

Does granting minority shareholders direct control over corporate decisions help reduce value decreasing corporate decisions? A natural experiment from China

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Abstract

Using a 2004 Chinese securities regulation that requires equity offering proposals to seek the separate approval of the majority of voting minority shareholders, we examine whether giving minority shareholders increased control over corporate decisions helps reduce value decreasing corporate decisions in firms with concentrated share ownership. We find that the regulation deters management from submitting value decreasing equity offering proposals in firms with higher mutual fund ownership but not in firms with higher ownership by either other institutional investors or individual investors. There is also weak evidence that minority shareholders are more likely to veto value decreasing equity offering proposals in firms with higher mutual fund ownership in the post-regulation period. Overall, our evidence suggests that the effect of granting minority shareholders increased control over corporate decisions on the quality of corporate decisions depends on the composition of minority shareholders.

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1. Introduction

Corporate ownership in many countries is highly concentrated and controlling shareholders are typically part of firm management (see e.g., La Porta et al. 1999; Claessens et al. 2000). In such firms the agency conflict between top firm executives and controlling shareholders is minimal and the major agency problem is the expropriation of minority shareholders by management/controlling shareholders (hereafter referred to as insiders or management for brevity). The extant international corporate governance literature (see La Porta et al. 2000 and La Porta et al. 2008 for a review) shows that lack of legal protection of minority shareholder interests is associated with smaller financial markets (La Porta et al. 1997; Shleifer and Wolfenzon 2002), more severe financial crises (Johnson et al. 2000), lower investment efficiency (Wurgler 2000), and slower economic growth (Beck et al. 2000). Hence, an important research question in the international corporate governance literature is to identify effective control mechanisms to protect minority shareholders from the expropriation of corporate insiders.¹

As minority shareholders normally delegate major corporate decisions to insiders, a common solution to insiders' expropriation is to design monitoring mechanisms (e.g., board of directors, auditors, etc.) to align the interests between insiders and minority shareholders. Due to the failure of many common monitoring mechanisms in controlling for insiders' expropriation of minority shareholders, there is a growing interest among activist minority shareholders in shifting the corporate decision making power from insiders to minority shareholders (see, e.g.,

¹ As noted by Jensen and Meckling (1976), rational minority shareholders will price protect and thus corporate insiders ultimately have to bear all the costs associated with the expected expropriation of minority shareholders. Therefore, one may wonder why firms domiciled in weak investor protection countries do not voluntarily commit themselves to good corporate governance. One theory suggested by Doidge et al. (2007) is that weak country-level investor protection (e.g., lack of judicial independence) directly increases the costs that firms incur to bond themselves to good governance.

Vascellaro and Tibken 2008). Regulators around the world have also been busy introducing legislation to combat perceived agency problems of insiders. In addition to enacting new laws to strengthen the effectiveness of existing monitoring mechanisms, regulators are showing an increasing willingness to propose regulations that would grant minority shareholders increased control over corporate decisions (e.g., Scannell 2009; Ridley and Menon 2009).

However, whether minority shareholders should be granted increased control over corporate decisions is still hotly debated (see, e.g., Vascellaro and Tibken 2008; Scannell 2009; Holz and Berman 2010).² Proponents (see, e.g., Bebchuk 2005) argue that granting minority shareholders increased control over corporate decisions is necessary to combat widespread agency problems of insiders and increase shareholder value. Opponents (see, e.g., Bainbridge 2006) counter that minority shareholders' direct participation in corporate decisions reduces shareholder value because minority shareholders either lack the requisite knowledge and expertise to make effective decisions or have incentives to make value decreasing decisions (e.g., Porter 1992). Furthermore, even if minority shareholders are granted increased control rights over corporate decisions by law, there is no guarantee that they will have the incentive to exercise the granted control rights (see Listokin 2010) or be able to effectively exercise such legal rights in countries with weak law enforcement.

