

# THE VALUE OF SHAREHOLDER ACTIVISM: NEW EVIDENCE FROM THE SPLIT-SHARE STRUCTURE REFORM IN CHINA

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## Abstract

We examine shareholder activism in the recent split-share structure reform in China. This unique event allows us to avoid the deficiencies in determining activism proxies and in measuring their effectiveness that plague the previous literature. We find that the effectiveness of shareholder activism is influenced by segmented institutional ownerships. Particularly, shareholder activism could have both positive and negative impacts on managerial behaviors in the presence of institutional investors' interest conflicts. We show that, even in its primitive stage, Chinese shareholder activism has demonstrated positive value in corporate governance.

**JEL Classification:** G12, G18

**Keywords:** Shareholder Activism, Split-share Structure Reform, Consideration, Positive Promises

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# 1 Introduction

Shareholder activism constitutes an important form of shareholders' efforts to influence corporate governance. In recent years, Chinese institutional investors have been increasingly involved in corporate governance and firm management as they grow to hold more securities.<sup>1</sup> They are considered a monitoring and disciplinary mechanism of growing importance in the Chinese financial system, in which takeovers are systematically discouraged and boards are ineffective (Allen *et al.* (2005)). In this paper, we take advantage of a special event – the Chinese split-share structure reform – to examine the value of shareholder activism. This unique event, in nature, allows us to avoid the deficiencies in determining activism proxies and in measuring their effectiveness that plague the previous literature.

The split-share structure has existed since the inception of the Chinese A-share market in the early 1990s.<sup>2</sup> The original purposes of the split-share structure were to enable state-owned enterprises to raise capital and, simultaneously, to allow the Chinese government to retain control of those enterprises. However, it was widely criticized for fostering speculations and agency problems and for hindering M&A activities (Hwang *et al.* (2006) and Liao *et al.* (2008)). In this split-share structure, two classes of domestic A shares with otherwise identical features, tradable and non-tradable, coexist for one company. Transactions of the non-tradable shares are contract-based and subject to approval of the State-owned Assets

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<sup>1</sup>According to the China Securities Regulatory Commission Annual Report 2007, institutional investors held approximately 50 percent of tradable stocks by the end of year 2007.

<sup>2</sup>A Chinese company that is publicly listed on domestic exchanges may issue three types of shares. A-shares are domestic common stocks traded on Shanghai Stock Exchange or Shenzhen Stock exchange. B-shares are listed on domestic exchanges but priced in US dollars. H-shares are listed on Hong Kong Stock Exchange.

Supervision and Administration Commission. Approximately 2/3 of the A-shares outstanding were non-tradables mainly held by the Chinese government and its affiliates, who assume significant control of the firms. Tradable shares were largely owned by institutional and individual shareholders. The split-share structure reform was initiated by the Chinese government to convert non-tradable A-shares to tradable shares in an effort to revitalize the Chinese stock market, which has been bearish since its initial partial share issue privatization (SIP) in 1990s (Liao *et al.* (2008)).

Since the original costs of non-tradable shares were significantly lower than the market prices of tradable shares, non-tradable shareholders, represented by firm management, were required by the China Securities Regulatory Commission (the Chinese counterpart of the SEC in the United States, hereafter CSRC) to negotiate with tradable shareholders to deliver a compensation package to the latter. A reform plan will only be passed if it contains a compensation package that is approved by at least 2/3 of tradable shareholders. Institutional shareholders, who held more than 20 percent of the total tradable shares in 2006 (Source: the WIND database), will play an important role in compensation package negotiations and approval.

In the same spirit as Woidtke (2002), we use the percentage of tradable shares held by institutional shareholders as a proxy for shareholder activism. The larger stake institutional shareholders have in a firm, the more incentive they will have in monitoring and getting involved in firm management. We propose three sets of measures for the effectiveness of shareholder activism on influencing managerial behaviors and firm values: consideration, positive promises made to tradable shareholders and abnormal stock returns around reform plan approval date. Consideration is measured as the number of shares that non-tradable shareholders transferred to tradable shareholders in exchange for the trading right for their

non-tradable shares. Consideration and positive promises will capture the influence of institutional shareholder activism on managerial decisions, while abnormal stock returns around reform plan approval date will reflect the impacts of activism on firm performance and firm value.

Institutional shareholders face potential conflicts of interests in monitoring firm management. Therefore, shareholder activism may have opposite effects on managerial decisions. Pound (1988) propose three hypotheses that predict contradictory relationships between firm performance and institutional ownership. We find that the impacts of shareholder activism on firm management are influenced by segmented institutional ownerships of tradable shares. Particularly, The value of consideration tends to be higher when institutional shareholders hold a larger percentage of tradable shares. In this case, shareholder activism plays a positive and effective role in affecting managerial decisions for tradable shareholders' interests. However, considerations turn to be relatively lower when institutional shareholders own a small percentage of the firms' tradable shares. Evidence suggests that institutional shareholders get actively involved in firm decision making to pursue different agendas in exchange for private benefits, rather than seeking higher compensation values. We demonstrate that shareholder activism could have both positive and negative impacts in the presence of institutional shareholders' interest conflicts.

Our analysis in general supports the argument that shareholder activism helps to improve firm performance and value. Positive promises made by firm management, though containing no direct monetary values, could lead to potential increases in firm and equity values. We find that the number of positive promises is positively correlated to institutional shareholding. In addition, the result reports both economically and statistically significant positive relationships between abnormal stock returns and institutional shareholding.

