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31 March 2008

Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China

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Abstract:
We examine the wealth effects of three regulatory changes designed to improve minority-shareholder protection in the Chinese stock markets. Using the value of a firm's related-party transactions as an inverse proxy for the quality of corporate governance, we find that firms with weaker governance experienced significantly larger abnormal returns around announcements of the new regulations than did firms with stronger governance. This evidence indicates that securities-market regulation can be effective in protecting minority shareholders from expropriation in a country with weak judicial enforcement. We also find that firms with strong ties to the government did not benefit from the new regulations, suggesting that minority shareholders did not expect regulators to enforce the new rules on firms where block holders have strong political connections.

JEL classification: G32; G34; G38

Keywords: China, convergence, enforcement, expropriation; political connections, investor protection, minority shareholder, regulation, tunneling.

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This Draft: March 31, 2008

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1. Introduction

Recent studies of corporate ownership around the world have found that diffuse

ownership is relatively uncommon and most corporations are controlled by large block holders.[1]

Consequently, the primary concern of corporate governance has broadened from mitigating the

agency conflicts between firm managers and diffuse shareholders (Berle and Means (1932);

Jensen and Meckling (1976)) to protecting minority shareholders from expropriation by a

controlling block holder and her management team (Shleifer and Vishny (1997)).[2]

In discussing needed governance reforms, La Porta *et* al. (2000) suggest that countries

change the "rules and enforcement mechanisms" for protecting investors "towards some

successful standard,"—a process they refer to as "legal convergence." [3] La Porta *et al*. (2002)

support this guidance by demonstrating that firms in countries with better investor protection are

more valuable than firms in countries with poorer investor protection.

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[1] La Porta *et al*. (1998) examine ownership of the ten largest firms in 49 countries; La Porta,
Lopez-de-Silanes and Shleifer (1999) examine ownership of the twenty largest firms in 27
wealthy countries; Claessens, Djankov and Lang (2002) examine ownership of firms in nine East
Asian countries; and Faccio and Lang (2002) examine ownership of corporations in thirteen
Western European countries. Holderness (2008) documents that large block holders also are
prevalent among U.S. listed firms.

[2] Johnson *et al*. (2000) refer to such expropriation as *tunneling*, which they define as "the transfer
of resources out of a company to its controlling shareholder (who is typically also a top
manager)." They discuss various forms of tunneling, as well as circumstances under which it is
legal in some civil-law countries. A number of studies, including Bertrand, Mehta and
Mullainathan (2002), Bae, Kang and Kim (2002) and Joh (2003), analyze how tunneling affects
firm value. Djankov and Murrell (2002) and Denis and McConnell (2003) provide surveys of
the literature on international corporate governance.

[3] See La Porta *et al*. (2000), p.20. Also, see Coffee (1999) and Gilson (2000) for a discussion of
the distinction between formal (what La Porta *et al*. refer to as legal) and functional convergence.

In this study, we examine the market reactions to three examples of "legal convergence" that occurred in China when the government's Chinese Securities Regulatory Commission ("CSRC") introduced new regulations aimed at reducing expropriation from minority shareholders by controlling block holders. The three regulations were all introduced in the second quarter of 2000 and were partly motivated by China's successful attempt to gain entrance into the World Trade Organization. The first new regulation substantially increased the rights of minority shareholders at a firm's Annual Shareholders' Meeting. Most importantly, the new regulation prohibited shareholders involved in related party trading from voting on the related party trading. The second regulation prohibited the issuance of loan guarantees by a firm to its controlling shareholder, and the third regulation improved the transparency and regulation of asset transfers to related parties.[4]

This is the first study of which we are aware that uses standard event-study methodology to analyse the link between investor protection and firm value, thereby reducing potential endogeneity problems inherent in the use of cross-sectional regressions. The causality between shareholder protection and firm value is clear: value changes, if any, are the result of the market's assessment that corporate governance has improved, reducing expected future expropriation of minority shareholders.

The prediction that share prices increase around the introduction of the new regulations assumes that the new regulations will be enforced by the regulator. This is consistent with the theoretical model of Glaeser, Johnson and Shleifer (2001), which predicts that, in emerging

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[4] The regulatory changes reflect the commitment of the Chinese government to improve corporate governance. The World Bank (2002, p. 102) concludes that "corporate governance has moved to the center stage of enterprise reform in China," and (p. 1) that many of the requirements for listed companies are "even stricter than in Hong Kong and other developed markets…and show the authorities' determination to protect minority shareholders."

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markets with relatively weak legal systems, regulators can provide an effective substitute for ineffective judicial enforcement. An alternative view, particularly relevant for China, is that the new regulations will not be enforced or will be enforced selectively, favouring companies with strong links to the government. Because the government, directly or indirectly, controlled the majority of listed firms in China during the period under study, minority shareholders might be sceptical about the effectiveness of the new regulations. If this is the case, we expect to see no or only a weak price reaction around the introduction of the new regulations, especially for firms most closely linked to the Chinese government (See Bhattacharya and Daouk (2002)).

The first part of our empirical analysis provides evidence of a ten-percent positive share market reaction around the introduction of the first regulation. This finding offers support for the model of La Porta *et al*. (2002, p.1168), which predicts that "poor shareholder protection is penalized with lower valuations." The market-wide price reactions around the second and third events are also positive but statistically insignificant. We discuss several reasons why our tests of market-wide price reactions might have limited power to test the impact of the regulatory events. The most important reason is that the regulations might have benefited only specific subsets of firms—for example, firms with the weakest governance or firms with the weakest ties to the government.

Consequently, we focus on cross-sectional models in the remainder of our analysis, utilizing the expected differential reactions to the regulations by different subsets of firms. More specifically, we test the hypothesis that effective regulation will result in larger value increases for minority shareholders of firms that are more likely to be subject to expropriation by controlling block holders.

In our first set of cross-sectional tests, we use the total value of all potentially damaging related-party transactions occurring during the year before the regulations were introduced as a proxy for the degree of expropriation from minority shareholders.[5] Around all three events, we find that minority shareholders in firms with higher total values of related-party transactions experienced significantly larger abnormal returns than minority shareholders in firms with lower or zero total value of related-party transactions. This is strong evidence that investors perceived the regulations as effective.

We also find that, for the group of firms with the most direct ties to the Chinese government, abnormal returns are unrelated to the value of related party transactions. This latter result suggests that investors were sceptical that the CSRC—a State-controlled regulator—would enforce the new regulations at firms with close ties to the government.

Our second set of cross-sectional tests analyse the relation between abnormal returns and less direct measures of expropriation by the controlling block holder, such as the cash-flow rights and identity of the controlling block holder, the presence of foreign shareholders, and the total shareholding of non-controlling block holders. Our results consistently show that minority shareholders of firms with weak corporate governance benefit disproportionately from the new regulations in the form of higher abnormal returns. This finding is consistent with the argument in Klapper and Love (2003) that shareholders of firms with weak governance are more reliant upon legal and regulatory protection from expropriation by controlling block holders. Moreover, consistent with the notion that regulators selectively enforce the new regulations, we find that minority shareholders in firms with private controlling block holders enjoy the largest value increases around the announcement of the new regulations.

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[5] Related-party transactions include transactions between the listed company and either its large

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We contribute to the literature in at least five ways. First, we contribute to the literature on regulation as a substitute for judicial enforcement (La Porta *et al.* (2000); Glaeser, Johnson and Shleifer (2001); Klapper and Love (2003); Bushee and Leuz (2005)). Using robust event-study methodology, we find significant positive abnormal returns accrue to firms with weak governance as proxied by the value of related-party transactions and a variety of less direct measures. We interpret these results as evidence that securities-market regulation can be effective in protecting minority shareholders from expropriation in a country with weak judicial enforcement

Second, we contribute to the literature on "tunneling" (Johnson *et al.* (2000)) that analyses related-party transactions between listed firms and their controlling block holders (Cheung *et al.* (2007); Cheung, Rau and Stouraitis (2006); La Porta, Lopez-de-Silanes and Zamarripa (2003)). We use the value of related-party transactions to calculate our proxy for the degree of expropriation by controlling block holders and provide evidence that regulations designed to protect minority shareholders disproportionately benefited firms with higher values of related-party transactions.

Third, we contribute to the literature on the importance of political connections (Fisman (2001); Johnson and Mitton (2003); Faccio, Masulis and McConnell (2006); Fan, Wong and Zhang (2007); Cheung *et al.* (2007)). We provide new evidence that, in a country with a weak judicial system, such as China, investors are sceptical that regulators will undertake actions that might harm controlling block holders with strong political connections. Specifically, we find that announcements of regulations designed to protect minority shareholders from expropriation by controlling block holders led to greater increases in value at firms with private block holders than

shareholders or entities controlled by those shareholders.

at firms with government block holders, with market-oriented SOE block holders falling in between. This result is consistent with the theoretical model in Glaeser, Johnson and Shleifer (2001) that, even though regulators are motivated to enforce regulations because their careers and budgets depend on finding violators, they are, on the other hand, likely to reach politically desirable decisions.

Fourth, we contribute to the literature on *why* State-owned firms perform poorly. The "political view" posits that politicians interfere and pursue political objectives other than profit maximization (Shleifer and Vishny, 1994), whereas the "managerial view" posits that States are poor monitors because there is no individual with strong incentive nor is there a public price to provide information (Laffont and Tirole, 1993). Here, we find that the Chinese government moved to improve corporate governance by strengthening regulations to protect minority investors and that these actions led to share price increases at firms with poor governance, but not at those with strong government ties in the form of direct State ownership. This is consistent with the political view that managers of State firms pursue political and/or personal objectives at the expense of minority shareholders, with complicit assistance of government regulators.[6]

Finally, we contribute to the growing body of work on corporate governance in China (Sun and Tong (2003); Cull and Xu (2005); Allen, Qian and Qian (2005); Wei, Xie and Zhang (2005); Fan, Wong and Zhang (2005, 2007))—especially the group of studies that have abandoned the "official" ownership scheme, which classifies owners of non-tradable shares primarily into two categories—*State Shares* and *Legal-Person Shares*—in favour of

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[6] Other studies that analyse how State ownership affects the performance of partially privatized firms are Kole and Mulherin (1997); Sun and Tong (2003); Boubakri, Cosset and Guedhami (2005a); D'Souza, Megginson and Nash (2005); and Gupta (2005).

classifications based upon the identity of the ultimate owner (Firth, Fung and Rui (2006);

Berkman, Cole and Fu (2007, 2008)).