The objective of this study is to provide some empirical evidence relevant to this debate. Specifically, we use a unique 2004 securities regulation issued by the China Securities Regulatory Commission (CSRC) to examine whether giving minority shareholders increased control over corporate decisions indeed helps improve the quality of corporate decisions in firms

² Harris and Raviv (2010) offer an excellent theoretical discussion on the costs and benefits of granting minority shareholders direct control over corporate decisions.

with concentrated share ownership. Prior to the 2004 regulation insiders of publicly traded Chinese firms frequently expropriated minority shareholders using various mechanisms, including issuing new equity followed by the tunneling of the equity offering proceeds to controlling shareholders. The new regulation intends to reduce the extent of insiders' expropriation by requiring several types of major corporate decisions (the most common of which is equity offering proposals) subject to the *separate* approval of the majority of minority shareholders who participate in the voting.

We conduct three types of empirical analyses. Our first analysis uses the equity offering proposals over the period 1/1/2004-6/30/2005 to test whether the 2004 regulation has a deterrence effect by discouraging insiders from submitting value decreasing proposals. As insiders' expropriation will directly reduce the amount of cash flows available to minority shareholders, which in turn will result in a decline in stock prices, an equity offering proposal is defined to be value decreasing or low quality (value increasing or high quality) if the stock market reaction to the announcement of the proposal (denoted as CAR) is negative (positive).³ Our second analysis examines the difference in the magnitude of CAR for the equity offering proposals actually *submitted* to minority shareholders for approval across the pre- and post-regulation periods. Our third analysis uses the detailed voting data available in the post-regulation period to examine two important questions related to minority shareholders' voting behavior: (a) Which minority shareholders are more likely to participate in the voting; and (b) whether minority shareholders' voting decisions are correlated with proposal quality.

³ Our definition of proposal quality is consistent with the definition of shareholder value in the existing governance literature (see, e.g., Shleifer and Vishny 1997), which is defined as a shareholder's cash flow rights associated with her stock ownership. The cash flow rights of stock ownership are available to both minority shareholders and controlling shareholders. However, a controlling shareholder could also enjoy private control benefits, which are not available to minority shareholders.

We conjecture that the effect of the 2004 regulation on the quality of corporate decisions should depend on the effectiveness with which minority shareholders exercise their newly granted control power. Hence, we also examine the influence of minority shareholder composition in the empirical analyses. We focus on the top 10 minority shareholders because the ownership of the top 10 minority shareholders is required to be disclosed quarterly. More importantly, economic theory suggests that large minority shareholders have a stronger incentive than small minority shareholders to exercise their voting rights. We decompose the top 10 minority shareholders into institutional investors and individual investors because the former are often regarded as more sophisticated and better informed. We further decompose institutional investors into mutual funds and other miscellaneous institutions because mutual funds are believed to be more independent and thus should have a greater incentive to monitor firm management (Brickley et al. 1988; Chen et al. 2007).

Our primary results can be summarized as follows. The 2004 regulation has a strong deterrence on value decreasing equity offering proposals in firms with higher mutual fund ownership but not in firms with higher ownership by either other institutional investors or individual investors. There is no evidence that the 2004 regulation has any significant effect on management's likelihood of submitting value increasing equity offering proposals.

Consistent with the deterrence effect of the 2004 regulation, we find that the mean CAR for the submitted proposals is significantly negative in the pre-regulation period but becomes significantly positive in the post-regulation period. The difference in CAR across the two periods is significant and increases with mutual fund ownership but not with the other institutional ownership or individual investor ownership.

With regard to minority shareholders' voting behavior in the post-regulation period, we find that consistent with economic theory, minority shareholders with lower stock ownership levels are less likely to vote on submitted proposals. Among the top 10 minority shareholders, individual shareholders are less likely to vote on submitted proposals than mutual funds and other institutional investors. The median voting participation rate is 62.8% for mutual funds, 48.8% for other institutions, but only 18.3% for individual shareholders. The top 10 individual shareholders' extremely low voting participation rate suggests that they are not active in corporate governance.

We find mixed evidence on the association between proposal quality and minority shareholders' veto decisions in the post-regulation period. We find no evidence of a negative association between proposal quality and minority shareholders' veto decisions for the full sample. However, there is weak evidence of a negative association for firms with higher mutual fund ownership. Though counterintuitive, this mixed evidence does not suggest that the 2004 regulation is ineffective. Instead, it is consistent with an equilibrium where insiders are deterred from submitting value decreasing proposals and therefore minority shareholders rarely face the need to veto submitted proposals.