Institutional shareholders may take three types of actions when they are unsatisfied with a firm's management. They could choose to vote with their feet - selling their stocks of the firm. They may get actively involved in corporate governance to influence managerial behaviors, as suggested by activism. Alternatively, they may choose to remain silent. Hirschman (1971) summarize those shareholder actions into three categories: exit, voice and loyalty. The previous literature on examining shareholder activism use shareholder proposals as proxies for shareholder activism. Mixed results were found on shareholder activism's impacts on corporate governance and firm performance. Among others, Smith (1996), Strickland *et al.* (1996), Carleton *et al.* (1998) and Del Guercio and Hawkins (1999) find evidence that supports the success of shareholder activism, while Karpoff *et al.* (1996), Wahal (1996) and Gillan and Starks (2000) find the opposite.

The disagreement among the previous studies arises from the complexities in selecting shareholder activism proxies and from the difficulties in measuring their effectiveness (Karpoff (2001) and Gillan and Starks (1998)). For instance, it is hard, if possible, to assure that the changes in firm performance are entirely driven by shareholder proposals. Other events, such as changing board members and modifying corporate charters, may affect firm performance and value as well. Furthermore, changing corporate management may not necessarily lead to changes in firm performance. An additional complication is that institutional shareholders usually negotiate with firm management privately, rather than publicly, to influence firm decisions. To solve the problems, researchers consider institutional shareholder ownership as a proxy for shareholder activism. Institutional investors would have more incentives in monitoring and influencing management, in both public and private ways, if they have greater interest in a firm. Carvell and Strebel (1987) and Edelman and Baker (1990) find the "neglected firm effect" - firm values are negatively correlated with institutional ownership.

McConnel and Servaes (1990) show a negative relationship between Tobin's Q and institutional ownership. However, their static analysis remains silent on the key question whether institutional investors take actions to influence firm performance.

The compensation package negotiations in the split-share structure reform offer an unparalleled opportunity to examine the value of shareholder activism. In this study, the dates on which tradable shareholders and non-tradable shareholders reach agreements on compensation packages are known, whereas the previous literature suffers difficulty in accurately pinning down shareholder proposal time, which is not publicly available. During the proposal time, other corporate events may occur and contaminate the measurement of the effectiveness of shareholder activism. In addition, shareholder proposals contain no legal restrictive power to firm management. Institutional investors usually talk with firm management before submitting their proposals. If an agreement has been reached, institutional shareholders will not submit a proposal at all. Thus, shareholder proposal is usually regarded as a result of failed talk between institutional shareholders and management. Our investigation does not suffer such problem since management could not ignore institutional shareholders' proposal because they need institutional shareholders' support for reform plan approval. The split-share structure reform was market-wide, involving almost all publicly listed companies in the Chinese market regardless their characteristics. That naturally eliminates the problems of representativeness and size bias. Moreover, there is no self-selection bias because the reforms were mandatory. This event study, in nature, avoids the endogeneity problem that plagues the previous studies on the relationship between firm performance and institutional ownership.

The remainder of this paper is structured as follows. Section 2 introduces research methodology and data; Regression analysis is carried out in Section 3; Section 4 performs robustness

check; Section 5 concludes the paper.

## 2 Analytical Framework

### 2.1 Hypothesis Development

Pound (1988) propose three hypotheses that offer theoretical predictions on the relationships between compensation value and institutional ownership. The relationships in turn provide implications for the influence of institutional shareholder activism on managerial decisions and firm performance.

The *efficient monitoring* hypothesis states that the informational and technical advantages possessed by institutional shareholders enable them to better negotiate for higher compensation values than small shareholders. It suggests a positive relationship between institutional ownership and compensation value. The *conflict of interest* hypothesis predicts that institutional shareholders may choose to support firm management decisions in exchange for favorable relationships and private benefits. According to the *strategic alignment* hypothesis, institutional shareholders have incentives to cooperate with firm management for long term benefits. The cooperation in general weakens the monitoring function of institutional shareholders on firm management. Both the *conflict of interest* and *strategic alignment* hypotheses predict a negative relationship between institutional ownership and compensation values to tradable shareholders.

Importantly, those hypotheses predict that there may exist a nonlinear relationship between compensation package value and institutional ownership. Institutional shareholders could be more likely to engage in cooperation with firm management in exchange for private

benefits that out-weight their potential gain in higher compensation value when their ownerships are low. In this case, the compensation value is negatively related to institutional ownership. On the other hand, when institutional shareholders hold a large percentage of tradable shares, they are more likely to pursue for higher compensation value in reform negotiations. As a result, compensation value should be positively correlated with institutional shareholder activism. We propose the following hypothesis to be tested:

*Hypothesis 1: There exists a U-shape nonlinear relationship between compensation value and shareholder activism.*

Firm management could make positive promises to sweeten a compensation package in reform negotiations. Those promises in general are beneficial to the improvements of firm performance and value in the future. For instance, controlling non-tradable shareholders' promise to inject additional capital signals that there are potential investment opportunities of positive net present values. Large non-tradable shareholders' promise to increase their holdings when stock price falls reduces the interest conflicts between original non-tradable and tradable shareholders. Firm management's promise for future dividend payments helps to mitigate the management-shareholder agency problems by paying out extra cash flows. Xu *et al.* (2008) find that abnormal stock returns are positively correlated with positive promises made by firm management in the split-share structure reform. Given institutional shareholders' superior capability in compensation negotiations compared to individual shareholders, we propose and test the following hypothesis:

*Hypothesis 2: There exists a positive relationship between the probability of firm management/non-tradable shareholders making positive promises and shareholder activism.*

Feng and Xu (2006) report an average of 3% abnormal stock returns on reform plan approval days. The magnitude of abnormal stock returns will reflect the aggregate market



expectations on how shareholder activism affects firm future values. Following the *efficient monitoring* hypothesis, we expect a positive relationship between the abnormal returns and shareholder activism. On the other hand, the *conflict of interest* and *strategic alignment* hypotheses suggest a negative relationship. Thus, we propose and test a third hypothesis:

*Hypothesis 3: There exist positive relationships between cumulative abnormal returns around reform plan approval and shareholder activism.*

## 2.2 Data

Our data on compensation packages, including considerations and promises, of the split-share reform comes from the WIND database, which is widely used by major research and financial institutions. Firm characteristics, stock returns and institutional shareholding data are obtained from the Tsinghua University Data Center and the WIND database respectively. Our original data contain 1223 firms that completed their split-share structure reforms as of 30 June 2007. We eliminated 11 financial firms, who themselves are institutional shareholders. We further excluded 75 firms that were publicly listed less than two years before their reforms to improve the reliability of our measures of firm characteristics. Moreover, 42 firms with incomplete financial information were excluded. Our final sample contains 1095 firms, among which 165, 859 and 71 firms finished their reforms in year 2005, 2006 and 2007 respectively. There are 30 firms selected by the CSRC as pilot firms to carry out split-share reforms in year 2005.