In the remainder of the article, we proceed as follows. Section 2 describes some of the

salient institutional details of the Chinese share markets, while Section 3 describes each of the

three regulatory changes designed to improve the protection of minority shareholders. In Section

4, we describe our data and methodology and develop our hypotheses. In Section 5, we present

our results, which are followed by a summary and conclusions in Section 6.

2. Institutional Details of the Chinese Share Markets

During the 1990s, the Chinese government corporatized and partially privatized almost a

thousand State-owned enterprises (SOEs) through share-issuance privatizations on the two

primary Chinese stock exchanges—the Shanghai Stock Exchange (SHSE) and the Shenzhen

Stock Exchange (SZSE). The corporatization and share-issuance privatization of large SOEs

were central elements of the Chinese strategy towards creation of a "modern-enterprise system."[7]

In China, there are two official types of controlling block holders: holders of *State* shares

and holders of *Legal-Person* shares.[8] *State* shares are those held by government agencies (e.g.,

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[7] Jones *et al*. (1999) coin the term "share-issuance privatizations." Sun and Tong (2003) evaluate
the changes in financial performance of Chinese firms following their share-issuance
privatizations.

[8] This distinction between *State* shares and *Legal-Person* emanates from a 1994 regulation
dealing with restructuring of SOEs. Article 8 of the Regulation for State-owned Shares in Stock
Corporations, which was announced on November 3, 1994 by the State Reform Commission for
Economic Restructuring and the State Assets Management Bureau, sets forth how contribution
of State assets to a stock corporation are to be classified. If a stock corporation is created out of
the assets of existing SOEs and the percentage of the stock corporation's assets accounted for by
contributed State assets is less than 50 then the assets are classified as State-owned *Legal-
Person* shares; if greater than 50 then the assets are classified as *State* shares. If a subsidiary of
an SOE is restructured as a stock company, then all of the assets should be classified as State-
owned *Legal Person*. If an entire SOE is restructured into a stock corporation, then all of the

the Bureau of State Property Management and local finance bureaus) and by some types of

corporatized SOEs. For most listed companies, *State* shares make up the largest percentage

ownership of any classification. *Legal-Person* (LP) shares are those owned by domestic

corporations or other non-individual legal persons. Hence, this category includes shares held by

the government through legal-person entities as well as shares held by private entities, both

domestic and foreign. Like *State* shares, *Legal-Person* shares cannot be traded on the two

exchanges or transferred to foreign investors, but can be transferred to domestic corporations,

when approved by the CSRC.[9]

Individuals and domestic corporations are allowed to hold *Tradable-A* shares. *Tradable-A*

shares are the only type of equity that can be publicly traded among domestic investors. In this

study, the market price of a listed company refers to the price of *Tradable-A* shares, and the

prices of such shares are used to measure the valuation effects of the regulations aimed at

improving the protection of minority shareholders.[10]

There are serious shortcomings in the official share classification for any analysis of

corporate governance of listed firms in China. To illustrate the confusion, we refer to Table 5 in

Delios *et al*. (2006), where the authors report the overlap between their 17 (ultimate) ownership

categories and the official Share Classification. For example, of the 556 times a State Asset

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assets should be classified as *State* share. If the stock corporation is newly set up, then assets
from the government should be classified as *State* shares and assets from SOEs or their
subsidiaries should be classified as State-owned *Legal-Person* shares.
[9] Berkman, Cole and Fu (2007) examine changes in market values and accounting returns for a
sample of publicly traded Chinese firms around announcements of block-share transfers among
government agencies, market-oriented State-owned enterprises and private investors.
[10] In addition to domestic shares, some firms have issued *foreign shares* (B-, H- and N-shares).
B-shares are available to foreign investors and are traded on the two domestic exchanges,
whereas H- and N-shares have an overseas listing. The governance structure for firms with an
overseas listing is more restrictive, and we exclude firms with H- or N-shares from our later tests
(see Xu and Wang, 1999).

Management Bureau (SAMB) was classified as a top-10 shareholder in a listed firm in their sample, the SAMB was officially classified as holder of State shares 105 times (19 percent), as a Legal Person shareholder 221 times (40 percent), and in 230 cases the SAMB was classified as *Tradable-A* shareholder or "Other". Similarly, private corporations were officially classified as holders of *State* shares in 7.4 percent of the cases, as holder of *Legal-Person* shares in 59.8 percent of the cases, and as holder of *Tradable-A* shares or "Other" in 32.8 percent of the cases.

Because of these ambiguities, we adopt the classification scheme of Chinese ownership developed by the National University of Singapore ("NUS") Business School and described in Delios *et al*. (2006). The NUS-classification produces 17 detailed classes of non-tradable shares, which we regroup in three groups of ultimate owners. The groups are as follows (where we refer to the Delios *et al*. (2006) detailed classifications in parentheses). *State Bureaucrats* includes: central government (1); local governments (2); government ministries (3); government bureaus (4); State asset-investment bureaus (6); State asset-management bureaus (7); State research institutes (10); and State-owned banks (16). The group *Market-Oriented SOEs* includes companies that formerly were government ministries (5); market-oriented state-owned enterprises (9) and infrastructure construction companies (8). The *Private Entities* classification includes security companies (11); investment funds (12); private companies (13); private individuals (14); foreign companies and individuals (15); and work unions (17).[11]

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[11] In order to sharpen the distinction between the three main ownership groups—*State Bureaucrats*, *Market Oriented SOEs* and *Private Entities*—we have repeated all tests excluding firms where the controlling block holder belongs to one of the following categories: companies that formerly were government ministries (NUS category 5); State research institutes (NUS category 10); foreign companies and individuals (15); State-owned banks (NUS category 16) and work unions (NUS category 17). Our results are robust to exclusion of these 63 firms from our sample.

Regulators typically required that *Tradable-A* shares account for more than 25% of total outstanding shares when a company went public. Until July 1999, individuals were prohibited from holding more than 0.5% of total shares outstanding for any listed company; subsequently, the legal maximum for individual shareholders was increased to 5.0%. The legal maximum for individual shareholdings and the absence of cumulative voting procedures significantly enhance the control rights of a firm's largest shareholder. The World Bank (2002, p. xiii), concluded that, in China, ". . . large shareholders often overstep the bounds of shareholder meetings and boards of directors and exercise direct effective control."

3. Regulations to Improve Minority Shareholder Protection

Minority-shareholder rights are poorly protected in China. Based on the index of investor protection developed by La Porta *et al*. (1999), MacNeil (2002) calculates an index score of two for China compared with a world average of three and a maximum of six. MacNeil also states that, in drafting the Company and Securities Law in China, lawmakers were primarily concerned with protecting State control over listed firms. Furthermore, courts in China have a long tradition of protecting State interests and have very little experience with private plaintiff-driven litigation. Clarke (2003, p. 504) writes "if corporate governance reform is understood to mean inserting appropriate private rights of action into the Company Law, it is unlikely to lead anywhere very soon."

The CSRC is designated as the regulator for securities activities. The CSRC has wide-ranging powers in respect of authorization, rule-making, investigation and enforcement of all aspects of the securities markets (see Zhu (2000)). The regulatory changes that we study were the first substantial improvement in minority-shareholder protection implemented by the CSRC, and

suggest an increased willingness by the Chinese leadership to subordinate the interests of controlling block holders (usually the State) to the interests of other shareholders (MacNeil (2002) and World Bank (2002)). Consistent with the argument in Glaeser, Johnson and Shleifer (2001), we expect that the regulation and enforcement by a specialized and relatively efficient regulator is an effective substitute for judicial enforcement.[12]

The three regulatory changes we study were announced within a two-month period during early 2000. We briefly review each regulation in this section and refer the reader to Appendix I for a more detailed description of each.

The first event is the introduction of a regulation that substantially increased the voting rights of minority shareholders at shareholder meetings. Among other things, this new regulation: prohibited shareholders involved in related party trading from voting at the shareholding meetings on the related party trading, empowered small shareholders to propose motions at a firm's shareholders Annual Meeting; required that candidates for directors be voted on individually rather than as a group; and granted new legal standing in Chinese courts to shareholders disputing procedures used or resolutions passed at a firm's Annual Meeting.

The second and third events that we study reduced the ability of controlling shareholders to expropriate minority shareholders in more direct manners. The second regulation prohibited a listed firm from issuing a loan guarantee to its controlling shareholder or related party. The third regulation greatly improved the transparency and regulation of asset transfers to related parties.

The following sections examine the effects of the introduction of the new regulations on the value of *Tradable-A* shares in the Chinese share markets.

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[12] Chen *et al.* (2005) argue that the CSRC is not a "toothless tiger." They show enforcement actions by the CSRC result in negative stock returns, more frequent auditor changes and more frequent CEO dismissal.

4. Methodology and Data

We use standard event-study methodology to analyse the link between investor protection and firm value. In addition to reducing potential endogeneity problems inherent in the use of cross-sectional regressions that relate investor protection to firm value, event studies analyze the change in value for the same sample of firms before and after the changes in the regulatory environment. As a result, we do not need to control for firm heterogeneity. A disadvantage of our approach is that market participants might anticipate the regulatory changes, in which case our results provide only a partial estimate of the value changes resulting from improving corporate governance.

4.1. Market-Wide Cumulative Abnormal Returns

To test the overall market impact of the new regulations, we form an equally weighted portfolio of all 887 sample firms (see below) and analyse the cumulative abnormal returns around the event. Our event window is taken from one day before the CSRC release of the new regulations until one day after the regulation was first published in the newspaper (Appendix I lists the exact dates for each event). We choose this definition of the event period, which results in relatively long event windows, based on our observation that share prices react around both the initial CSRC release day and the subsequent newspaper announcement. We conjecture that the prolonged reaction is the result of the initial release to a limited number of market participants including the securities regulatory offices, the stock exchanges, and the listed companies. The restricted release makes it likely that many, if not most, minority shareholders receive the information only after publication in the newspapers.

We estimate two models to test the market-wide price reaction to the regulatory changes. First, we estimate the cumulative mean-adjusted returns around each event using the following model:

$$Market\ Return_t = \beta_0 + \Sigma \beta_J\ Event\ J + \varepsilon_t, \quad J = 1\ to\ 3 \qquad (1)$$

where:

Market Return $_t$ is the return for day t on the equally weighted market portfolio of firms only listed on the Chinese stock exchanges;[13]

β_0 is the mean portfolio return during the sample period;

Event J, J = 1 to 3, are dummy variables that equal $1/n_J$ for the dates within the event window of length n_J days for the Jth regulation, and 0 otherwise, where $n_1 = 11$, $n_2 = 10$ and $n_3 = 23$;[14]

β_J, J = 1 to 3, are the estimated cumulative mean-adjusted returns during each event window J;

ε_t is an i.i.d. random-error term for day t.