We conduct a series of robustness checks and find no evidence that our results are attributable to alternative explanations, such as confounding regulatory announcements or a general improvement in investor protection during our sample period. Overall, our results suggest that giving minority shareholders increased control over corporate decisions can help reduce value decreasing corporate decisions but only when there are large and independent institutional investors.

Our study makes several important contributions. First, we contribute to a growing international corporate governance literature following La Porta et al. (1997, 1998) that analyzes the effect of legal environment on shareholder value and financial market development. A general finding from this literature is that strong country-level investor protection is associated with improved earnings quality, higher shareholder value and faster financial market development (see, e.g., Hung 2001; Djankov et al. 2008). Most studies in this literature examine a country's legal environment as a whole (typically using the indices from La Porta et al. 1998) and do not examine the specific mechanisms through which law affects financial markets. Understanding the consequences of introducing specific investor protection mechanisms is important because country-level legal reforms are often incremental and piecemeal. In addition, the majority of the studies use cross-country regressions and therefore their conclusions are subject to the well-known concerns of endogeneity, measurement error, and correlated omitted variables (see La Porta et al. 2008). A key contribution of our study is to directly demonstrate the effect of adopting one specific investor protection mechanism (i.e., the shift of corporate control from insiders to minority shareholders) on the quality of corporate decisions.⁴ In addition, as detailed in Section 2, our unique setting allows us to overcome several common methodological challenges the extant literature faces in establishing the causal effect of changing minority shareholders' control over corporate decisions on the quality of corporate decisions.

Second, our results are also relevant to a growing literature on the proxy voting decisions of mutual funds (see, e.g., Davis and Kim 2007; Cremers and Romano 2007). An interesting

⁴ Given that many Chinese laws and regulations are ineffective in protecting minority shareholders' interests, the positive effect of the 2004 regulation is really surprising. One potential explanation is that the 2004 regulation is directly enforced by minority shareholders themselves rather than by government agencies which may not act in the best interests of minority shareholders. Our finding is consistent with La Porta et al. (2006) who argue that laws that facilitate private enforcement are more effective in protecting minority shareholder interests than laws that require public enforcement.

finding from this literature is that mutual funds often support management in proxy voting (see Cremers and Romano 2007), raising questions about the governance role of mutual funds. However, the evidence from our study suggests that a key governance role of mutual funds is to deter management from submitting value decreasing proposals.⁵ Therefore, a narrow focus on mutual funds' actual voting behavior would significantly understate the governance role of mutual funds (see Section 4.2 for a more detailed discussion of this issue).

Third, our study contributes to understanding the governance role of institutional investors in emerging markets with weak country-level investor protection. Despite the potential institutional frictions and agency conflicts that may hinder mutual funds' participation in corporate governance (e.g., Firth et al. 2010), our results suggest that mutual funds can play a positive role in strengthening the corporate governance of publicly traded firms in countries with weak investor protection.

Finally, we provide timely information to government regulators around the world who are debating about the costs and benefits of granting minority shareholders direct control over corporate decisions. The evidence from our study suggests that giving minority shareholders a direct say on corporate decisions can help improve the quality of corporate decisions, but only in firms with large and independent institutional investors.

The rest of the paper is organized as follows. Section 2 discusses the institutional background and related research. Section 3 discusses the effect of the regulation on

⁵ Using a private database consisting of the correspondence between TIAA-CREF and 45 firms it contacted about governance issues between 1992 and 1996, Carleton et al. (1988) find that TIAA-CREF is able to reach agreements with targeted companies more than 95 percent of the time. In more than 70 percent of the cases, this agreement is reached without shareholders voting on the proposals. Our results are consistent with Carleton et al. (1988) despite the significant differences in investor protection between China and the U.S.

management's proposal submission decision. Section 4 analyzes minority shareholders' voting behavior in the post-regulation period. Section 5 concludes.