In our sample, 65% firms are listed on Shanghai Stock Exchange. The rest of 35% firms are listed on Shenzhen Stock Exchange. The average book values of the firms are RMB 3.66 billion with a minimum of RMB 90 million and a maximum of RMB 521 billion (RMB 7 equals

USD 1 approximately). The average leverage ratio is approximately 50%. The average return on equity is approximately 4%. In our sample, there are approximately 9% firms that issue B-/H-shares besides domestic A-shares. Approximately 72% of the firms are state-controlled, providing a lower boundary for the number of firms for which the negotiations between non-tradable shareholders and tradable shareholders are actually the negotiations between firm management and tradable shareholders. The diversification of the firm characteristics reflects the fact that our sample includes almost all publicly listed companies in the Chinese stock market, confirming that our analysis is immune to self-selection bias.

## 2.3 Methodology

We follow Woidtke (2002) to use the percentage of tradable shares held by institutional investors as a proxy for shareholder activism. The idea behind our choice of activism proxy is that the larger stake institutional shareholders have in a firm, the more incentive they will have in monitoring and getting involved in firm management. We use three sets of explanatory variables to measure shareholder activism's impacts on managerial decisions and firm performance in our regression analysis. They are consideration (*CONS*), positive promises made by firm management (*PPs*) and cumulative abnormal stock returns around reform plan approval date (*CARs*). We will formally introduce those variables below. Particularly, consideration and positive promises capture the impacts of activism on managerial decisions. Abnormal stock returns reflect the aggregate market expectations on the effects of activism on the improvement of firm future performance and value. Our prior is that positive relationships between the explanatory variables and institutional ownership would suggest that the presence of shareholder activism has positive influence on managerial behaviors and firm

performance, *ceteris paribus*.

We use the following regressions to analyze the impacts of shareholder activism on consideration and cumulative abnormal returns:

$$CONS_i = \alpha + \beta_1 \times PIN_i + \beta_2 \times PINSQ_i + \sum_{j=1}^n \theta_{i,j} \times Control_{i,j} + \varepsilon_i \quad (1)$$

$$CAR_i = \alpha + \beta_1 \times PIN_i + \sum_{j=1}^n \theta_{i,j} \times Control_{i,j} + \varepsilon_i \quad (2)$$

where subscript  $i$  denotes firm  $i$ .  $PIN$  denotes the percentage of tradable shares held by institutional shareholders.  $PINSQ$  denotes the square of the percentage of tradable shares held by institutional shareholders. We include  $PINSQ$  to capture the potential non-linear relationship between activism and its impacts on consideration.  $Control_{i,j}$  denotes the  $j$ th control variable for firm  $i$ .

Consideration represents the number of non-tradable shares transferred to tradable shareholders for every ten tradable shares they hold. In order to gain trading right for their non-tradable shares, non-tradable shareholders need to transfer some of their non-tradable shares to tradable shareholders of the same firm as compensation, given the fact that the original costs of non-tradable shares were significantly lower than the current market prices of tradable shares. Our measure of consideration takes into account a variety of share transfer forms (in cash, share transfer or issuing warrant). Tradable shareholders are supposed to be better off with higher considerations.

The stock prices incorporate and react to a variety of information on firm future performance. As shown in Figure 1, positive abnormal stock returns are observed around reform plan announcement dates, suggesting that the market expects split-share structure reform

plans to increase long-term firm and equity values. We measure 3-day, 5-day and 11-day cumulative abnormal returns, denoted by  $CAR3$ ,  $CAR5$  and  $CAR11$  respectively, around reform plan approval dates. We expect positive relationships between the abnormal returns and shareholder activism.

[insert Figure 1 here]

We use the Ordinal Logit regression to examine the interaction between positive promises and shareholder activism:

$$\ln \left( \frac{\Pr(\text{promise}_i)}{1 - \Pr(\text{promise}_i)} \right) = \alpha + \beta_1 \times PIN_i + \sum_{j=1}^n \theta_{i,j} \times \text{control}_{i,j} + \varepsilon_i \quad (3)$$

We include four types of positive promises made by firm management, who represent non-tradable shareholders or are non-tradable shareholders themselves. Those promises include promise to increase shareholding by controlling shareholders ( $PI$ ), promise for future dividend payments ( $PD$ ), promise for capital injection by controlling shareholders ( $PC$ ) and other types of positive promises ( $PO$ ). For each promise category, we assign 1 if the firm makes at least one promise of the type and 0 for no promise made.<sup>3</sup> In addition, We create a total promise ( $PT$ ) variable that equals the sum of the four positive promise dummy values to measure the overall quantity of positive promises made by a firm. A larger number for this total promise variable implies a greater benefit for tradable shareholders in reform plan negotiations. We expect a positive correlation between shareholder activism and positive promises made.

[insert Table 1 here]

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<sup>3</sup>Limited by our data, we are not able to measure the quality of those promises made by firms in the stock split share structure reform.

