia Times, July 23, 2011.
[210] Debra Mao, *CITIC Pacific Didn't Know Currency Exposure Impact, Court Told*, Business Week, December 7,2011.

Later CITIC Group revised its loan facility plan to take up instead the $1.5 billion convertible bond issued from CITIC Pacific. Upon conversion, CITIC Group's shareholding in CITIC Pacific would increase to 57.6% from 29.4%, securing a controlling stake. [211] Unlike the restructure plan of CAO in which all the investors bear the loss to some extent, in this case, nearly all the money-losing contracts were absorbed by the deeper pocket of the parent SOE, though later the market moved toward a favorable direction for CITIC and mitigated the losses.

However, even after paying such a high price, CITIC Group did not unseat Yung until the latter resigned after the legal proceeding was initiated by Hong Kong police in the next year, demonstrating the manager-dominance in the SOEs, especially when the mangers own some personal influence. CITIC Group's inaction was not due to the relative unimportance of the Hong Kong arm, the successor of Yung for the chairman, Chang Zhenming, was a key player in the CITIC Group and famous for his capacity. He was vice chairman of CITIC Group and before that presided over one of the four biggest banks in China. The coming of such a mighty person indicated the desire of the parent SOE, after sacrificing a lot for the pricey mistakes not attributed to it, was determined to reduce the residual influence of Yung who retained 11.5% shares after the subscription and conversion of bonds. After taking the office, Chang stated that businesses that "we cannot actively participate in management" would be sold or restructured"[212] and emphasized the importance of better communication between headquarters and subsidiaries.[213]

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[211] Vivian Wai-yin Kwok, *CITIC Pacific's $1.5 Billion Bailout: The Tarnish Remains*, Forbes, November 13, 2008.
[212] Justine Lau and Xi Chen, *CITIC Pacific to Weed Out Non-Core Assets*, Financial Times, May 26, 2009.
[213] AFP, *Scandal-plagued CITIC Pacific books 2009 profit,* Mar 10, 2010, http://business.asiaone.com/Business/News/Story/A1Story20100310-203816.html.

V. Intertwined Perspectives Concerning Oversea Listed SOEs: State, Enterprise, foreign regulators and how they affect the governance

A. What advantages could and have been achieved by oversea listing

As I probed in Part 3B, there are economic, technical and governance advantages promised by oversea listing. Generally speaking, economic advantages like more proceeds are relatively easier to be achieved by the listing, especially major SOEs that often possessed good financial shapes and market prospects, sweeteners attractive in the eyes of international investors. Technical advantages such as accessible high-quality regulation are basic features of the listing mechanism, look like easy to be automatically obtained once the listing is done. Re governance advantages, things are complex. Formal benefits like international recognition seem to be warranted as long as the firm is not plagued by a scandal. Pre-listing substantive arrangements accomplished by the listing preparation also appears to be permanently imbedded by the firms' preparation activities, such as the establishment of board committees on internal control, audit, compensation, the separation of the chair and the CEO, etc.

But the ongoing monitoring and compliance merits of the oversea listing, which should be the most significant component from the governance perspective, turns to be the most vulnerable chain since its function requires sincere and continuous efforts from both the company and other market participants. The case studies above display that though it is the state which strives for the governance effect for SOEs by resorting to oversea listing, the state involvement in it, especially after something goes sour, will be negative for the realization of the governance goals. Let's go back to the episodes.

B. Common Features? Striking Similarities across the two Cases

Comparing the two eye-catching events transpiring in divergent places, it is noticeable that so many similarities were in existence and present fertile analytical ground. They may indentify some key features of the system, indicate system-specific vulnerabilities in the broader governance context.

1. Both were once star firms in the markets. Indeed, after the Titanic has been saved, they go on to be prestigious.

2. Both owned super market positions. The fatal mistakes of them lie in recklessly entering a new battlefield with the hope of speculation which turns out to be too complex for them.