2. Institutional background and related research

2.1. Institutional background

Prior to China's split share structure reform beginning in May 2005 that makes all shares tradable, domestically listed Chinese firms (often referred to as A share firms) had two types of common stocks: non-tradable shares and tradable shares. Non-tradable shares are largely owned by a controlling shareholder (typically a local government, the central government, or an SOE) and typically represent two thirds of a firm's share capital. Tradable shares are listed on one of the two domestic stock exchanges and can be owned by Chinese citizens, domestic institutions and qualified foreign institutional investors. We refer to the tradable shareholders as minority shareholders in this paper. Except for the difference in tradability, the non-tradable shares and tradable shares enjoy equal voting rights. Chen and Yuan (2006) find that the non-tradable shares owned by controlling shareholders of A share firms are very illiquid (typically selling for less than 20% of the market price), thus limiting the ownership benefits of equity to the controlling shareholders if they wish to sell in the short run. However, the controlling shareholders are likely long term shareholders in many firms and thus can still reap the ownership benefits of equity via future cash dividends.

Due to lack of investor protection in China (see Allen et al. 2005), controlling shareholders (i.e., non-tradable shareholders) of A share firms have a strong incentive to instruct their appointed management to tunnel the resources of A share firms to themselves (e.g., Jian and

Wong 2008; Berkman et al. 2010; Fan et al. 2007; Jiang et al. 2010).⁶ Prior to the issuance of the 2004 regulation, management of A share firms often issued new equity and then tunneled the proceeds of the equity offerings to controlling shareholders through various channels including related party transactions and related party loans (CSRC 2004).⁷ Even though equity offering proposals were required to be approved by more than 50% of all shareholders (both tradable and non-tradable) who participate in the voting, the tradable shareholders had no ability to stop the corporate insiders from proposing value decreasing proposals due to the dominant ownership of controlling shareholders in most A share firms.

To curb such egregious expropriation behavior, the CSRC issued a binding regulation in 2002 that required A share firms to seek the separate approval of the majority of voting tradable shareholders for any new share issuance that exceeds 20% of the firm's total common shares outstanding. Unfortunately this regulation turned out to be ineffective because the 20% threshold is too high and most firms easily circumvented the regulation by simply issuing new equity below the 20% threshold. Hence, the CSRC issued a tougher binding regulation entitled "*Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders*" on December 7, 2004. In addition to the previous requirement that major corporate decisions be approved by more than 50% of all shareholders (both tradable and non-tradable) who participate in the voting, this new regulation (often referred to as segmented voting

⁶ In addition to the agency conflict between the controlling shareholder and minority shareholders, there could also exist the traditional agency conflict between all shareholders (i.e., minority and controlling shareholders) and the management in state-controlled Chinese firms. This is because the controlling shareholder of state-controlled firms is the government and thus may not have the same incentive as the controlling shareholder of a family controlled firm to monitor the management. However, the existence of the agency conflict between management and all shareholders further increases the need of minority shareholder protection.

⁷ Equity offerings in China were typically priced at a discount relative to prevailing market prices to induce minority shareholders to participate. However, controlling shareholders rarely participated in the offerings because the new shares they acquire would be treated as non-tradable shares even though they had to pay the same price as minority shareholders for the new shares.

regulation) requires several major corporate decisions (e.g., equity offering, major corporate restructuring, and overseas listing of subsidiaries) to be separately approved by more than 50% of the tradable shareholders who participate in the voting.⁸ The new regulation applied to all domestically listed firms and took effect on December 7, 2004. The 2004 regulation was intended to be a temporary measure to combat widespread abusive equity offerings prior to the split share structure reform that would make non-tradable shares tradable. The 2004 regulation expired automatically upon the completion of the split share structure reform, which ended by the end of 2007 for most A share firms (see Li et al. 2010).

2.2. Related research

Not much is known from the extant literature on the economic effects of granting minority shareholders direct control over corporate decisions in firms with concentrated share ownership. One stream of research relevant to us is the large and growing international corporate governance literature following La Porta et al. (1997, 1998) that examines the cross-sectional association between country-level investor protection (typically defined using the indices from La Porta et al. (1998)) and shareholder value and financial market development (see La Porta et al. 2008 for a review). The evidence from this literature suggests that strong country-level investor protection is associated with improved capital allocation (Wurgler 2000), higher shareholder value and faster financial market development (see, e.g., La Porta et al. 1997, 1998,

⁸ In addition to the segmented voting rule, the 2004 regulation also contains the four minor investor protection provisions: (a) strengthening the role of independent directors by requiring material related party transactions and the hiring and dismissal of the company auditor subject to the approval of at least one half of the independent directors; (b) improving investor relations by encouraging management to improve the quality of corporate disclosures and investor communications; (c) encouraging listed firms to adopt a regular dividend policy and prohibiting listed firms that have not distributed cash dividends in the past three years from issuing new equity; and (d) holding controlling shareholders and company executives to the standard of fiduciary duty for minority shareholders and increasing the administrative penalties for violation of such fiduciary duty. As explained in Section 3.3, we believe our results are unlikely to be explained by any of these four minor investor protection provisions.