Table 1 describes the statistics of the variables in the regressions. The  $CAR3$ ,  $CAR5$  and  $CAR11$  are 10.3%, 10.7% and 14% respectively. Amongst control variables, we include firm size ( $SIZE$ ), which is the natural log of firms' assets one year prior to the split-structure share reform. Growth ( $GWH$ ) is computed using the average of the operating income growth rates observed in the two years prior to the reform. The average growth rate is 23.7% with a standard deviation of 56%. The oscillation is due to the fact that our sample firms come from 13 different industries classified by the CSRC. We include profitability ( $PFY$ ), which is the return on firm net assets one year before the reform. Other control variables for firm characteristics include market/book ratio ( $MB$ ) and leverage ratio ( $LEV$ ). Yao *et al.* (2007) and Zheng *et al.* (2007) report a positive relationship between consideration and non-tradable share/total share ratio. Thus, we include the ratios of non-tradable shares over total shares outstanding ( $RNT$ ) to control for that effect. We include firm beta ( $BETA$ ) to control for market risk.

We use a set of dummy control variables as well. They include the batches of reform ( $BATCH$ ). The CSRC selected 30 firms as a pilot batch to carry out split-share reforms. Those firms were of relatively good performance and low risk. We assign 0 to firms that were in the pilot batch and 1 to those were not. Firms that issue B-/H-shares may be subject to additional shocks and influence compared to those issue A-shares only. We therefore include a dummy variable to specify whether a firm issues B-/H-shares besides A-shares. A dummy value 1 is assigned to firms that issue B-/H-shares besides A-shares.

A Chinese mainland firm may list its domestic A-shares on either Shanghai Stock Exchange or Shenzhen Stock Exchange. To control for the exchange effect, we include an exchange dummy ( $EXCH$ ), for which we assign 1 (0) to firms listed on Shanghai (Shenzhen) Stock Exchange. We include a state control dummy ( $SOE$ ) as well because approximately

72% firms in our sample are state-controlled. For the state control dummy, we assign 1 to firms that are state controlled and 0 to those are not. We include a industry dummy (*IND*) to control for the industry effect.

Table 2 reports the correlations between the dependent variables. We find that consideration is negatively correlated with positive promises at 1% significance level. That suggests that share transfer and positive promises could be used as substitutes to compensate non-tradable share-holders in reform negotiations. The positive and significant correlations between pairs of positive promises indicate that firms that made promises for dividend payments tend to make promises for share injections as well.

[insert Table 2 here]

The cumulative abnormal returns of different time window lengths tend to correlated positively and significantly. We notice that cumulative abnormal returns are negatively correlated with consideration and the total promises dummy. However, those negative relationships are statistically insignificant. Since cumulative abnormal returns may be affected by both consideration and promises, the impacts of consideration and positive promises could offset each other, given the negative correlation between the two. In addition, the *CARs* and positive promises could be simultaneously influenced by other factors, such as institutional ownership. Therefore, the correlations reported in this table may not necessarily contradict our cross-sectional regression results.

## 3 Regression Analysis

### 3.1 Main Results

Table 3 reports the regression results of the relationship between consideration and institutional shareholding. As reported in Column 6, the consideration is negatively (positively) correlated with *PIN* (*PINSQ*) with coefficients of  $-2.16$  ( $1.99$ ). The t-statistic indicates that those relationships are significant at 1% confidence level. Li *et al.* (2007) report a negative relationship between consideration and institutional shareholding as well. The evidence indicates that there exists a nonlinear relationship between compensation value and institutional ownership. Consistent with the prediction of Hypothesis 1, the results show that when institutional shareholders have a larger stake in a firm, they are more likely to get actively involved in reform negotiations for higher compensation value. Activism imposes positive impacts on managerial decisions for non-tradable shareholders' interests. However, evidence suggests that, when institutional ownership is relatively low, institutional investors are prone to engaging in cooperation with firm management in exchange for private benefits that out-weight their potential gains in higher compensation value. In this case, the compensation values are negatively related to institutional ownership. The results remain robust after including control variables in our regressions.

[insert Table 3 here]

We omit share structure control variables and firm financial variables in our model 1 and 2 regressions respectively. Model 3 regression includes all control variables. Amongst control variables, the coefficient of growth rate is  $-0.09$  with a t-statistic of  $-3.95$ , suggesting that, for

firms with greater growth opportunities, tradable shareholders are likely to demand less non-tradable share transferred, because they could be alternatively compensated through gains in future firm growth. In the same vine, consideration appears negatively related with firm profitability. However, that is not statistically significant. We find consideration is positively correlated with state control dummy, suggesting that the non-tradable shareholders of state-owned firms are more willing to transfer more shares to tradable shareholders in exchange for the trading right for their shares. One potential explanation could be that the non-tradable shares of state-controlled firms have lower original costs compared to those of non-state-controlled firms.

The non-tradable shareholders of firms of relatively higher non-tradable share/total share ratios transferred more shares to their tradable counterparts for compensation. The coefficient of  $RNT$  is 3.28 and significant at 1% level. This is consistent with the findings in Le and Yuan (2006). In order to float a large number of non-tradable shares in the market, non-tradable shareholder are more willing to pay higher compensation to tradable shareholders. The coefficient of 0.48 of B-/H-share dummy implies that firms that issue B-/H-shares pay relatively higher compensation to their tradable shareholders. Those firms have more incentives to send out positive signals to investors in B-/H-share markets.

Table 4 depicts the testing results for Hypothesis 2 – the relationship between positive promises made by firm management and institutional shareholding. Column 2 to 11 report the regression results for total promise ( $PT$ ), promise to increase shareholding by controlling shareholders ( $PI$ ), promise for future dividend payments ( $PD$ ), promise for capital injection by controlling shareholders ( $PC$ ) and other types of positive promises ( $PO$ ) respectively.