Second, as a robustness check intended to control for market-wide price movements unrelated to the regulations, we estimate a model that includes the contemporaneous return on an equally weighted portfolio of 24 firms from China that are listed on the Hong Kong Stock Exchange (HK Return $_t$). These firms have their headquarters and business activities in mainland China, but their shares are only listed on the Hong Kong Stock Exchange. We expect that the

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[13] When we use a value-weighted market index, we find similar results.
[14] We define the dummy variable as equal to 1/n, where n is the length of the event window, so that the coefficient on our dummy variable measures the cumulative adjusted return over the entire event window. Were we to define the dummy variable as equal to 1, then the coefficient would instead measure the average daily adjusted return over the event window.

new regulations are of little importance to these firms, as Chinese companies with an overseas listing are subject to additional provisions in their articles of association that already substantially limited the power of their controlling shareholders.[15] The empirical model is:

$$Market\ Return_t = \beta_0 + \Sigma \beta_J\ Event\ J + \beta_4\ HK\ Return_t + \varepsilon_t \qquad (2)$$

where:

$HK\ Return_t$ is the return for day t on the equally weighted portfolio of 24 firms from China that are listed on the Hong Kong Stock Exchange; and

$Market\ Return_t$, β_0, $Event\ J$, β_J and ε_t are defined as above.

We estimate each model over a period of 250 trading days that ends July 25, 2000—one day after the newspaper release of the asset transfer regulation (event 3).

As another test of robustness, we re-estimate eq. (1) and eq. (2) where we redefine the event windows to incorporate, for each regulation, two five-day event windows centred on the CSRC release date and first publication date. This shortens the length of our event windows so as to limit the effects of potentially confounding events. We refer to these as *Five-day Event Windows* whereas we refer to our primary windows as *Long Event Windows.* [16]

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[15] MacNeill (2002, p. 51) argues that the amendments in the articles of overseas listed firms "should be viewed as a considerable enhancement of the governance structure by comparison with domestic-only listed Chinese companies." There are 24 firms from China that are only listed on the Hong Kong Stock Exchange, and 19 Chinese firms that are listed in Hong Kong and also on one of the two Chinese stock exchanges. Inclusion of these 19 firms in HK Return$_t$ does not change any of our results. Note that Cheung *et al.* (2006) show that the likelihood of connected transactions in Chinese firms listed in Hong Kong is higher than for Hong-Kong-based firms.

[16] We have estimated both models over longer periods of 500 and 750 trading days, and have extended model (2) by including the world market index. The results are robust to these changes.

4.2. Cross-Sectional Differences in Cumulative Abnormal Returns

In addition to testing market-wide changes in value attributable to improved shareholder protection, we also test whether the new regulations have differential impacts on firms depending on the extent to which minority shareholders might be expropriated by the controlling block holders. We expect that firms where minority shareholders face greater expropriation should disproportionately benefit from the new regulations. In our first set of cross-sectional tests, we use the total value of the related-party transactions in the year preceding the announcement of the new regulations as an observable proxy for (potential) minority shareholder expropriation. We refer to this measure as *EXPROP*. We hypothesize that, during the event windows, firms with high values of *EXPROP* outperform firms with low values of *EXPROP*.

We also test whether the identity of the controlling block holder influences the relation between *EXPROP* and changes in firm value. Specifically, we test whether the relation is stronger among firms controlled by *State Bureaucrats*, *MOSOEs* or *Private Entities*. Because *State Bureaucrats* have the closest ties with the Chinese government, we conjecture that *State Bureaucrats* are least likely to be the target of regulatory action aimed at reducing expropriation. Consequently, we conjecture that, among firms that have substantial related-party transactions, the beneficial effects of the new regulations is smallest for minority shareholders in listed firms controlled by *State Bureaucrats*. Similarly, because *Private Entities* have the weakest links with the government, we conjecture that minority shareholders of listed firms controlled by *Private Entities* will gain most from the new regulations.

In our second set of cross-sectional tests, we use several more indirect proxies of the likelihood of minority shareholder expropriation. In these tests, we focus on the hypothesis that shareholders of firms with weak governance are more reliant upon legal and regulatory

protection from expropriation by controlling block holders than are shareholders of firms with strong governance (Klapper and Love (2003)). Therefore, shareholders of firms with weak corporate governance should benefit disproportionately from the new regulations.

As proxies for the value of firm-specific corporate governance, we use: the cash-flow rights of the controlling shareholder, the type of controlling shareholder ("*State Bureaucrats*," "*MOSOEs*," and "*Private Entities*"), the dominance of the controlling shareholder ("*Non-Controlling Block Holders*") and the presence of foreign shareholders ("*B-Shares*"). In addition, we include dummy variables that indicate whether the CEO is the Chairman of the Board ("*CEO is Chair*") and whether or not the firm has at least one independent director ("*Independent Director*").

4.2.1 Related Party Transactions and Cumulative Abnormal Returns

Cheung *et al.* (2007) classify related-party transactions into: i) transactions that are *a priori* likely to result in expropriation of the listed firm's minority shareholders; ii) transactions likely to benefit the listed firm's minority shareholders; and iii) strategic transactions that are, perhaps, not expropriation. Our direct, firm-specific measure of expropriation—*EXPROP*—is defined as the sum of the values of all transactions likely to result in expropriation of minority shareholders for each firm in 1999, scaled by the market capitalisation of the firm as of the end of 1999.[17]

We hypothesize that, during the event windows, firms with high expropriation (proxied by high values of *EXPROP*) outperform firms with low expropriation (proxied by low values of

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[17] We obtain similar results if we use the unscaled value of related-party transactions, and if we scale by total assets or total revenue. The results in Cheung *et al*. (2007) are based on values of related-party transactions scaled by market capitalization.

EXPROP).[18] To test this hypothesis, we use a portfolio time-series regression, which is designed

to deal with the econometric problem that arises when there is cross-correlation in the firm return

processes from which the CARs are estimated. Cross-correlation is likely in our setting because,

for each event, the event date and event windows are identical across sample firms. The portfolio

time-series regression provides unbiased estimates of the coefficients along with standard errors

that fully account for cross-sectional heteroskedasticity and cross-security dependence (see

Sefcik and Thompson (1986)).[19]

We implement the portfolio time-series approach by forming a portfolio that is long in

high-*EXPROP* firms and short in low-*EXPROP*. We define high-*EXPROP* firms as those in the

highest *EXPROP* tercile and low-*EXPROP* firms as those in the lowest *EXPROP* tercile. As a

robustness test, we also show results for portfolios based upon the lower half (fifth) and upper

half (fifth) of the EXPROP distribution. We hypothesize that the regulatory changes are more

beneficial for firms with high expropriation than for firms with low expropriation. In other

words, we expect our portfolio to have positive abnormal returns during the event periods. To

control for market risk, we include the return on an equally weighted portfolio of firms listed on

the Chinese stock exchanges:

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[18] This hypothesis rests on the assumption that investors are able to identify and discount firms
with a high level of expropriation. In our results section we present evidence that strongly
supports this assumption.

[19] The problems of heteroscedasticity and cross-sectional dependence can, in principle, also be
addressed in a generalized-least-squares (GLS) regression. Several studies, however, show that
GLS tests are highly sensitive to errors in specifying the abnormal return model. (See, for
example, Chandra and Balachandran (1990)). Grammatikos and Saunders (1990) apply the
Sefcik and Thompson methodology to study the effect of bank loan-loss reserve announcements
on bank stock returns. Forbes (2002) uses the Sefcik and Thompson methodology to study the
international transmission of financial crises at the firm level. Espahbodi *et al*. (2002) use this
methodology to analyse cross-sectional differences in stock price reactions to proposals to
change the way firms have to account for stock-based compensation.

$R \ (High\text{-}EXPROP_t) - R \ (Low\text{-}EXPROP_t) = \beta_0 + \Sigma \beta_J \ Event \ J + \beta_4 \ Market \ Return_t + \varepsilon_t \ (3)$

where:

> $R \ (High\text{-}EXPROP_t)$ is the return for day t on an equally weighted portfolio of the highest
>
> third (half, fifth) firms based upon *EXPROP*;
>
> $R \ (Low\text{-}EXPROP_t)$ is the return for day t on an equally weighted portfolio of the lowest
>
> third (half, fifth) firms based upon *EXPROP*;
>
> β_J, J = 1 to 3, give the estimated differences in the cumulative abnormal returns (CARs)
>
> of the *High-EXPROP* and *Low-EXPROP* portfolios during each event window J; and
>
> *Market Return*$_t$, *Event J* and ε_t are defined as above.

As before, we estimate the model over a period of 250 trading days that ends one day after the

newspaper release of asset transfer regulation (Event 3).

4.2.2 Ownership Structure and Differences in Cumulative Abnormal Returns

Following La Porta *et al.* (2002), we assume that the ultimate owner of the largest

shareholder has effective control over a firm.[20] We consider three variables that might mitigate

the incentive of the controlling shareholder to expropriate minority shareholders and positively

impact a firm's value.

First, the incentive to expropriate outside investors is moderated by the cash-flow

ownership of the controlling shareholder (see La Porta *et al.* (2002) and Claessens *et al.* (2002)).

The greater are the cash-flow rights of the largest shareholder, the smaller is the difference in her

cash-flow and control rights (where we assume that the ultimate owner of the largest shareholder

has effective control). Hence, we expect the beneficial effect of the regulation for minority

shareholders to decrease with the cash-flow rights of the controlling shareholder. Our empirical

model includes a dummy variable ("*Cash-Flow Rights > 30%*") that assumes a value of one if

the largest shareholder owns more than 30 percent of all shares outstanding, and zero

otherwise.[21]

Second, we define a variable that measures the control rights of the non-controlling block

holders. *Non-Controlling Block holders* is the sum of the shareholdings of the second through

tenth largest shareholder. Lins (2003) finds that large, non-management block holders can act as

a partial substitute for weak institutional governance mechanisms. We expect the ability of the

largest shareholder to expropriate firm value decreases as the relative shareholdings of block

holders with the ability and incentive to monitor the actions of the largest block holder increase

(see, for example, Bennedsen and Wolfenzon (2000)).