2002; La Porta et al. 2006; Djankov et al. 2008). However, this literature does not examine the specific channels through which law affects financial markets.⁹ Understanding the effects of specific investor protection provisions is important because legal reforms are typically incremental and piecemeal. More importantly, this literature does not distinguish investor protection provisions that facilitate minority shareholders' monitoring of insiders who makes corporate decisions from investor protection provisions that shift the control over corporate decisions from insiders to minority shareholders.¹⁰ In addition, many studies in this literature suffer from the problems of correlated omitted variables, measurement error and endogeneity (see La Porta et al. 2008 for a discussion of these issues). We believe it is still an open question whether improving a country's investor protection would naturally lead to an improvement in the quality of corporate decisions, especially in weak investor protection countries.

In response to recent corporate scandals (e.g., Enron) and the 2007 financial crisis, both U.S. federal and state governments have proposed regulatory rules that would grant shareholders an increased say on many important corporate issues such as executive compensation and director nomination (e.g., Scannell 2009). For example, the U.S. House of Representatives passed a Say-on-Pay Bill in 2007, which allows shareholders to have an annual advisory vote on

⁹ A notable exception is Atanasov et al. (2010) who study the effect of a 2002 Bulgarian law change that prohibits dilutive equity offerings, freezeouts and going-private transactions. However, they do not consider the issue of how granting minority shareholders direct control over corporate decisions affects the quality of corporate decisions.

¹⁰ Due to the widespread use of plurality voting rules in the U.S. (i.e., director elections do not require a majority shareholder vote), most director elections in U.S. firms are uncontested. Nevertheless, Cai et al. (2009) and Fischer et al. (2009) show that firms whose elected directors receive fewer shareholder votes are more likely to experience CEO and board turnover, lower CEO compensation, better investment decisions, and a higher likelihood of removing anti-takeover defenses. Their evidence suggests that even when minority shareholders do not gain direct control over corporate decisions, their mere expression of displeasure could significantly affect firm behavior. Casual observations suggest that their conclusions are unlikely to apply to many weak investor protection countries where share ownership is concentrated and insiders' expropriation of minority shareholders is rampant despite the loud and frequent complaints by minority shareholders (e.g., the period prior to the 2004 regulation in China). It is also important to note that these two studies do not examine the effect of *regulatory* changes in investor protection on managerial behavior.

executive compensation. Cai and Walkling (2010) find that the market reaction to the passage of the Say-on-Pay Bill was significantly positive for firms with high abnormal CEO compensation, with low pay-for-performance sensitivity, and responsive to shareholder pressure. It is difficult to determine whether the evidence in Cai and Walkling can be readily extended to China because country-level investor protection is much weaker in China than in the U.S. In addition, share ownership is much more concentrated in China than in the U.S. and therefore the nature of the agency conflict is quite different in China than in the U.S.

With respect to publicly traded Chinese firms, Berkman et al. (2010) examine the abnormal stock returns to the announcements of three Chinese securities regulations within a two-month period in 2000.¹¹ Berkman et al. find that firms with weaker governance experienced significantly larger abnormal returns around the announcements of the three regulations than did firms with stronger governance. While their results suggest that the three regulations help increase the degree of investor protection, it is difficult to determine whether the three regulations result in a significant increase in minority shareholders' direct control over corporate decisions.