[insert Table 4 here]



We find that all positive promise measures are positively correlated to institutional ownership. Among them, *PT*, *PC* and *PO* are statistically significant at 1% level, and *PD* is significant at 5% level. The results confirm our Hypothesis 2 that there exists overall a positive relationship between the probability of firm management making positive promises in the reform and shareholder activism. Shareholder activism appears effective in affecting managerial decisions that lead to higher firm values in negotiations. Large non-tradable shareholders' promises for share purchases could reduce the interest conflicts between the original non-tradable and tradable shareholders. Like Xu *et al.* (2008), we find that management's promises for future dividend payments help to mitigate the managerial agency problems. All evidence supports Hypothesis 2.

Table 5 illustrates the impacts of shareholder activism on the cumulative abnormal returns around reform announcement date.

[insert Table 5 here]

We find that *CAR3*, *CAR5* and *CAR11* are all positively correlated with institutional ownership. That supports our Hypothesis 3 in that the market responded more positively to split-share structure reform plan approvals for firms whose shares were largely held by institutional investors. Given that market prices incorporate a variety of information about firm future performance and values, the results imply that institutional shareholder activism casts positive influence on the improvements in firm performance.

## 3.2 Robustness Checks

To check the robustness of our findings, we perform the same regressions on two subsamples – the percentages of tradable shares held by mutual funds and qualified foreign institutional investors (*QFII*). For mutual funds, a major institutional investor group in the Chinese security markets, we find qualitatively same results as those in the main results.

Table 6 reports the regression results of the relationship between consideration and mutual fund shareholding. The consideration is negatively (positively) correlated with *PIN* (*PINSQ*) with coefficients of  $-2.68$  ( $3.34$ ). The t-statistic indicates that the relationships are statistically significant at 1% level. The results confirm the existence of a nonlinear relationship between compensation value and mutual fund ownership, supporting our Hypothesis 1. Furthermore, the coefficients reported in Table 6 are of higher values compared to those reported for the full-sample regression in Table 3, indicating that mutual fund activism was more effective in pursuit for higher consideration than other institutional investor activism.

[insert Table 6 here]

Column 2 to 11 of Table 7 report the regression results for the relationships between mutual fund activism and positive promises. We find that all positive promise measures except for *PI* are positively correlated to mutual fund ownership. Among them, *PT* and *PO* are statistically significant at 1% level. *PD* and *PC* are significant at 10% level. The results are consistent with the ones in the full-sample regressions in that there exists an overall positive relationship between mutual fund activism and the probability of firm management making positive promises.

[insert Table 7 here]

Table 8 reports the impacts of mutual fund activism on cumulative abnormal returns around reform announcement dates. We find that  $CAR3$ ,  $CAR5$  and  $CAR11$  are positively correlated with mutual fund ownership. Both the coefficients and statistical significance levels are higher compared to those in the full sample results, suggesting that the market reacted more positively to the news of reform approvals for firms whose shares are largely held by mutual funds. The overall evidence indicates that mutual funds appear to play an active role in the split-share structure reforms.

[insert Table 8 here]

In an unreported regression analysis, we perform the same tests with qualified foreign institutional investor ( $QFII$ ) ownerships. For all three sets of effectiveness measures, we do not find significantly positive relationships. The results suggest that qualified foreign institutional investors are not influential on Chinese companies' corporate governance.

## 4 Conclusions

Shareholder activism is broadly defined as shareholders actions to influence managerial decisions and firm performance. In this paper, we examine the value of shareholder activism in the split-share structure reform recently took place in China. This unique event, in nature, allows us to avoid the deficiencies that plague the previous literature and to present a clear analysis on the value of shareholder activism.

The value of shareholder activism appears to be influenced by segmented institutional ownerships of tradable shares. Compensation values tend to be higher when institutional shareholders hold a large percentage of tradable shares, suggesting that shareholder activism

plays a positive and effective role in affecting firm management. However, compensation values are relatively lower when institutional shareholders own a small percentage of tradable shares. Our analysis indicates that shareholder activism could have both positive and negative impacts in the presence of institutional investors' interest conflicts.

Evidence shows that the probability of firm management making positive promises is positively correlated to institutional shareholder activism, offering support to the argument of effective shareholder activism. Stock prices react positively to institutional shareholder activism around reform approvals as well. We report both economically and statistically significant positive relationships between abnormal stock returns and institutional shareholding.

Shareholder activism in China is still in its primitive stage. Nevertheless, the split-share structure reform provides Chinese institutional shareholders an opportunity to get actively involved in firm management. In this special event, they have demonstrated their strength in affecting managerial decisions and firm future performance. They are expected to play more significant roles in corporate governance.

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TABLE 1: DESCRIPTIVE STATISTICS OF REGRESSION VARIABLES

This table reports the descriptive statistics of regression variables. *CONS* denotes consideration. *PT* denotes total positive promises. *PI* denotes promise for equity purchase. *PD* denotes promise for dividend payments. *PC* denotes promise for capital injection. *CAR3, 5, 11* denote 3-,5-11-day cumulative abnormal returns respectively. *PIN* denotes the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch.