3. If routine internal control and governance arrangements have got adequate respect as they have been designed, such huge calamities could well be avoided.

4. The failure of internal control and governance was due to unrestricted power of one or a handful of senior executives. Manager-dominance was severe. The boards and the parent companies were virtually rubber stamps.

5. When the losses were swelling, both chose to engage in illegal cover-ups until it was no longer possible. And these constituted the hard core of the scandals. This means smaller uncovered disgraces could have been in existence.

6. Parent SOEs were the first and primary aider they turned to. Due to significant amounts of money involved, the Chinese government was not out of the sight.

7. Both listing places are small economies and economically rely on China mainland to some extent. Both are famous for their rule-of-law and did take actions that may not happen in the China mainland. But it was arguable that they were somewhat lenient when imposing punishments on the offspring of the leviathan.

8. The parent firms paid a lot to smooth the unrest. Investors were basically content with the result. The reputations of the two international financial center seemed to be preserved.

These common characteristics display some persistent and inherent features with the governance of oversea listed SOEs and lay a base for our further discussion. For example, the denouement of the crises is highly suggestive of a strategy pursued by the Chinese authorities that would entail high cost rescue.

C. Implications of the State Ownership and control for oversea listing firms

Oversea listed SOEs are special. They operate in the form of business organizations and engage in commercial activities. Sometimes, they may look just the same as their peers from the private sector. When listed in an international exchange and with thousands of outside shareholders pour in, they may vigorously argue, especially in the transnational contexts, that they are public companies, and just happen to have a controlling shareholder whose name is the state.

These claims are not baseless, but the crucial behind-the-scenes players still breathe. By examining these cases, we may find that in a number of aspects the visible or invisible presence of the state ownership and control affects the governance of such firms in non-trivial ways:

1. A more Severe Agency Problem which may loose the Internal Control

An ownership structure with a state controlling shareholder is the source of severe agency problem. Chen of Sinopec in Beijing is a king in his domain, and Chen of CAO acts like the head of a dominion. The required understandings of the foreign commercial, legal and institutional environments far exceed the ability of bureaucrats, pushing the delegation of more de facto decision powers to younger, aggressive and commercial-minded, but also sometimes more reckless SOE executives. Besides, the superiors not only lack the capacity to rein in oversea managers and detect malfeasances, but passion to intervene. For instance, when Chen of CAO desperately looked for Jia for assistance, the latter was incommunicable because he was participating in a regular communist bureaucrat training session. Even in such an emergence, other executives of the parent company were unwilling to make decisions. [214] And it seemed that there is no clear guidance for emergency handling when the president was absent.

When front line managers fail to behave optimally, the problems of low efficiency and loose internal control in SOEs would be magnified. When the unrestricted management was mislead to imprudently partake in risky activities, the

[214] Mure Dickie, *Ex-CAO chief attacks CAOHC*, Financial Times, February 19, 2005, at 6.

whole system collapsed. But if the managers are "smart" enough or less ambitious to play with the corporate treasures, invisible though magnificent harm would escape public notices.

2. Implicit Bailout Guarantees from the Government which reduce the incentive for ex ante market monitoring

Oversea listed SOEs tend to be those bigger and more profitable ones whose governmental controllers attempt to employ the extraterritorial listing as a method to enhance market discipline for them and beautify the images of the whole corporation group. But the higher visibility brought by this action makes their controller: the government even more vulnerable to the failure of such firms to some extent.

The Chinese government has tried for years to emphasize that SOEs are unrelated with one other, it explicitly stipulates in the Article 217 of revised Company Law that "the enterprises controlled by the state do not incur a connection relationship simply because their shares are controlled by the state".[215] However, the inherent impulse to treat SOEs as arms of the government is revealed at critical times. The state's attempts to salvage the SOEs without denying its concern about the image of SOEs as a whole brought economic effects which offset its earlier legal efforts. This pushes international investors to view SOEs as not really separated from the state, and SOEs become big enough, though perhaps not "too big", not to fail.