Another stream of research relevant to us is the U.S. literature on shareholder activism. Again, it is difficult to determine whether the U.S. evidence on shareholder activism can be readily extended to countries with concentrated stock ownership. More importantly, this literature studies voluntary shareholder activism rather than mandatory regulatory changes in investor protection. The common corporate issues targeted by activist shareholders include

¹¹ The first regulation allows shareholders with more than 5% voting rights to propose motions for discussion at the shareholders' annual meeting and prohibits shareholders involved in a related party transaction from voting on the transaction. The second regulation prohibits listed firms from issuing loan guarantees to their shareholders, shareholders' controlled or affiliated companies, or any individual. The third regulation requires the board to perform a rigorous due diligence on any material asset acquisition or disposal.

executive compensation, board structure, shareholder voting rights, and anti-takeover provisions in corporate charters (see, e.g., Johnson et al. 1997; Gordon and Pound 1993). As noted in a survey paper by Gillian and Starks (2007), there is no conclusive evidence that shareholder activism has a significant impact on firm operations, earnings or stock returns. Gillian and Starks (2007) show that one important reason for the mixed evidence is the methodological challenges that researchers face in establishing the causal effect of changing minority shareholders' control over corporate decisions on shareholder value. First, minority shareholders' control over corporate decisions often changes slowly. Therefore, a researcher may find it difficult to reliably measure a small change in minority shareholders' control or detect the effect of the small change on shareholder value.

Second, most changes in minority shareholders' control over corporate decisions deal with general corporate governance issues (e.g., board structure or voting procedures) rather than specific corporate decisions. Hence, it is difficult to directly attribute any observed change in managerial behavior (e.g., change in corporate investment) to a change in minority shareholders' control.

Third, even if a change in minority shareholders' control deals with a specific corporate decision, a researcher generally cannot observe the outcome of the specific decision made by minority shareholders and thus has to infer the impact of the change in minority shareholders' control from aggregate performance outcomes such as stock prices or accounting earnings. As stock prices and accounting earnings reflect the effects of multiple economic forces, any association between changes in minority shareholders' control and changes in stock prices or earnings could be subject to alternative explanations.

The experimental setting of our study can overcome all of these methodological challenges. In particular, the 2004 regulation represents a significant mandatory shift in the control over corporate decisions from management to minority shareholders and deals with specific corporate decisions (i.e., equity offering proposals). In addition, we can observe the outcomes of the specific decisions made by minority shareholders. Therefore, it is relatively straightforward to establish the causal link between an increase in minority shareholders' control over corporate decisions and the change in the quality of the targeted corporate decisions in our setting.

3. The effect of the 2004 regulation on the quality of management's equity offering proposals

We use two complementary approaches to examine the effect of the 2004 regulation on the quality of managerial equity offering proposals. In section 3.1, we examine whether the 2004 regulation deters managers from submitting value decreasing equity offering proposals (referred to as the deterrence effect). In Section 3.2 we examine whether the average quality of *submitted* equity offering proposals is higher in the post-regulation period than in the pre-regulation period.

Consistent with the notion of shareholder value maximization (see Shleifer and Vishny 1997), which focuses on the cash flow rights of stock ownership as reflected in stock prices, we use the stock market reaction to the announcement of an equity offering proposal (denoted as CAR) to proxy for proposal quality. CAR is the market adjusted cumulative abnormal return over the [-2, +10] trading days around the proposal announcement date.¹² The difference between the proposal announcement date and the proposal voting date is at least 20 trading days

¹² To allow the possibility of information leakage, we also start the CAR measurement from trading day -5 and find similar inferences (untabulated).

for all but one proposal. For this one proposal, the holding period of CAR is 9 trading days only that end in the day before the voting date. In section 3.3.1 we will discuss the potential limitations of CAR as a proxy for proposal quality and provide additional sensitivity checks to rule out alternative explanations.

We extend the holding period of CAR to 10 trading days after the proposal announcement for several reasons. First, the Chinese stock exchanges limit the maximum daily stock price movement to be $\pm 10\%$ only so that a short window CAR may not fully capture the quality of a proposal. Second, equity offering is a complex business decision and thus minority shareholders may need more time to digest the information included in the proposal and search for private information to evaluate the merits of the proposal. This is especially important in China because management usually does not provide detailed information on equity offering proposals. Finally, the Chinese stock market is dominated by small retail investors and there are not enough sophisticated investors such as financial analysts or institutional investors who can help quickly impound into stock prices the value implications of an equity offering proposal. Consistent with this argument, Ma (2004) finds a significant drift in the Chinese stock market's reactions to announcements of many major corporate decisions, including equity offering proposals. Hence, we believe that an abnormal return measured over a longer period should better capture proposal quality.¹³

3.1. The deterrence effect of the 2004 Regulation

3.1.1. The sample and data sources

¹³ Prior China related event studies also use relatively long periods to measure abnormal returns (see, e.g., Fan et al. 2008; Berkman et al. 2010).