Mnemonic	Mean	Standard Deviation	Median	Min	P5	P95	Max
<i>CONS</i>	2.960	0.789	3.000	0.220	1.379	4.000	7.000
<i>PT</i>	0.465	0.674	0.000	0.000	0.000	2.000	3.000
<i>PI</i>	0.076	0.265	0.000	0.000	0.000	1.000	1.000
<i>PD</i>	0.222	0.416	0.000	0.000	0.000	1.000	1.000
<i>PC</i>	0.044	0.205	0.000	0.000	0.000	0.000	1.000
<i>PO</i>	0.123	0.329	0.000	0.000	0.000	1.000	1.000
<i>CAR3</i>	0.103	0.259	0.052	-0.359	-0.117	0.468	3.231
<i>CAR5</i>	0.107	0.265	0.060	-0.359	-0.134	0.479	3.249
<i>CAR11</i>	0.140	0.280	0.085	-0.344	-0.135	0.579	3.233
<i>PIN</i>	0.094	0.142	0.024	0.000	0.000	0.441	0.861
<i>PFY</i>	0.004	0.267	0.041	-4.830	-0.314	0.194	0.410
<i>BETA</i>	1.074	0.302	1.062	0.071	0.592	1.586	2.233
<i>LEV</i>	0.503	0.182	0.512	0.013	0.184	0.787	1.173
<i>GWH</i>	0.237	0.560	0.188	-0.873	-0.211	0.768	14.559
<i>SOE</i>	0.720	0.449	1.000	0.000	0.000	1.000	1.000
<i>RNT</i>	0.605	0.112	0.622	0.146	0.392	0.750	0.913
<i>BH</i>	0.093	0.291	0.000	0.000	0.000	1.000	1.000
<i>SIZE</i>	21.326	0.967	21.260	18.324	19.929	22.951	26.978
<i>EXCH</i>	0.646	0.479	1.000	0.000	0.000	1.000	1.000
<i>BATCH</i>	0.973	0.163	1.000	0.000	1.000	1.000	1.000
<i>year2006</i>	0.784	0.411	1.000	0.000	0.000	1.000	1.000
<i>year2007</i>	0.065	0.246	0.000	0.000	0.000	1.000	1.000



TABLE 2: CORRELATIONS OF DEPENDENT VARIABLES

This table reports the correlations of dependent variables. *CONS* denotes consideration. *PT* denotes total positive promises. *PI* denotes promise for equity purchase. *PD* denotes promise for dividend payments. *PC* denotes promise for capital injection. *CAR3*, 5, 11 denote 3-,5-11-day cumulative abnormal returns respectively. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

	<i>CONS</i>	<i>PT</i>	<i>PI</i>	<i>PD</i>	<i>PC</i>	<i>PO</i>	<i>CAR3</i>	<i>CAR5</i>	<i>CARS11</i>
<i>CONS</i>	1								
<i>PT</i>	-0.337***	1							
<i>PI</i>	-0.154***	0.509***	1						
<i>PD</i>	-0.125***	0.682***	0.104***	1					
<i>PC</i>	-0.132***	0.349***	0.023	0.025	1				
<i>PO</i>	-0.325***	0.558***	0.092***	0.034	0.042	1			
<i>CAR3</i>	-0.059*	-0.015	-0.051*	-0.037	0.02	0.046	1		
<i>CAR5</i>	-0.052*	-0.014	-0.053*	-0.036	0.024	0.045	0.985***	1	
<i>CAR11</i>	-0.037	-0.019	-0.057*	-0.032	0.023	0.034	0.924***	0.945***	1

TABLE 3: REGRESSION RESULTS FOR CONSIDERATION

This table reports the regression results for consideration. *PIN* denotes the percentage of tradable shares held by institutional investors. *PINSQ* denotes the square of the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

	Model 1		Model 2		Model 3	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
<i>Intercept</i>	2.988***	4.50	1.847***	3.06	1.636***	2.62
<i>PIN</i>	-1.947***	-4.41	-2.417***	-6.05	-2.162***	-5.44
<i>PINSQ</i>	1.518*	1.89	2.220***	2.89	1.991***	2.63
<i>PFY</i>	0.018	0.080			-0.11	-0.53
<i>BETA</i>	0.247***	2.66			0.151*	1.81
<i>LEV</i>	0.051	0.35			0.11	0.91
<i>GWH</i>	-0.139***	-4.85			-0.0915***	-3.95
<i>SOE</i>			0.374***	7.36	0.379***	7.68
<i>RNT</i>			3.310***	15.95	3.285***	15.82
<i>BH</i>			0.520***	5.75	0.482***	5.99
<i>SIZE</i>	-0.004	-0.15	-0.04	-1.40	-0.04	-1.27
<i>EXCH</i>	0.076	1.62	-0.01	-0.23	-0.01	-0.23
<i>BATCH</i>	-0.16	-0.92	-0.11	-0.70	-0.11	-0.68
<i>Year2006</i>	-0.351***	-5.50	-0.306***	-5.46	-0.332***	-5.76
<i>Year2007</i>	-0.696***	-4.96	-0.581***	-5.27	-0.677***	-5.23
<i>Industry</i>	As control variable		As control variable		As control variable	
<i>N</i>	1095		1095		1095	
Adj. R-sq	0.115		0.346		0.354	

TABLE 4: REGRESSION RESULTS FOR POSITIVE PROMISES

This table reports the regression results for positive promises. *PIN* denotes the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch. *PI* denotes promise to increase shareholdings by controlling shareholders. *PD* denotes promise for future dividend payments. *PC* denotes promise for capital injection by controlling shareholders. *PO* denotes other types of positive promises, and *PT* denotes total promise. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