Third, we include a dummy variable ("*B-Share*") that is equal to one for firms having

both A- and B-shares outstanding and equal to zero for all other firms. Some Chinese firms offer

two classes of shares: Class-A shares, which can only be held by domestic investors, and Class-B

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[20] Note that the legal maximum for individual shareholdings in China and the absence of
cumulative voting procedures reinforces the idea that the ultimate owner of the largest
shareholder has effective control.

[21] We would have preferred to use data on cash-flow rights and control rights of the ultimate
controlling shareholder. Unfortunately this data for listed firms in China is only available from
year-end 2002. Fan, Wong and Zhang (2005) show that, across a sample of 750 State-controlled
firms, the average ratio of cash-flow to voting rights of the ultimate owner equals 0.96. For the
62 listed firms in their sample that are controlled by private entities, they find that the average
ratio of the cash-flow to voting rights is 0.54. Given the larger wedge between cash-flow and
control rights at listed firms with private entities as ultimate owner, we conjecture that
expropriation of minority shareholder wealth is more severe at firms controlled by private
owners.

shares, which can only be held by foreign investors.[22] Most Class-B shareholders are international financial institutions, whereas most Class-A shareholders are individual investors, with only limited ownership by domestic financial institutions (see Mei, Scheinkman and Xiong (2004)). In addition to the difference in investor sophistication, firms with only Class-A shares use Chinese accounting rules (PRC GAAP) to prepare their financial statements, whereas firms with Class-A and Class-B shares report their results based on both PRC GAAP and International Accounting Standards (IAS). In general, IAS are regarded as providing superior transparency as compared to PRC GAAP (World Bank (2002)). Given the differences in the level of sophistication of the shareholders and the level of transparency of the financial statements, we expect that controlling shareholders of firms with Class-B shares are less likely to expropriate minority shareholders.

We also include a variable that indicates whether the largest owner of the listed firm is a *State Bureaucrat*, a *MOSOE* or a *Private Entity*. As discussed before, the type of controlling block holder is important because it might proxy for the likelihood of regulatory action in case of expropriation by the controlling block holder. We expect regulators are most likely to pursue expropriation by private controlling block holders and least likely to pursue *State Bureaucrat* controlling block holders.

Finally, we include dummy variables that equal one when the Chief Executive Officer is the Chairman of the Board, ("*CEO is Chair*") and when the firm has at least one independent director ("*Independent Director*").

In estimating the association between the cumulative abnormal returns and the ownership variables, we include firm size and leverage as controls. *Firm Size* is defined as the natural log of

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[22] On February 19, 2001, the CSRC announced that Chinese citizens would be allowed to hold

the total assets as per end of 1999. *Leverage* is the defined as the book value of debt divided by the book value of total assets.

As before, we employ the portfolio time-series regression methodology, which involves three steps. First, we orthogonalize our nine independent variables so that each has zero correlation with the other independent variables.[23] Second, for each of the nine orthogonalized variables, we construct a portfolio that is short on firms in the lowest third (half, fifth) and long on firms in the highest third (half, fifth) of the orthogonalized variable's distribution. Third, we regress the returns for each of the nine portfolios on the market return and a dummy variable (*Events*), using the following model:[24]

$$R(OV\text{-}High_t) - R(OV\text{-}Low_t) = \beta_0 + \beta_1 \, Events + \beta_2 \, Market \, Return_t + \varepsilon_t \qquad (8)$$

where:

R (*OV-High $_t$*) is the return for day t on an equally weighted portfolio of the highest third (half, fifth) firms based upon orthogonalized variable OV (*Cash-Flow Rights >30% $_i$*, *Non-Controlling Block Holders $_i$*, *B-Shares $_i$*, *MOSOE $_i$*, *Private $_i$*, *CEO is Chair $_i$*, *Independent Director $_i$*, *Firm Size $_i$* or *Leverage $_i$*);

R (*OV-Low $_t$*) is the return for day t on an equally weighted portfolio of the lowest third (half, fifth) firms based upon orthogonalized variable OV (*Cash-Flow Rights >30% $_i$*,

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and trade Class-B shares.

[23] The nine variables are *Cash-Flow Rights > 30% $_i$* ; *Non-Controlling Block Holders $_i$* ; *B-Shares $_i$* ; *MOSOE $_i$*; *Private Entity $_i$* ; *CEO is Chair $_i$* ; *Independent Director $_i$* ; *Firm Size $_i$* ; and *Leverage $_i$*. Each of the nine variables is replaced by the residual from a regression of that variable on an intercept and the other eight independent variables.

[24] We combine the three event-dummy variables (*Event 1*, *Event 2* and *Event 3*) into one dummy variable (*Events*) that equals one during each day of the three event windows to increase the power of our tests. Results from analysing each of the three events separately are available from the authors.

Non-Controlling Block Holders $_i$, B-Shares $_i$, MOSOE $_i$, Private $_i$, CEO is Chair $_i$,

Independent Director $_i$, Firm Size $_i$ or Leverage $_i$);

Events is a dummy variable that equals 1 / 44 for the dates within the three long event

windows, and 1 / 30 for the dates within the three 5-day event windows;

β_1 gives the estimated difference in the cumulative abnormal return (CAR) of the high-

OV and low-OV portfolios during the three event windows; and

Market Return $_t$, Event J and ε_t are defined as above.

As before, the model is estimated over a period of 250 trading days that ends July 25, 2001.

4.3 Data

The data used in this study include information on accounting values, stock prices and

ownership structure. We obtained accounting data and data on related-party transactions from

the CSMAR/GTA database for 918 companies listed on the Chinese Stock Exchanges as of year-

end 1999. We also obtained information on the number of independent directors, and the identity

of the CEO and Chairman of the Board from CSMAR/GTA. We obtained daily share-price

information for each of our sample firms from Datastream. Classification of the ten largest

shareholders into *State Bureaucrats*, *MOSOES*, and *Private Entities* is based on Delios *et al*.

(2006).[25]

From our initial sample of 918 firms, we delete 19 firms that are cross-listed on overseas

exchanges (see footnote 10). We delete 2 firms for which we can not obtain sufficient

information on the shareholdings of the largest 10 shareholders. Finally, we define 23 separate

industry sectors at the level of two-digit standard industrial classification, which we obtained

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[25] The data are available from http://www.bschool.nus.edu.sg/staff/bizakd/owner.htm.

from the CSRC. To obtain reliable estimates of industry-adjusted Q for our sample firms, we delete 10 firms from our sample where there are fewer than five firms in the industry. The three sets of deletions leave us with a final sample of 887 firms.

5. Results

5.1 Descriptive Statistics

Panel A of Table 1 presents descriptive statistics for the related-party transactions and shows that, in 1999, a total of 6,113 related-party transactions were recorded in the annual reports of our sample firms.[26] Following Cheung *et al*. (2007), we classify 495 of these transactions as potentially beneficial for the listed company because it received cash, loans or guarantees from the related party. We classify the remaining 5,618 transactions as (potentially) harmful. Overall, the beneficial transactions have a value of RMB 39.77 billion whereas the harmful transactions have a value of RMB 296.34 billion.[27] Within the harmful transactions, the most numerous category involves sale or purchase of commodities (2,644) which also accounts for most of the aggregate value (RMB 211.22 billion or 71.5%); there also were 583 transactions involving provision of services, with a total value of RMB 13.76 billion or 4.7% and 540 transactions involving the purchase, transfer or swap of assets, with a total value of RMB 15.69 billion or 5.3%.

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[26] Appendix 2 contains a detailed description of the different types of related party transactions.
[27] Cheung *et al.* (2007) analyse related party transactions between Chinese listed firms and their state-owned block holders during 2001-2002. The median transaction value of the harmful related party transactions in their sample is 43 million RMB, and the median value scaled by the market value of the firm is 1 percent. Cheung *et al.* point out that in China enforcement of the rules is weak, and there may be companies that fail to disclose connected transactions, or understate the value of the deal in their financial statements.

Panel B of Table 1 presents descriptive statistics for *EXPROP*, our expropriation proxy, which we calculate as the aggregate value of harmful related-party transactions for each firm during 1999 (2001) divided by the firm's year-end 1999 market capitalisation. For the full sample, the mean and median values of *EXPROP* for 1999 were 6.54% and 1.85%, respectively. In 2001, the corresponding values were 33.1% and 1.92%. For the total sample, there is no significant change in the mean and median value of EXPROP between 1999 and 2001.

The second part of Panel B shows the mean values of *EXPROP* for our three groups of controlling block holders: *State Bureaucrats*, *MOSOEs* and *Private Entities*. We also report the average quintile rank for each ownership type (ranks range from 0 for firms in the lowest quintile of the EXPROP distribution to 4 for firms in the highest quintile of the EXPROP distribution). In 1999, the highest mean value of *EXPROP* and the highest mean rank are observed at *MOSOEs* whereas the lowest mean of EXPROP and the lowest mean rank are observed at *State Bureaucrats*. In 2001 *MOSOEs* still have the highest mean and the highest mean rank, however the lowest mean of EXPROP and the lowest rank are now observed at *Private Entities*. The last column indicates that the increases in the mean value of EXPROP and the mean rank for *State Bureaucrats* are significant.

In the last two rows of Table1, Panel B we report the p-value of the test whether the differences in EXPROP and ΔEXPROP between the three ownership types are significant. When we use the values of EXPROP and ΔEXPROP the differences are never significant. However, using ranks we find that the difference in EXPROP between the three ownership types is significant both before and after the regulatory changes. We also find that there are significant differences between the ownership types in terms of the change in the mean rank, suggesting that

State Bureaucrats were least responsive to the new regulation and *Private Entities* were most responsive to the new regulation.[28]

Table 2 presents descriptive statistics for our analysis variables both for the entire sample of 887 firms and for three groups of firms ranked into terciles based on the level of our expropriation proxy *EXPROP* (the sum of the value of all the potentially harmful related-party transactions that took place in 1999, scaled by the market value of the firm as of December 1999). The last column presents the *p*-value of a *t*-test that the means are the same for the group with low *EXPROP* and high *EXPROP*.

Table 2 shows a negative association between industry-adjusted *Tobin's Q* and *EXPROP*, suggesting that investors do discount firms that are exposed to more expropriation by the controlling block holder. Industry-adjusted *Tobin's Q* is measured as of year-end 1999 and is calculated as the sum of the market value of equity and the book value of debt divided by the book value of total assets. We control for differences in Q across industries by calculating the median Q for each industry and then by subtracting the appropriate industry median from each firm's Q. The average industry-adjusted Q for the high *EXPROP* group is −0.25, whereas the average industry-adjusted Q for the low *EXPROP* group is 1.04. This difference is significant at the 1-percent level.