Although the 2004 regulation requires several types of managerial proposals (e.g., equity offering, major corporate restructuring, and overseas listing of subsidiaries) to be separately approved by the majority of tradable shareholders, we only use the equity offering proposals (including general offerings, rights offerings, and convertible bond offerings) in our empirical tests for the following reasons. First, equity offerings were one of the most common methods corporate insiders employed to expropriate minority shareholders prior to 2004. Second, the frequency of equity offering proposals is considerably higher than that of any of the other managerial proposals. During our sample period the number of equity offering proposals is more than 200 but the number of the other types of managerial proposals such as the overseas listing of a subsidiary is less than a dozen and thus cannot be used to conduct a meaningful study. Third, for certain types of corporate proposals (e.g., major corporate restructuring), management can easily avoid the required approval of tradable shareholders by manipulating the terms of the proposals. Hence, the sample of such proposals is severely biased. Finally, mixing different types of managerial proposals could create difficulty in identifying suitable control variables in our research design and the interpretation of our empirical results.

We limit our empirical analysis to the eligible firm months over the period 1/1/2004-6/30/2005. In principle a firm can submit a proposal on any date and therefore our following regression analysis should be run using daily data. We choose to aggregate the data to the monthly level because running the regression analysis using daily data requires too much computational power. Our sample starts on 1/1/2004 because data on the detailed top 10 minority shareholder ownership are not available before 2004. Our sample ends on 6/30/2005 because very few firms submitted equity offering proposals for shareholder approval after June 2005, likely reflecting management's anticipation that the CSRC would not process equity offerings

proposals due to the split share structure reform. Note that all equity offering proposals approved by shareholders require the final approval of the CSRC.¹⁴

We follow various CSRC regulations to identify all the A share firm months that are eligible to propose equity offerings (general offerings, rights offerings, or convertible bond offerings) as of the beginning of each observation month (see the Appendix for the details of the identification method). After deleting observations missing control variables, there are 21,512 firm months during our sample period and 11,924 (55.4%) firm months representing 855 unique firms are deemed eligible to propose equity offerings. The inferences in Table 2 are qualitatively similar if we include all of the firm-month observations. We used a Chinese firm data base WIND to identify the sample of equity offering proposals submitted in our sample period and hand collected all the relevant information on the equity offering proposals, such as the announcement date, voting date, and the voting outcomes. All the financial data used in this study are obtained from WIND and CSMAR.

3.1.2. Methodology

For all the A share firm months eligible to propose equity offering proposals over the period 1/1/2004-6/30/2005, we use the following multinomial logit model to test the effect of the 2004 regulation on management's decision to submit value increasing versus value decreasing equity offering proposals:

$$SUBMISSION_{it} = a + b * AFTER + c * CONTROL_{it} + \varepsilon_{it} \quad (1)$$

¹⁴ In fact most equity offering proposals announced in our post-regulation period were not processed by the CSRC due to the split share structure reform that started in April 2005. As a result, we cannot compare how the proceeds from the equity offerings are used differently in the pre- and post-regulation periods.

where i and t are firm and month indicators, respectively. $SUBMISSION_{it}$ is 0 if firm i does not submit a proposal in month t , 1 if firm i submits a value increasing (i.e., $CAR > 0$) proposal in month t , and 2 if a firm i submits a value decreasing (i.e., $CAR \leq 0$) proposal in month t . $AFTER$ is a dummy variable that is equal to one for the 7 months in the post-regulation period (i.e., December 2004 and after), and zero for the 11 months in the pre-regulation period.^{15, 16} $CONTROL$ is a list of common determinants of equity offerings discussed below.