This is a little ironical, since the fallout can be greatly attributed to insufficient de facto control from the parent company and the government, but as long as the latter keeps the nominal control, they will feel obligated to take account for its bailout, maintaining the formal dignity of an empire whose territory is being eroded by autonomous managers from time to time. Though the oversea subsidiary has been so untamed and made the government incur considerate inconvenience and cost, the latter still regards itself (and is regarded by international investors, in a mutual reinforcing way) as the one holds the accountability and would not simply get rid of the trouble-making former.

[215] An English version of P.R. China Company Law [Gong Si Fa] (2005) is available at http://www.lawinfochina.com/display.aspx?lib=law&id=4685.

This makes the bailout a logical result. On one hand, such a fiasco would be a high profile event which humiliates the giant parent SOE and the ultimate governmental controller. On the other, well, the controller has access to sufficient funds to save these companies from the debacles and could achieve its goal of buying the face. As a matter of fact, the habitual way of the Chinese authorities to deal with scandals is assuming the responsibility in a less spectacular way (silently paying the money) coupled with openly denying the responsibility. For instance, in CAO case, the government described the episode as a speculation excess, deflects the public attention away from the fraud and inside trading. [216] The wrong was attributed to individuals instead of an organization fault, while the big "organization" of the Chinese authorities helped bear the heavy burden of financially recovering from the meltdown.

As the Chinese government did not hide this behavior model and allow such a prospect to form in the mind of the oversea market participants, international investors would get a stronger reason to be less cautious about the governance of such enterprises. Anyway, these are privileged major firms supported by a mighty entity and constantly afford satisfying performances (This partly explains why the years-long corruption activities of the head of Sinopec continued without being noticed by the market). Many people seem to hold the view that when the government brings their SOE companies to the market, they have made a quasi insurance that could provide investors with some measure of ex post protection, especially in the international market where the "national image" is involved. This may be based on the thoughts that the government, as a repeated player with more at stake, should be more concerned with their reputation than a private player. And the Chinese government appears to be willing to buy this story.

Thus with an expectation of bailout, why bother to worry about the firm operation too much? As investors are content with the promise of bailout for risky investing target, moral hazards appear, they stop short of requiring continuous governance

[216] Curtis J. Milhaupt & Katharina Pistor, Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World, 133.

compliance. Exceptions for the uniform rule and slacks are allowed, passivity would be a reasonable choice. In short, an implicit guarantee of SOEs by the state would ex ante reduce the incentives and effectiveness of market monitoring.

3. A Loose ex post Market Discipline which Fails to Punish the Wrongdoers

In conjunction with the above observation but from an ex post viewpoint, bailouts by the state run counter to the original purpose of oversea listing: to exert more discipline on SOEs and save money for their true owners: the Chinese people. But now, ambigous and loose standards of bailout make the enterprises potential fiscal black holes.

For example, during the restructure of CAO, the parent firm provided creditors with "a sweetened repayment deal" in order to fend off litigation efforts of ousting its Beijing-appointed managers. [217] "Successful" face-saving results also would alleviate the Chinese government's motivation to start the painful but more fundamental long run reforms in the area of SOE. Anyway, there is agency cost for the bureaucrats too, they would like to treat a disaster as a fluke and feel comfortable for not going a step further in structural breakthrough attempts. The similar but larger disaster in CITIC Pacific partly reflects how little lesson SOEs and Beijing SOE supervision bureaucrats have drawn from their failed counterparts like CAO.

In short, the seemingly noble justification of "protecting international investors" may work at the expense of the ultimate investors of SOEs in their homeland, the basic efficiency of the market discipline, enlarging the potential moral risk and leading to more debacles.