There is no significant relation between *Leverage* and *EXPROP*, but firms with higher *EXPROP* are significantly larger in terms of total assets.

Firms with a high level of expropriation are more likely to have a *MOSOE* as controlling block holder and are less likely to have a *State Bureaucrat* as controlling block holder. There is

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[28] The conclusions do not change when we measure the relevant variables over a two-year period before the regulation and a two- or five-year period after the regulations.

no significant difference in the likelihood of having a *Private Entity* as controlling block holder for firms in the low and high EXPROP group.

Contrary to our expectations, but consistent with Cheung *et al*. (2007), we find that firms with high *EXPROP* are more likely to have controlling block holders that own 30 percent of the shares or more. Cheung *et al*. (2007) argue that expropriation is concentrated in listed firms with the highest state ownership because these are firms where the managers of the SOE might find it easiest to carry out connected transactions. Consistent with this explanation, non-controlling block holders own a larger percentage of the shares of firms that have low expropriation than of firms with a high level of expropriation.

Surprisingly, low expropriation firms are more likely to have the same person as CEO and Chairman of the Board. There is no significant difference between the low and high *EXPROP* groups in the proportion of firms with independent directors or the proportion of firms with B-shares.

5.2 Market-Wide Impact of the Regulations

As detailed in section 4.1, we use standard event-study methodology to obtain mean-adjusted and market-adjusted abnormal returns around the announcements of each regulatory change. In Table 3, we present the results of this analysis. In Columns 2 and 3, we present results using the *Long Event* Windows, whereas, in Columns 4 and 5, we present the results using the *Five-day Event Windows.* For each of the three events, Columns 2 and 4 present cumulative mean-adjusted returns and Columns 3 and 5 present cumulative market-adjusted returns, where we use a portfolio of Chinese firms that trade on the Hong -Kong Stock Exchange in an attempt to control for market-wide movements unrelated to the regulatory events.

In Column 2 of Table 3, we see that the cumulative mean-adjusted return for the 11-day *Long Event Window* around the announcement of the shareholder-meeting regulation is a positive 10.1 percent. This increase in the market's market value is significant at better than the five- percent level (p-value = 0.03). Around the announcements of the ban of related guarantees and the restriction on asset transfers, the cumulative mean-adjusted returns are positive 1.1 percent and positive 1.9 percent, respectively, but these abnormal returns are not significantly different from zero. In Column 3 of Table 3, we see that the cumulative market-adjusted returns are very similar to the cumulative mean-adjusted returns shown in Column 2. Moreover, when we use Five-day Event windows, the results are largely unchanged.

The high volatility in the Chinese stock market, combined with the long event windows, make it difficult to discern significant price reactions to market-wide events. An additional problem is the presence of several confounding events. The most significant confounding events were during the first event window: on May 19, the opening of a second board was announced, as was the opening of the market to Qualified Foreign Institutional Investors (QFII).[29] It is important to note that these confounding events do not affect the cross-sectional results to the extent that the impact of these events on stock prices is not related to the level of expropriation or the quality of corporate governance.

In the next section, we investigate whether there is evidence of cross-sectional differences in share price reaction based on differences along these two dimensions.

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[29] When we exclude May 19 from our event window, the abnormal return around the first event is around 8 percent. For all four models, CARs are significant at the 5 percent level.

5.3 Related Party Transactions and Cross-Sectional Differences in CARs

This section presents the results of our cross-sectional tests based on *EXPROP*. We first

present two regression models that validate *EXPROP* as measure of expropriation of minority

shareholders.

5.3.1 Validity of the EXPROP measure

In Panel A of Table 4, we present the results of a cross-sectional regression where our

measure of firm-specific expropriation - *EXPROP $_i$* - is regressed against several corporate

governance characteristics and firm characteristics. In Panel B of Table 4, we analyse the relation

between *EXPROP $_i$* and industry-adjusted *Tobin's Q*, controlling for the same corporate

governance characteristics and firm characteristics.

Panel A of Table 4 shows a positive and highly significant relation between firm size as

measured by the natural log of total assets and (scaled) expropriation activity. *Leverage* is not

significantly related to *EXPROP*. Related-party transactions have a larger value for firms that

have a *Private Entity* or a *MOSOE* as controlling shareholder. This result is consistent with the

conjecture that *Private Entities* and *MOSOEs* have stronger incentives to maximize profits than

State Bureaucrats and, therefore, are more likely to engage in expropriation of minority

shareholders of the listed firms under their control. Surprisingly, there is no relation between

expropriation activity and concentrated ownership. We had expected to find significant negative

coefficients for the interaction variables of ownership type (especially *Private Entity* and

MOSOE) and the dummy variable indicating that cash flow rights are larger than 30 percent.

Consistent with our expectations we find that expropriation is lower if the listed firm has

issued *B-Shares*. Similarly, expropriation is lower when *Non-Controlling Block Holders* own

more shares, and the impact of this shareholding is larger if the non-controlling shares are held by private entities. This finding is consistent with Berkman *et al*. (2008) who report that firms with higher percentage ownership by private non-controlling block holders are less likely to issue related guarantees.

Finally, we find that whether the *CEO is Chairman* and the presence of *Independent Directors* are unrelated to the level of expropriation.

Panel B of Table 4 presents the results of a regression of industry-adjusted *Tobin's Q* on the same set of explanatory variables, plus the level of expropriation. Consistent with earlier research, we find industry-adjusted *Q* decreases with firm size and leverage. Consistent with the notion that *MOSOEs* and *Private Entities* have a stronger incentive to maximize firm value, we find that *Q* is higher if the firm has a *Private Entity* or *MOSOE* as controlling shareholder. *Tobin's Q* is also higher for firms with high non-controlling ownership from *Private Entities* and *MOSOEs*. Finally, we find that *Tobin's Q* is lower for firms with a high level of expropriation, again indicating that investors discount these firms.

5.3.2 Related-Party Transactions and Cross-Sectional Differences in CARs

In Table 5, we report the results from estimating eq. (3)—our tests for difference in the CARs of the portfolio of the high and low expropriation firms. For each of the three regulatory changes, Panel A of Table 5 reports the results based on splitting the full sample into three groups based upon the value of *EXPROP*. In Panels B1 – B3 of Table 5, we present the results when the sample is further split based on the ownership type of the largest share holder. Finally, Panel C of Table 5 reports the cumulative abnormal returns for the hedge portfolio cumulated

across all three events when the full sample is split into two, three and five groups based on the value of *EXPROP*.

Panel A of Table 5 shows that the high *EXPROP* portfolio outperforms the low *EXPROP* portfolio for each of the three events, and that this outperformance is significant at the one-percent level for the shareholder meeting regulation and the asset transfer regulation, and the 10-percent level for the related-guarantee regulation. Around the announcement of the new shareholder-meeting rules, the portfolio of firms in the high-*EXPROP* tercile outperformed the portfolio of firms in the low-*EXPROP* tercile by 3.5 percent. Around the announcement of the ban of related guarantees, this difference is 1.8 percent; and around the announcement of the tighter rules on asset transfers, the difference is 5.2 percent. If we sum across the three events, the total out-performance of the high-*EXPROP* group over the low-*EXPROP* group is more than ten percentage points.

It is instructive to note that returns around the announcement of the regulation on asset transfers show the largest difference between the high- and low-expropriation portfolios. This finding is consistent with Johnson *et al*. (2000) and Bertrand *et al*. (2002), who show that non-arms length transactions among related firms are an important channel for "tunneling."

Panels B1-B3 of Table 5 present the CARs around the three regulatory events for different groups based on the identity of the controlling block holder (*State Bureaucrat*, *MOSOE* or *Private Entity*). More specifically, for the stocks in each ownership group, we form zero-cost portfolios that are long the tercile of high-expropriation stocks and short the tercile of low-expropriation stocks. For *State Bureaucrats*, there is no evidence that high-*EXPROP* firms significantly outperform low-*EXPROP* firms around the announcements of the new regulations. For the group of *MOSOE*s, the out-performance of high-*EXPROP* firms relative to low-*EXPROP*

firms is positive for all events and significant at the 5% level for the shareholder meeting and asset transfer events. The most noticeable out-performance of high-*EXPROP* firms relative to low-*EXPROP* firms is observed for the group of firms controlled by *Private Entities*. The CAR around each of the events is significant at the 5%-level and the total CAR across all three events is 18.2 percent. These results are consistent with our hypothesis that the regulation is likely to be perceived as more (less) effective for firms where the controlling block holder has weaker (stronger) ties with the government.[30]

In Panel C of Table 5, we report the cumulative abnormal return where we cumulate across all three regulatory events, for portfolios that are long in high-*EXPROP* firms and short in low-*EXPROP* firms. The results in the first (second/third) column are based on portfolios where the high-*EXPROP* firms are those in the highest *EXPROP* half (third/fifth) and low-*EXPROP* firms are those in the lowest *EXPROP* half (third/fifth). For the full sample and also for the subsamples of *MOSOEs* and *Private Entities*, the cumulative abnormal return on the hedge portfolio increases if the portfolio contains stocks with more extreme values of *EXPROP*. For the total sample, the CAR increases from 7.4 percent to 11.7 percent when we move from two groups to five groups. For *MOSOEs*, the CAR is 9.0 percent when we split the sample in two groups, and 15.1 percent when we split the sample into five groups. Finally, for *Private Entities*, the CAR across all three events equals 10.4 percent when we split the sample into two groups and equals 20.3 percent when we split the sample into five groups.

To summarize, our results suggest that the market found the three regulations to be credible attempts at improving corporate governance of Chinese firms. For each of the three

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[30] The results are also consistent with Cheung *et al*. (2007), who find that minority shareholders discount a firm more in reaction to a connected transaction by a State-owned enterprise (they do

events, we find large and statistically significant differences in the reactions of firms with high and low levels of expropriation, even though, as shown in Table 3, the market-wide reaction was positive but not significantly different from zero for the related-guarantee and asset-transfer events. Our evidence also shows the regulations were perceived to be ineffective for firms with controlling block holders with the closest ties to the government.