	Model 1		Model 2		Model 3		Model 4		Model 5	
	<i>PT</i>		<i>PI</i>		<i>PD</i>		<i>PC</i>		<i>PO</i>	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
<i>Intercept</i>			-6.796*	-1.68	-11.43***	-4.7	-10.31***	-2.75	1.894	0.61
<i>PIN</i>	2.475***	5.09	0.114	0.13	1.324**	2.28	2.086***	2.85	2.947***	4.33
<i>PFY</i>	-0.433	-1.24	0.763	0.59	2.520**	2.39	-0.865**	-2.5	-0.236	-0.75
<i>BETA</i>	-0.26	-1.16	-0.465	-1.01	-0.312	-1.09	0.553	0.9	-0.101	-0.29
<i>LEV</i>	-1.670***	-3.94	-1.451*	-1.67	-2.658***	-5.22	-1.504	-1.58	1.013	1.47
<i>GWH</i>	0.196***	3.39	0.317***	2.71	0.339**	2.21	-0.022	-0.17	-0.42	-1.15
<i>SOE</i>	-0.623***	-3.9	-1.083***	-3.72	-0.123	-0.64	0.601	1.36	-1.203***	-5.5
<i>RNT</i>	-2.256***	-3.53	-4.976***	-4.58	-0.896	-1.18	-0.971	-0.76	-3.329***	-3.81
<i>BH</i>	-0.676***	-2.63	-0.211	-0.43	-0.871***	-2.65	0.0262	0.06	-0.894**	-2.17
<i>SIZE</i>	0.372***	4.26	0.529***	2.81	0.467***	4.33	0.248	1.37	-0.0902	-0.66
<i>EXCH</i>	-0.0374	-0.28	0.105	0.39	0.238	1.44	0.284	0.83	-0.423**	-2.1
<i>BATCH</i>	-0.513	-1.49	-2.343***	-4.4	1.436***	2.72			0.159	0.22
<i>Year2006</i>	0.072	0.37	-0.736**	-2.19	0.309	1.32	1.145	1.57	0.211	0.65
<i>Year2007</i>	0.132	0.4			0.0921	0.2	2.195***	2.65	0.187	0.36
<i>Industry</i>	As control variable		As control variable		As control variable		As control variable		As control variable	
<i>N</i>	1095		1002		1095		1014		1050	
pseudo R-sq	0.069		0.212		0.122		0.105		0.125	

TABLE 5: REGRESSION RESULTS FOR CUMULATIVE ABNORMAL RETURNS AROUND REFORM PLAN APPROVAL DAY

This table reports the regression results for cumulative abnormal returns. *PIN* denotes the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

	Model 1		Model 2		Model 3	
	<i>CAR3</i>		<i>CAR5</i>		<i>CAR11</i>	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
<i>Intercept</i>	0.318	1.53	0.311	1.5	0.348	1.64
<i>PIN</i>	0.0862*	1.93	0.0847*	1.89	0.0899*	1.94
<i>SIZE</i>	-0.0153	-1.52	-0.0151	-1.5	-0.0169	-1.64
<i>MB</i>	-0.00438	-1.37	-0.00493*	-1.69	-0.00440*	-1.83
<i>LEV</i>	0.0629	1.29	0.0754	1.53	0.0841*	1.67
<i>BH</i>	0.0947**	2.4	0.0949**	2.5	0.0897**	2.41
<i>Year2006</i>	0.0475***	4.34	0.0488***	4.37	0.0790***	6.53
<i>Year2007</i>	0.554***	7.68	0.574***	8.01	0.633***	8.89
<i>N</i>	1095		1095		1095	
Adj. R-sq	0.265		0.274		0.282	

TABLE 6: REGRESSION RESULTS FOR CONSIDERATION (MUTUAL FUNDS)

This table reports the regression results for consideration (mutual funds). *PIN* denotes the percentage of tradable shares held by institutional investors. *PINSQ* denotes the square of the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

	Model 1		Model 2		Model 3	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
<i>Intercept</i>	3.152***	4.8	1.972***	3.33	1.748***	2.86
<i>PIN</i>	-2.222***	-4.38	-3.024***	-7.07	-2.675***	-6.23
<i>PINSQ</i>	2.469**	2.34	3.852***	4.14	3.446***	3.79
<i>PFY</i>	0.000372	0			-0.127	-0.6
<i>BETA</i>	0.263***	2.8			0.162*	1.93
<i>LEV</i>	0.0847	0.58			0.145	1.15
<i>GWH</i>	-0.139***	-4.78			-0.0898***	-3.86
<i>SOE</i>			0.384***	7.51	0.389***	7.85
<i>RNT</i>			3.328***	15.92	3.302***	15.84
<i>BH</i>			0.525***	5.7	0.484***	5.94
<i>SIZE</i>	-0.0155	-0.53	-0.0456*	-1.77	-0.0447	-1.64
<i>EXCH</i>	0.0686	1.45	-0.017	-0.43	-0.0161	-0.41
<i>BATCH</i>	-0.172	-0.95	-0.119	-0.76	-0.116	-0.73
<i>Year2006</i>	-0.343***	-5.45	-0.296***	-5.31	-0.325***	-5.68
<i>Year2007</i>	-0.694***	-4.92	-0.566***	-5.08	-0.675***	-5.17
<i>Industry</i>	As control variable		As control variable		As control variable	
<i>N</i>	1095		1095		1095	
adj. R-sq	0.104		0.338		0.347	

TABLE 7: REGRESSION RESULTS FOR POSITIVE PROMISES (MUTUAL FUNDS)

This table reports the regression results for positive promises (mutual funds). *PIN* denotes the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch. *PI* denotes promise to increase shareholdings by controlling shareholders. *PD* denotes promise for future dividend payments. *PC* denotes promise for capital injection by controlling shareholders. *PO* denotes other types of positive promises, and *PT* denotes total promise. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