4. An Inactive Oversea Regulator

The involvement of the state controller of these firms may impact the behaviors of oversea regulators too. In the normal environment of handling private-owned companies, a sensible regulator will try hard to punish the non-compliance, irregularity and conduct on-going checks since such behaviors also serve the interest of the regulator. But major foreign SOEs are different big animals. They may have

[217] Wayne Arnold, *After crash, China Aviation Oil Offers Creditors Sweeter Repayment Deal*, N.Y. Times, May 13, 2005.

satisfying performance which is not the result of book-cooking and let the regulator relax. A multitude of inconvenient signals and red flags could go undiscovered when times are good. As the problems pop out, the regulators may be reluctant to act against them as normally required by the law.

First, they may reasonably take into consideration the long term economic interest of that jurisdiction and not to irritate the formidable entity behind liable firms. Second, since there is a possibility that someone will pay for the losses sufficiently, why need they to insist the “formal justice”? This problem may be particularly acute in the environments where the primary way of legal enforcement is regulator-dominated and where the jurisdiction is tiny, depending heavily on the import of external economic resources. Unsurprisingly, such places also gradually become the favorite destination of oversea listed SOEs.

What’s more, when the sword of oversea securities regulators is no longer that horrible, the expected value of a enhance deterrence effect by such a listing dissipates. After all, SOE managers are not without legal restraints in a domestic exchange, all the efforts and costs devoted into the pricey process of oversea listing aim for increased discipline. Hence a discount of the might of the stick is not desirable from a social perspective.

In other words, if the “wealthy” Chinese government makes do with such a compensating model of problem solving, the benefits of oversea listing would be diluted. The mechanism could still be useful for corporations in principle, but not as useful in the case of major SOEs as their counterparties in the private sector, since the relationships between controller, companies, regulators and investors are somewhat distorted.

D. Public Governance is the Key to Improve the Governance of Oversea listed SOEs

Liberal economics are taking SOEs and state capitalism more serious now. But the basic and long-established legal doctrines have not been fundamentally shaken and remained their mainstream positions, especially in the financial centers. It is not impossible for SOEs, which are built on non-market and non-rule-of-law style of operation, to behave and be treated like a typical business entity.

During the restructure, CAOHC attempted to argue that as an organ of the Chinese government, Singapore's courts had no jurisdiction over it. However, Singapore's High Court rejected the claim of legal immunity.[218] Though this was done more for the consideration of protecting Singaporean investors, the same logic could exempt the Chinese state legal and even moral responsibility for the salvage. In fact, one renowned Singaporean businessman who became the new chair of CAO admitted that if one firm acts exactly like a commercial players, other market participants would well understand and stop short of asking for financial supprots from the government. But if it does not or the government voluntarily gives up the shield of separation, any sensible and profit-seeker would not forgo the opportunity. (Similarly, international investors, more interested in profit rather than mere market-oriented behaviors, would welcome subsidies got by SOEs, regardless of negatives effects imposed on their competitors and the market. In fact, many SOEs getting abundant subsidies are oversea-listed. And sometimes the government may even be incentivized to subsidize them so as to maintain “a good international robustness/image for Chinese companies”.)

Surely, doing things like an ordinary corporation is easier said than done. Such a requirement would go beyond things like conducting arm’s length transactions and robust internal control, more structural reforms may be demanded. In 2005, China National Offshore Oil Corporation (CNOOC)’s bid for the acquisition of American oil firm Unocal unexpectedly set off a storm of congressional criticism, many Chinese were outraged for the claim that this was a government attempt. Frankly speaking, it was a little too sensitive for the American to view this as a thinly disguised takeover by the Chinese government. But the bigger picture is that CNOOC was under firm control of the government to such an extent that just two years prior to the bid its then

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[218] Wayne Arnold, *After Crash, China Aviation Oil Offers Creditors sweeter repayment deal*, N.Y. Times, May 13, 2005.

president was suddenly relocated by the government to a governor post. Such capriciousness is what Westerners are unfamiliar with and it is understandable that they grip the Chinese state when assuming a control and/or responsibility is beneficial for them.