5.3.2 Other Governance Proxies and Cross-Sectional Differences in CARs

In the previous section, we demonstrated significant cross-sectional differences in the share price reactions of firms with high and low levels of expropriation as proxied by the total value of potentially harmful related-party transactions in the year before the regulations were announced. In this section, we provide additional evidence on cross-sectional differences in the share-price reactions of firms classified into low- and high-governance portfolios using seven traditional corporate governance proxies, including the cash-flow rights of the largest shareholder, the shareholding of non controlling shareholders, the presence of B-shares and the type of controlling shareholder.

The results from estimating our portfolio time-series models appear in Table 6. We present the results from the time-series model, eq. (4), based upon three portfolios: long on the high-third (half/fifth) and short on the low-third (half/fifth) of firms based upon each orthogonalized explanatory variable. We present the results using both our Long Event Windows and our Five-Day Event Windows. Because the results are generally consistent across the six alternative specifications (2 windows times three groupings), we focus our discussion primarily on the results based upon three groups of firms using the Long Event Window.

not distinguish between market-oriented SOEs and other government block holders) than in

First, we find weak evidence that suggests CARs tend to be lower for firms where the cash-flow rights of the largest shareholder are higher than 30 percent (*Cash-Flow Rights >30%*).[31] Firms in the lowest third for this variable outperform the firms in the highest third by a statistically significant 2.7 percentage points. Similar results are obtained when we split the sample into two groups and when we use the five-day windows, but the CAR is insignificant when we split the sample into five groups. We conclude that there is only weak evidence that minority shareholders in firms where the largest shareholder has greater ownership benefit less from the regulations relative to those where the largest shareholder has less ownership.

Second, we consistently find a negative and significant relationship between the CARs and our *Non-Controlling Block Holders* variable. Firms with larger holdings by the non-controlling block holders experienced significantly smaller increases in value around the announcement of the new regulations than firms with smaller shareholding by non-controlling block holders. The total difference in the cumulative abnormal return around the three events between the high- and low-tercile portfolios is 5.9%, statistically significant at the 1% level.

Third, there is no significant relation between MOSOE ownership and the CARs. This result is inconsistent with the notion that minority shareholders in market oriented SOEs are more likely to benefit because the regulator is more likely to enforce the new regulations when a *MOSOE* is the controlling block holder than when a *State Bureaucrat* is the controlling block holder. The evidence is also inconsistent with our result in Table 4, where we show that the group of *MOSOE*s with high *EXPROP* outperform the group of *MOSOE*s with low *EXPROP*.

reaction to connected transactions by Private Entities.
[31] Note that we can split our sample into thirds based upon a dummy variable because it has been orthoganalized against the other eight explanatory variables rendering it semi-continuous.

However, we do find that firms controlled by *Private Entities* have larger price increases around the introduction of the regulations. This is supportive of the idea that private controlling block holders are more likely to expropriate than State owners, as they actually receive cash flows from the firm, whereas cash flows of shares ultimately owned by the State accrue to the taxpayer rather than to the government bureaucrats who exercise the State's control rights. The result is also consistent with the idea that the regulator is more likely to enforce the regulations in case of expropriation by a private block holder. The total difference in the cumulative abnormal return around the three events between the highest and lowest tercile portfolios is 4.7% and is statistically significant at the 1% level.

Fourth, the presence of foreign shareholders (*B-Shares*) has a negative effect on the abnormal return for the three announcements. These results are consistent with our hypothesis that controlling shareholders of firms with foreign shareholders are less likely to expropriate minority shareholders because of the greater transparency and greater sophistication of these minority shareholders. The total difference in CARs around the three events between the highest and lowest tercile portfolios is 8.6%, statistically significant at better than the 1% level.

There is no consistent evidence that shareholders in firms where the *CEO is Chairman* benefited from the new regulations. Using the long event windows, the results suggest that shareholders in firms without *Independent Directors* benefit from the new regulations. However, when we use five-day event windows, the CARs are insignificant. Thus, consistent with the findings in Table 4, where we found no evidence that these variables are related to a firm's industry-adjusted Q, our results suggest that minority shareholders do not perceive themselves to be more at risk of expropriation at firms where the CEO also wears the Chairman's hat and at firms without independent directors.

Other results in Table 6 show that the CARs around the announcements are not related to leverage. This result is consistent with the idea that creditors in China play a very limited role in the governance of firms. The four largest banks in China control the majority of banking assets in the country and are directly controlled by the Chinese government. These banks typically allocate credit to individual firms on the basis of national policy rather than on financial condition or performance, and typically are not involved in active monitoring.[32]

The CAR is positively related to firm size, indicating that larger firms benefited relatively more from the new regulations than smaller firms. This result is consistent with our finding that larger firms are engaged in more related party transactions (scaled by market capitalisation) than small firms.

Overall, our results suggest that firms with higher levels of expropriation (proxied by several variables that have been used as indicators of the quality of corporate governance) benefited more from the regulations than firms with lower levels of expropriation.

6. Summary and Conclusions

Recent studies of corporate ownership around the world show that listed firms typically have controlling block holders. For such firms, the primary concern of corporate governance is the protection of minority shareholders from expropriation by a controlling block holder and her management team.

In this study, we examine whether securities-market regulations intended to improve minority shareholder protection in China—a civil-law transitional economy with poorly developed institutions—can be effective. Our results suggest that they can—at least for firms that

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[32] In a study by the World Bank, the authors observe that "creditors are among the least effective

do not have close ties to the government. We find that firms with higher level of expropriation from minority shareholders disproportionately benefit from the regulations relative to firms with lower levels of expropriation from minority shareholders (whether proxied by a direct measure of expropriation based on the total value of related party transactions, or measures of firm-specific corporate governance such as the relative power of the largest shareholder, the presence of foreign shareholders and other corporate governance related variables).

We also report evidence that suggests effectiveness of the new regulations is highest for firms with private controlling block holders and lowest for firms where the controlling block holder has the closest ties with the government. This evidence confirms the importance of political connections, as it suggests that Chinese minority shareholders expect the regulator to enforce the regulations when a private block holder engages in expropriation but not when State controlled entities engage in expropriation.

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instruments of corporate control in China" (World Bank (2002), p. xvi)

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Appendix 1:
Chinese Regulatory Changes Occurring During the First Quarter of 2000

On May 18, 2000, the CRSC released a new regulation regarding the procedures for shareholder meetings, while emphasizing that all corporate directors have a fiduciary duty to conduct proper shareholder meetings. The new regulation was publicly announced on May 26, 2000.[33] The most important improvements in terms of minority investor protection are:

i)   Shareholders who hold, separately or jointly, more than five percent of the voting power may propose motions for discussion at the shareholders' Annual General Meeting.

ii)   When the meeting votes on associated trading, shareholders involved in the associated trading shall not participate in the voting, and their rights to vote shall not be counted among the aggregate shares possessing voting rights.

iii)   When a motion concerning the election of directors and members of the supervisory board is discussed at the shareholders' meeting, shareholders shall vote on the candidate for director or supervisor individually.

iv)   When disputes occur concerning the assembling and convening of a meeting, voting procedures, or the legitimacy and effectiveness of a resolution, the parties concerned can take legal action in a People's Court in order to resolve the dispute.

On June 6, 2000, the CSRC released a new regulation prohibiting listed firms from issuing loan guarantees to their shareholders, shareholders' subsidiaries, and individuals. In addition, if the firm should issue a loan guarantee to an unrelated party, it should obtain a mutual guarantee to control risk, and the firm's managers are prohibited from signing a loan guarantee contract without approval of the board, or approval at a shareholders' meeting. This regulation was first publicly reported in Chinese newspapers on June 15, 2000.

On June 26, 2000, the CSRC released a new regulation regarding reorganizations of listed companies. The regulation, which was published in the newspapers on July 24, 2000, stipulates that if gross (net) assets are acquired or sold that account for more than 50% of the latest audited gross (net) assets of the listed company, or the profit from acquired or sold assets account for more than 50% of the latest audited profit of the listed company, then the listed company shall perform the following procedures:

i)   The board of directors shall conduct a feasibility study and disclose the information as if it was a public offering.

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[33] Before publication in the newspapers, the regulatory changes were first released to a limited number of market participants: the securities regulatory offices, the stock exchanges and the listed companies.

ii)   The board shall hire accounting and law firms qualified to conduct securities business to certify the relevant issues.

iii)   The board shall issue a resolution on the relevant issues and report to the Stock Exchange within two days after the resolution is made, and announce to the public the resolution with the comments of the intermediaries and the board of supervisors.

iv)   Upon examination and approval of the shareholders meeting, the listed company shall implement the plan of asset purchase or sale.

v)   If the counter-party has a tacit understanding with the controlling shareholder of the listed company, the transaction shall be deemed an affiliated transaction, which shall be subject to the relevant rules and regulations.

vi)   After the major purchase or sale of assets, the listed company shall ensure the separation of personnel, assets and accounting from its controlling shareholder.

1. Commodity Transaction
All businesses involving the sale of commodities, including goods, products, materials, raw materials, water, electricity, gas and power, purchase of commodities and supply of commodities in related party transactions.

2. Asset Transaction
All businesses involving the purchase of assets (other intangible and fixed assets except commodities), and transfer, use, swap, restructuring and trust of asset in related party transactions

3. Receiving or Rendering of Services
After shareholding companies are restructured and listed, they generally strip off semi-social non-productive assets, but still need affiliated companies to provide related services. Therefore, two parties will sign an agreement with regard to expenses payment and sharing with related parties before listing. Fund transfer occurring in the activities is an important aspect in China listed firms related party transactions.

4. Agency, commissioning
A listed firm entrusts its related parties for financing, processing and consigning. It can also be the related parties accept the listed firm's entrustment to carry on business.

5. Fund transaction
Since listed firms are closely connected with their parent companies in business, a certain amount of related-parties accounts receivable occur. Listed firms make advances to their parent companies via charging capital tied-up fees so that listed firms have their income increased on one hand and parent companies obtain needed fund on the other hand. But if the amount is excessively large or the term is too long, it will affect listed firms' operating, investment and financial condition. It includes loans or equity fund in the form of cash or in kind.

6. Guarantee and pledge
A listed firm and its parent company or each affiliated companies provide mutual guarantee. Related guarantee between a listed firm and its main shareholders, especially controlling shareholder, can be bi-directional. Either the listed firm provides guarantee for main shareholders' debts or main shareholders provide guarantee for the listed firm.

7. Lease
Because it is not wholly listed, an asset leasing relationship between a listed firm and its parent companies is commonly existed, including the lease of intangible assets, such as the right to land use and trademark, and the lease of fixed assets, such as facilities and equipment.