	Model 1		Model 2		Model 3		Model 4		Model 5	
	<i>PT</i>		<i>PI</i>		<i>PD</i>		<i>PC</i>		<i>PO</i>	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
<i>Intercept</i>			-7.118*	-1.78	-11.67***	-4.79	-10.69***	-2.84	1.789	0.57
<i>PIN</i>	2.521***	4.42	-0.553	-0.53	1.159*	1.66	1.905*	1.94	3.621***	4.43
<i>PFY</i>	-0.38	-1.04	1.038	0.75	2.736**	2.52	-0.833**	-2.4	-0.206	-0.65
<i>BETA</i>	-0.297	-1.31	-0.506	-1.1	-0.334	-1.17	0.518	0.84	-0.11	-0.31
<i>LEV</i>	-1.705***	-4.04	-1.513*	-1.74	-2.684***	-5.28	-1.570*	-1.69	1.031	1.51
<i>GWH</i>	0.197***	3.44	0.318***	2.72	0.342**	2.18	-0.0123	-0.1	-0.433	-1.17
<i>SOE</i>	-0.638***	-3.99	-1.081***	-3.7	-0.128	-0.67	0.588	1.35	-1.228***	-5.61
<i>RNT</i>	-2.275***	-3.56	-4.963***	-4.56	-0.916	-1.21	-1.019	-0.81	-3.400***	-3.86
<i>BH</i>	-0.647**	-2.55	-0.212	-0.44	-0.864***	-2.63	0.0305	0.07	-0.874**	-2.13
<i>SIZE</i>	0.395***	4.51	0.548***	2.95	0.482***	4.47	0.273	1.52	-0.0854	-0.62
<i>EXCH</i>	-0.0243	-0.18	0.116	0.43	0.247	1.5	0.304	0.89	-0.405**	-2.01
<i>BATCH</i>	-0.48	-1.41	-2.368***	-4.46	1.435***	2.74			0.254	0.33
<i>Year2006</i>	0.0619	0.32	-0.724**	-2.14	0.314	1.34	1.15	1.58	0.206	0.63
<i>Year2007</i>	0.127	0.39			0.101	0.22	2.191***	2.64	0.185	0.36
<i>Industry</i>	As control variable		As control variable		As control variable		As control variable		As control variable	
<i>N</i>	1095		1002		1095		1014		1050	
pseudo R-sq	0.065		0.212		0.12		0.101		0.126	

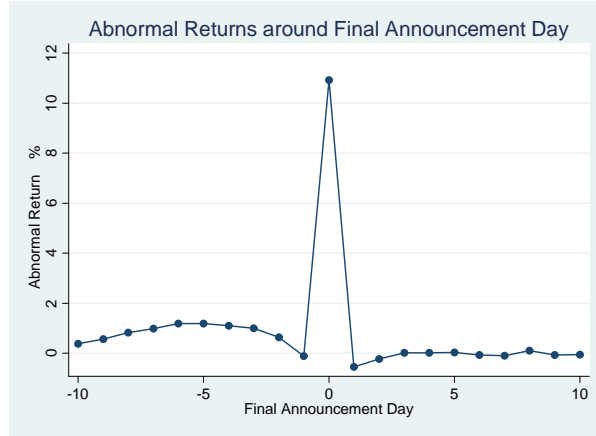
TABLE 8: REGRESSION RESULTS FOR CUMULATIVE ABNORMAL RETURNS AROUND REFORM PLAN APPROVAL DAY  
(MUTUAL FUNDS)

This table reports the regression results for cumulative abnormal returns (mutual funds). *PIN* denotes the percentage of tradable shares held by institutional investors. *PFY* denotes profitability. *BETA* denotes firm CAPM  $\beta$ . *LEV* denotes leverage ratio. *GWH* denotes growth. *SOE* denotes state-controlled. *RNT* denotes non-tradable/total share ratio. *BH* denotes issuing B-/H-shares. *SIZE* denotes log of firm size. *EXCH* denotes exchange. *BATCH* denotes reform batch. Note: \*, \*\* and \*\*\* represent 10%, 5% and 1% significance levels respectively (two-tails).

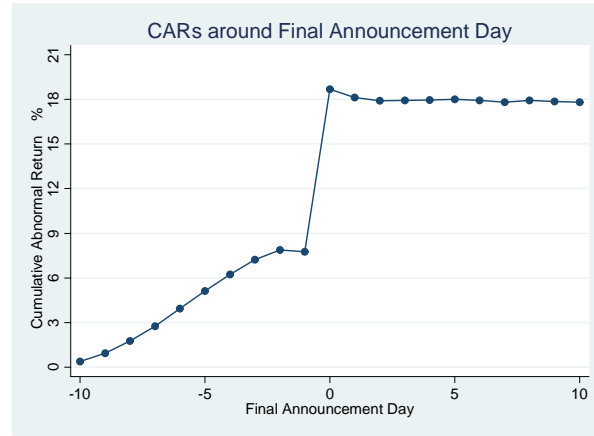
	Model 1		Model 2		Model 3	
	<i>CAR3</i>		<i>CAR5</i>		<i>CAR11</i>	
	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
<i>Intercept</i>	0.326	1.58	0.326	1.58	0.355*	1.68
<i>PIN</i>	0.116**	2.19	0.122**	2.3	0.118**	2.14
<i>SIZE</i>	-0.0157	-1.57	-0.0158	-1.58	-0.0171*	-1.67
<i>MB</i>	-0.00458	-1.43	-0.00521*	-1.78	-0.00458*	-1.89
<i>LEV</i>	0.0642	1.32	0.0777	1.59	0.0851*	1.7
<i>BH</i>	0.0953**	2.41	0.0958**	2.52	0.0903**	2.43
<i>Year2006</i>	0.0475***	4.34	0.0489***	4.37	0.0791***	6.52
<i>Year2007</i>	0.554***	7.68	0.574***	8.01	0.633***	8.89
<i>N</i>	1095		1095		1095	
Adj. R-sq	0.265		0.275		0.282	

FIGURE 1: ABNORMAL RETURNS AND CUMULATIVE ABNORMAL RETURNS AROUND REFORM APPROVAL

The figure illustrates the averages abnormal returns ( $ARs$ ) and cumulative abnormal returns ( $CARs$ ) around reform plan approvals for firms in our sample. The  $CARs$  reported in Figure 1(B) are computed using the abnormal return on day -10 as base. The  $CARs$  used in our regressions are computed using the abnormal returns around the reform plan approval (announcement) dates. For example  $CAR3$  equals the sum of  $AR_{-1}$ ,  $AR_0$  and  $AR_1$ .



(A) Abnormal Returns



(B) Cumulative Abnormal Returns