Thus the fundamental solution to the corporate governance of SOEs lies in public governance. The hybrid status between the government arm and the enterprise is not stable, either should be chosen. A fundamental solution to the governance troubles revealed by this paper lies in the reorientation of the Chinese government itself. Only when the authorities evolve more to the direction of a neutral government, the external market mechanisms could be realize its full potential without the efficiency of oversea law and regulation being undermined.

Some dramatic measures may be advanced. Despite the trend that the role of the state in the world's second-largest economy has steadily expanded, a February 2012 economic report on China prepared by the World Bank and government insiders considered to have the ear of the nation's leaders, the prescriptions for saving China from an economic crisis include scaling back its vast SOEs and commercialize their operation. Being overseen by asset-management firms is a suggestion. [219] Such restructure would aim at reducing the government's concern with the performance and destiny of specific SOEs and let the state become more detached.

A mature stock market could judge stocks separately and individually, with a less synchronicity, a healthy SOEs system also should strive to not worry about the implication of the fiasco of one particular member. This not merely means that the P.R. China leviathan could be tamed to give due respect to international financial centers, this promises healthier oversea listed Chinese enterprises and a more stable global market.

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[219] Bob Davis, *New Push for Reform in China*, Wall Street Journal, February 23, 2012. The whole report is available at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/02/28/000356161_20120228001303/Rendered/PDF/671790WP0P127500China020300complete.pdf.

VI. Conclusion: the Role of the State determines the governance functions of oversea listing

P.R. China's state-owned sector is at the crossroads. Despite a general trend in its capital market is that regulators and investors alike are paying more attention to the fundamentals of corporate governance, [220] breakthroughs will never be easily obtained. The balance is determined by the still powerful state, whose interest does not always coincide with the market or the people. The state intentionally applies most advanced market institutions including oversea listing to achieve tremendous accomplishments in the progress of the market and law, but the flaws of remaining heavy state involvements have also been exposed in this process, sometimes very acutely.

The attempt of oversea listing is an effort of reform made possible by the state which pushes China towards a market end. As a strong monitoring and enforcement mechanism, it may work effectively in many aspects that alternative ways of corporate governance may not be efficient, making SOE managers more cautious and law-abiding. It also represents a signal of embracing the outside rule and order. Even the choice of ceasing to list SOEs on the toughest U.S. exchanges may still be overall of positive effects.

However, it fails to be a marvelous antidote. It helps reduce the incidence and severity of the problems, but far from eliminating them. Nontrivial problems arise in the application of such an approach. Improper government acts not only may constrain the function of oversea listing, but bring about negative effects (like bailout). These reflect structural elements that cannot be cured simply by more sincere efforts on the current tracks.

The work of this paper is more descriptive rather than conclusive. It shows both the bright and dark sides. Due to their characteristics, I choose to depict the strengths theoretically while try to link the weakness with concrete disgraceful events, but this

[220] Benjamin L. Liebman and Curtis J. Milhaupt, *Reputational Sanctions In China's Securities Market*, 108 COLUM. L. REV. 929, 956 (2008).

by no means implies that the merits of oversea listing are superficial or abstract. The oversea listing itself is not related to the governance disasters. To the contrary, the strict disclosure requirements in the oversea listing places, for instance, assists reveal the underlying crises more efficiently. Otherwise, CAO and CITIC Pacific would be willing to keep the skeleton in the cupboard for even longer times. Here I just want to highlight that though oversea listing sounds really good, it can not cure all the ills, endeavors of greater magnitude are needed. Otherwise, influenced by the large elephant[221], oversea listing may even occasionally work counteractively, like the handling of the two major SOEs has showed, higher visibility achieved by oversea listing may exemplify the already distorted government incentives to bailout and set in motion some negative consequences in the listing place.

[221] This metaphor refers to the state, Mark J. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE, 2003 used it to mean political environment, "its effect hardly ever analyzed, but it can deeply affect the shape, structure, and governance institutions", p.v.