8. Trust Operating (management side)
Operating right entrust management and business between listed firms and affiliated companies, including transact operating right and business trust management and other management related aspects.

9. Donation
Grant, donation or other business activities between listed firms and affiliated companies

10. Non-monetary transaction
Both transaction parties make exchanges with non-monetary assets, including equity for equity transactions, but excluding non-monetary transactions involved in company mergers. The transactions do not involve monetary assets or only involve a small number of monetary assets.

11. Equity transaction
All equity related transaction involved with stock transfer, stock entrust, distribution of dividend occurring between a listed firm and affiliated companies

12. Debt transaction
Debt transfer, debt repayment, debt restructuring and all other transactions relating to debts, occurring between a listed firm and related companies

13. Cooperative project
A related party transaction in the form of cooperative investment means that a listed firm and its related companies make a joint investment in a specific project and distribute the income by the proportion agreed upon in advance.

14. License agreement
Transactions involving the licensing of intellectual property and intangible assets, occurring between a listed firm and its related companies

15. R&D achievements
Transactions where a party of a listed firm and its affiliated company transfers its unfinished research product or project and developed product or project to the other party

16. Key managers' remuneration
Transactions where a listed firm accepts the remuneration paid by its affiliated company to its managers or a related company accepts the remuneration paid by the listed firm to its managers

17. Other events
Related party transactions which do not fall into the above categories or unclassified related party transactions.

(Source: GTA/CSMAR Manual on Related-Party Transactions)

Table 1:
Related Party Transactions of Chinese listed firms in 1999
Panel A presents frequency and average value of the different types of related party transactions for 887 Chinese listed firms in 1999. (Source: the GTA/CSMAR Related-Party Transactions Database). Transactions are classified as potentially beneficial for the listed company if the listed firm received cash, loans or guarantees from the related party, all other related party transactions are classified as harmful (see Cheung *et al*. 2007). A detailed description of each type of related-party transaction is provided in Appendix 2.

Panel B reports descriptive statistics for the variable $EXPROP_i$, which is the sum of the value of potentially harmful related party transactions in 1999, scaled by the market value of firm *i* as of year-end 1999. *State Bureaucrat* is a dummy variable equal to one if the largest block holder classified as a State Bureaucrat; *MOSOE* is a dummy variable equal to one if the largest block holder is a market-oriented State-owned enterprise; *Private Entity* is a dummy variable equal to one if the largest block holder is a private entity. Classifications are based upon 17 detailed categories of ultimate ownership established researchers at the National University of Singapore as described in Delios *et al*. (2006). The t-statistic in the last column of Panel B tests if ΔEXPROP is different from zero. The p-values in the last two rows are based on test of equality of means (medians) across the three types of ownership of the largest shareholder.

Panel A: Related Party Transactions for Chinese firms in 1999		
Transaction	Observations	Mean Value (in million RMB)
Beneficial	495	80.34
Harmful	5,618	52.75
Detailed Classification of Harmful Related Party Transactions		
	Observations	Mean value	% of total
Commodity	2,644	79.89	71.5
Asset	540	29.06	5.3
Services	583	23.60	4.7
Commission	165	47.72	2.7
Fund Transfer	420	27.24	3.9
Guarantee	360	43.36	5.3
Lease	402	16.08	2.2
Operating trust	33	9.22	0.1
Non-Monetary Transaction	2	0.00	0.0
Stock Transaction	203	43.74	3.0
Debt Transaction	34	42.88	0.5
Cooperative Project	67	36.92	0.8
R&D	34	0.73	0.0
Manager Remuneration	22	9.60	0.1
License	81	0.44	0.0
Other Events	28	32.01	0.3

Panel B: Descriptive Statistics EXPROP

		EXPROP 1999	EXPROP 2001	ΔEXPROP	t-stat
All	Mean	0.065	0.331	0.266	1.1
	Median	0.019	0.019	0.001	
State Bureacrats	Mean	0.046	0.075	0.029	2.2
	Mean rank	1.580	1.788	0.208	2.3
MOSOEs	Mean	0.075	0.468	0.392	1.0
	Mean rank	2.227	2.185	-0.041	-0.8
Private Entities	Mean	0.046	0.068	0.023	1.5
	Mean rank	1.884	1.766	-0.116	-0.6
Equality of means: p-value		0.100	0.750	0.780	
Equality of ranks: p-value		0.001	0.001	0.040	

Table 2:
Sample Descriptive Statistics by Expropriation Terciles

The sample consists of 887 publicly traded Chinese firms, segmented into three terciles based upon the sum of the value of potentially harmful related party transactions in 1999, scaled by the market value of the firm as per December 1999. Industry-adjusted Tobin's Q is measured at the end of year 1999. Tobin's Q is the sum of the market value of equity and the book value of debt divided by the book value of total assets. We control for differences in Q across industries by calculating the median Q for each industry and then by subtracting the appropriate industry median from each firm's Q. Total Assets is expressed in million RMB. Leverage is the book value of debt divided by the book value of total assets at the end of year 1999. *State Bureaucrat* is a dummy variable equal to one if the largest block holder classified as a State Bureaucrat; *MOSOE* is a dummy variable equal to one if the largest block holder is a market-oriented State-owned enterprise; *Private Entity* is a dummy variable equal to one if the largest block holder is a private entity. Classifications are based upon 17 detailed categories of ultimate ownership established researchers at the National University of Singapore ("NUS") as described in Delios et al. (2006). *CF > 30* assumes a value of 1 if the largest shareholder owns more than 30 percent of all outstanding shares (and 0 otherwise). *Non-Controlling Block Holders* is the sum of the shareholdings of the second through tenth largest shareholders. *B-Shares* is equal to one for firms that have both A- and B-shares outstanding and equal to zero for all other firms. *CEO is Chair* is a dummy variable that equals one when the Chief Executive Officer is also the Chairman of the Board, and *Independent Directors* is a dummy variable that is equal to one when the firm has at least one independent director. For each variable in column 1, the last two columns report the difference in the means of firms in terciles one and three, followed by the corresponding *p*-value.

		Expropriation				
	All	Low	Medium	High	Low - High	p-value
Industry Adjusted Tobin's Q	0.519	1.036	0.773	-0.249	1.285	0.001
Total Assets	146,473	103,692	122,353	213,230	- 109,538	0.001
Leverage	0.428	0.432	0.420	0.432	0.000	0.986
State Bureaucrat	0.239	0.333	0.241	0.141	0.192	0.001
MOSOE	0.656	0.546	0.669	0.753	-0.208	0.001
Private Entity	0.096	0.112	0.084	0.091	0.021	0.407
CF > 30	0.733	0.631	0.757	0.811	-0.180	0.001
Non-Controlling Block Holders	0.168	0.191	0.184	0.128	0.063	0.001
B-Shares	0.079	0.061	0.088	0.088	-0.027	0.215
CEO is Chair	0.117	0.149	0.111	0.091	0.058	0.030
Independent Directors	0.023	0.024	0.007	0.037	-0.013	0.343

Table 3:
Cumulative Abnormal Returns around Regulatory Events

This table reports the cumulative abnormal returns (CARs) around announcements of three new regulations intended to improve corporate governance at Chinese publicly listed firms. The first new regulation substantially increased the rights of minority shareholders at a firm's Annual Shareholders' Meeting; the second prohibited the issuance of loan guarantees by a firm to its controlling shareholder; and the third improved the transparency and regulation of asset transfers to related parties. We estimate CARs using an equally weighted portfolio consisting of all 887 sample firms. The results in column two (four) and three (five) are based on eq. (1) and eq. (2), respectively:

$$Market\ Return_t = \beta_0 + \Sigma \beta_j\ Event\ J + \varepsilon_t \qquad\qquad (1)$$
$$Market\ Return_t = \beta_0 + \Sigma \beta_j\ Event\ J + \beta_5\ HK\ Return_t + \varepsilon_t \qquad\qquad (2)$$

where *Market Return $_t$* is the return on an equally weighted market portfolio during day t; *Event J,* J = *1* to *3* are dummy variables that equal 1/n for the dates within the event window of length *n* for the first, second and third regulation and equal zero otherwise; *Hong-Kong Return $_t$* is the return for day t on an equally weighted portfolio of 24 Chinese firms listed on the Hong Kong Stock Exchange; and β_{j}, J = 1 to 3 are the estimated cumulative adjusted returns associated with each event window. The model is estimated over 250 trading days ending July 25, 2000 (one day after the newspapers published the third regulation). The Long Event Windows for Events 1, 2 and 3 are 11, 10 and 23 trading days, respectively, and span the period from the initial announcement of the regulation by the CSRC to the first publication by the financial press. The Five-Day Event Windows span the five days centered on the CSRC announcement and the five days centered on the first publication by the financial press.
t-statistics are in parentheses.
^{a}, ^{b}, and ^{c} indicate statistical significance at the .01, .05, and .10 levels, respectively.

Variable	Long Event Windows		Five-Day Event Windows	
	Model (1)	Model (2)	Model (1)	Model (2)
Intercept	0.002	0.001	0.002	0.001
	(1.6)	(1.4)	(1.5)	(1.4)
Event 1:	0.101 ^{b}	0.117 ^{b}	0.099 ^{b}	0.107 ^{b}
Shareholder Meeting	(2.1)	(2.3)	(2.1)	(2.3)
Event 2:	0.011	0.001	0.011	-0.001
Related Guarantees	(0.2)	(0.0)	(0.2)	-(0.0)
Event 3:	0.019	0.006	0.023	0.011
Asset Transfer	(0.3)	(0.1)	(0.5)	(0.3)
Hong-Kong		0.086 ^{b}		0.079^{c}
Return		(2.0)		(1.9)

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Table 4:
Cross-Sectional Regression Models to Explain *EXPROP* and *Tobin's Q*

Panel A reports the results of a cross-sectional regression with *EXPROP* as dependent variable. *EXPROP* is defined as the sum of the value of potentially harmful related-party transactions in 1999, scaled by the market value of the firm as of December 1999.

Panel B reports the results of a cross-sectional regression with industry-adjusted Tobin's Q as dependent variable. Industry-adjusted Tobin's Q is measured at the end of year 1999. Tobin's Q is measured as the sum of the market value of equity and the book value of debt divided by the book value of total assets. We control for differences in Q across industries by calculating the median Q for each industry and then by subtracting the appropriate industry median from each firm's Q. All independent variables are defined in Table 2. There are 887 observations. [a], [b], and [c] indicate statistical significance at the .01, .05, and .10 levels, respectively.

	Panel A: EXPROP	Panel B: Industry-adjusted Q
Intercept	-2.978 a	12.846 a
	-8.8	13.1
Total Assets	0.286 a	-1.062 a
	10.1	-12.8
Leverage	0.062	-1.944 a
	0.5	-6.1
MOSOE	0.299 a	0.480 c
	2.9	1.7
Private Entity	0.365 a	0.796 b
	2.9	2.3
Cash-Flow Rights > 30 * State Bureaucrat	0.144	0.793 a
	1.4	2.8
Cash-Flow Rights > 30 * MOSOE	-0.001	0.035
	0.0	0.2
Cash-Flow Rights > 30 * Private Entity	-0.060	-0.213
	-0.4	-0.6
Non-Controlling Block Holder * State Bureaucrat	-0.007 b	0.014
	-2.4	1.6
Non-Controlling Block Holder * MOSOE	-0.004	0.021 a
	-1.5	3.0
Non-Controlling Block Holder * Private Entity	-0.009 a	0.025 a
	-3.2	3.3
B-Shares	-0.183 b	0.062
	-2.2	0.3
CEO is Chair	-0.088	-0.173
	-1.3	-0.9
Independent Directors	0.263 c	-0.125
	1.8	-0.3
EXPROP	n/a	-0.269 a
		-2.9

Table 5:
Difference in Cumulative Abnormal Returns by Degree of Expropriation

This table reports on the relation between *EXPROP* and cumulative abnormal returns (CARs). Each cell in Panels A and B1-B3 presents the difference in the CARs of the high- and low-*EXPROP* groups around each of the three announcements of new regulations. Panel C reports the cumulative abnormal returns for the hedge portfolio cumulated across all three events when the full sample is split into two, three and five groups based on the value of *EXPROP*.

The first new regulation substantially increased the rights of minority shareholders at a firm's Annual Shareholders' Meeting; the second prohibited the issuance of loan guarantees by a firm to its controlling shareholder; and the third improved the transparency and regulation of asset transfers to related parties. *EXPROP* is defined as the sum of the value of potentially harmful related-party transactions in 1999, scaled by the market value of the firm as of December 1999. We estimate the following model:

$$R\ (High\text{-}EXPROP_t) - R\ (Low\text{-}EXPROP_t) = \beta_0 + \Sigma\beta_J\ Event\ J + \beta_5\ Market\ Return_t + \varepsilon_t \qquad (9)$$

where: R (*High-EXPROP $_t$*) is the return for day t on an equally weighted portfolio of the highest third of firms based upon EXPROP;

R (*Low-EXPROP $_t$*) is the return for day t on an equally weighted portfolio of the lowest third of firms based upon EXPROP;

β_J, J = 1 to 3, are the estimated differences in the cumulative abnormal returns (CARs) of the high-EXPROP and low-EXPROP portfolios during each event window J;

The model is estimated over 250 trading days ending July 25, 2000 (one day after the newspapers published the third regulation). Panel A presents results from estimating the relation between EXPROP and CARs for the full sample while Panel B1-B3 presents the results for three mutually exclusive sub-samples containing only firms controlled by *State Bureaucrats*, *MOSOEs* or *Private Entities*. These results are based upon splitting each sample into three groups on the basis of *EXPROP*. The *Long Event Windows* for Events 1, 2 and 3 are 11, 10 and 23 trading days, respectively, and span the period from the initial announcement of the regulation by the CSRC to the first publication by the financial press. The *Five-Day Event Windows* span the five days centered on the CSRC announcement and the five days centered on the first publication by the financial press. *t*-statistics are in parentheses.
[a], [b], and [c] indicate statistical significance at the .01, .05, and .10 levels, respectively.

	(2) Shareholder Meeting	(3) Related Guarantees	(4) Asset Transfers	(5) All Three Events
Panel A: All Firms				
Long Event Windows	0.035 **a**	0.018 **c**	0.052 **a**	0.101 **a**
	(2.9)	(1.7)	(3.0)	(4.1)
Five-Day Event Windows	0.026 **b**	0.016	0.024 **b**	0.065 **a**
	(2.2)	(1.5)	(2.1)	(3.2)
Panel B1: State Bureaucrats				
Long Event Windows	0.003	0.010	0.003	0.015
	(0.2)	(0.7)	(0.2)	(0.6)
Five-Day Event Windows	0.009	0.009	-0.016	0.002
	(0.8)	(0.8)	(-1.3)	(0.1)
Panel B2: MOSOEs				
Long Event Windows	0.039 **b**	0.023	0.052 **b**	0.110 **a**
	(2.4)	(1.5)	(2.3)	(3.3)
Five-Day Event Windows	0.027 **c**	0.021	0.030 **b**	0.078 **a**
	(1.8)	(1.4)	(2.0)	(2.9)
Panel B3: Private Entities				
Long Event Windows	0.065 **b**	0.048 **b**	0.074 **b**	0.182 **a**
	(2.5)	(2.0)	(2.0)	(3.4)
Five-Day Event Windows	0.041 **c**	0.045 **c**	0.037	0.123 **a**
	(1.7)	(1.9)	(1.5)	(2.8)

Panel C: Total CARs for different groups

	(1) 2 Groups	(2) 3 Groups	(3) 5 Groups
All firms			
Long Event Windows	0.074 **a**	0.101 **a**	0.117 **a**
	(4.1)	(4.1)	(3.6)
Five-Day Event Windows	0.047 **b**	0.065 **a**	0.066 **b**
	(3.1)	(3.2)	(2.5)
State Bureaucrats			
Long Event Windows	0.032	0.015	0.021
	(1.4)	(0.6)	(0.7)
Five-Day Event Windows	0.018	0.002	-0.016
	(0.9)	(0.1)	(0.0)
MOSOEs			-0.1
Long Event Windows	0.09 **a**	0.110 **a**	0.151 **a**
	(3.9)	(3.3)	(3.2)
Five-Day Event Windows	0.058 **c**	0.078 **a**	0.092 **b**
	(3.0)	(2.9)	(2.4)
Private Entities			
Long Event Windows	0.104 **b**	0.182 **a**	0.203 **a**
	(2.2)	(3.4)	3.2
Five-Day Event Windows	0.069 **c**	0.123 **a**	0.137 **a**
	1.9	(2.8)	2.6

Table 6:
Corporate Governance and Differences in Cumulative Abnormal Returns

This table presents the results from estimating the relation between a set of governance-related variables and the cumulative abnormal returns around announcements of three new regulations intended to improve corporate governance at Chinese listed firms. The first new regulation substantially increased the rights of minority shareholders at a firm's Annual Shareholders' Meeting; the second prohibited the issuance of loan guarantees by a firm to its controlling shareholder; and the third improved the transparency and regulation of asset transfers to related parties. We use a portfolio time-series regression model to regress an event-window dummy on the returns from a portfolio that is long on the highest and short on the lowest third (half, fifth) of firms based upon orthogonalized explanatory variable *OV*: (*Cash-Flow Rights > 30%, Non-Controlling Block Holders, B-Shares, MOSOE, Private Entity, CEO is Chair, Independent Director, Firm Size* or *Leverage*; which are defined in Table 2).
The model is as follows:

$$R \, (High\text{-}OV_t) \, - R \, (Low\text{-}OV_t) = \beta_0 + \beta_1 \, Events \, + \beta_2 \, Market \, Return_t + \varepsilon_t \qquad (8)$$

where: *Events* is a dummy variable that equals 1 / 44 for the dates within the three event window (or 1 / 30 for dates within the 5-day event windows), and zero otherwise; $R \, (High\text{-}OV_t)$ is the return on the High-OV portfolio; $R \, (Low\text{-}OV_t)$ is the return on the Low-OV portfolio; *Market Return_t* is the market return on day t; and ε_t is an i.i.d. error term.

Each cell gives the difference in the CARs of the High-OV and Low-OV Portfolios during the event window around the three regulatory changes. The models are estimated over 250 trading days ending July 25, 2000 (one day after the newspapers published the third regulation). The *Long Event Windows* for Events 1, 2 and 3 are 11, 10 and 23 trading days, respectively, and span the period from the initial announcement of the regulation by the CSRC to the first publication by the financial press. The *Five-Day Event Windows* span the five days centered on the CSRC announcement and the five days centered on the first publication by the financial press. *t*-statistics appear in parentheses.
[a], [b], and [c] indicate statistical significance at the .01, .05, and .10 levels, respectively.

	Long Window			5-day-window		
	2 Groups	3 Groups	5 groups	2 Groups	3 Groups	5 groups
Cash-Flow Rights > 30%	-0.046 [a]	-0.027 [c]	0.003	-0.029 [b]	-0.024 [b]	-0.012
	-(3.1)	-(1.8)	(0.2)	-(2.4)	-(2.0)	-(0.8)
Non-Controlling Block holders	-0.057 [a]	-0.059 [a]	-0.052 [b]	-0.035 [b]	-0.034 [b]	-0.029
	-(3.2)	-(2.8)	-(2.2)	-(2.4)	-(2.0)	-(1.5)
MOSOE	0.011	0.011	-0.014	-0.002	0.001	-0.006
	(0.9)	(0.7)	-(0.8)	-(0.2)	(0.1)	-(0.4)
Private Entity	0.047 [a]	0.047 [a]	0.05 [a]	0.023 [b]	0.032 [b]	0.028 [c]
	(3.2)	(3.2)	(2.6)	(1.9)	(2.2)	(1.8)
B-shares	-0.069 [a]	-0.086 [a]	-0.101 [a]	-0.037 [b]	-0.04 [b]	-0.043 [c]
	-(3.5)	-(3.5)	-(3.3)	-(2.2)	-(2.1)	-(1.7)
CEO is Chair	0.032 [a]	0.030 [c]	-0.001	-0.015	0.014	-0.001
	(2.6)	(1.7)	-(0.0)	-(1.5)	(1.0)	-(0.0)
Independent Directors	-0.043 [b]	-0.055 [b]	-0.054 [b]	-0.013	-0.022	-0.021
	-(2.6)	-(2.5)	-(2.5)	-(1.0)	-(1.2)	-(1.1)
Leverage	-0.023	-0.028	-0.033	-0.008	-0.011	-0.016
	-(1.4)	-(1.3)	-(1.2)	-(0.6)	-(0.6)	-(0.7)
Total Assets	0.093 [a]	0.129 [a]	0.15 [a]	0.052 [a]	0.068 [a]	0.083 [a]
	(4.2)	(4.3)	(4.4)	(2.9)	(2.7)	(2.9)