If minority shareholders are independent and thus have the incentive to use their newly granted control power to veto value decreasing proposals, rational management should be deterred from submitting value decreasing proposals (i.e., the coefficient on $AFTER$ should be negative for value decreasing proposals). This is because insiders (i.e., management and controlling shareholders) do not obtain any benefit from submitting a proposal that is expected to be vetoed by minority shareholders. More importantly, there are significant costs associated with submitting a proposal that will be vetoed. One cost is the nontrivial time and resources devoted to the preparation of the proposal that could be otherwise spent in more productive activities. Another cost is the damage to management and directors' reputation resulting from the vetoing of a value decreasing proposal. In addition, management may also be forced to face the media and investors to explain the reasons for the veto, which could be embarrassing to management

¹⁵ Even though the regulation became effective on December 7, 2004, we treat the entire December 2004 as part of the post period. There were no equity offering proposals announced over December 1, 2004-December 6, 2004.

¹⁶ Upon the release of the exposure draft of the regulation on September 27, 2004, some firms might have attempted to avoid the final regulation by accelerating future equity offering proposals to the period 9/27/2004-12/7/2004. As a robustness check, we also define $AFTER$ using September 2004 as a cutoff and find similar inferences. Empirically, we find little evidence of acceleration of value decreasing proposals from the post-regulation period to the pre-regulation period. This finding could be due to two reasons. First, the 2004 regulation was proposed and passed quickly. Second, the CSRC requires a minimum gap of 30 days between the mailing date and voting date of a managerial proposal submitted to shareholders for approval. As a result, management could find it difficult to accelerate value decreasing proposals to avoid the 2004 regulation.

(see, e.g., “Equity Offering Proposal Vetoed, Fuyao Inc. Has to Look For Alternative Financing Sources”, China Mining Journal, June 23, 2004).

To the extent that they are rational, minority shareholders should not veto value increasing equity offering proposals and therefore we should not expect the 2004 regulation to have a deterrence effect on value increasing equity offering proposals. Therefore, we do not expect the coefficient on *AFTER* to be negative for value increasing proposals.

To make sure that the coefficient on *AFTER* is not due to systematic differences in the characteristics of the sample firms across the two time periods, we follow existing corporate finance research (see, e.g., Jung et al. 1996; Berger et al. 1997; Myers 2003; Leary and Roberts 2010) by including the following common equity financing determinants (see Table 1 for variable definitions). All control variables are defined using the most recently available information as of the beginning of month *t*. *Q* is a proxy for investment opportunities. We expect higher *Q* firms to be more likely to raise equity capital. *CASH* and *CFO* are proxies for the availability of internal funds. Firms with higher *CASH* and *CFO* are expected to be less likely to raise equity capital. *LEV* is a proxy for debt capacity and financial distress. We expect higher *LEV* firms to be more likely to raise equity capital. *VOLATILITY* is a proxy for the financial distress risk. We expect firms with higher *VOLATILITY* to be more likely to raise equity rather than debt. *AR12* is a proxy for the inverse of information asymmetry or stock price overvaluation. We expect firms with higher *AR12* to be more likely to issue equity capital.¹⁷ *ASSETS* is the natural logarithm of total assets at the end of the quarter prior to month *t*. *ASSETS* is a proxy for the inverse of information asymmetry and also controls for potential size effects. Finally, we

¹⁷ We also used the 12-month raw return or both *AR12* and the 12-month market return and found similar inferences (untabulated).

include industry fixed effects (INDCD in CSMAR) because firms in certain industries may have a stronger need to raise equity.¹⁸

We conjecture that the efficacy of the 2004 regulation should hinge on whether and how minority shareholders are expected to vote on submitted managerial proposals. Hence, we also examine whether the effect of *AFTER* varies with a firm's minority shareholder ownership structure. Economic theory suggests that the incentive to participate in shareholder voting should increase with a shareholder's stock ownership (see Section 4.1 for direct confirmative evidence). Hence, we focus on the stock ownership of the top 10 minority shareholders, which is required to be disclosed quarterly since the end of 2003.

We consider the ownership of the following three types of top 10 minority shareholders: mutual funds (*MUTUAL_OWN*), other institutional investors (*OTHERINST_OWN*), and individuals (*INDIVIDUAL_OWN*) (see Table 1 for variable definitions).¹⁹ All three ownership variables are defined using the most recent available data as of the beginning of month *t*. As the 2004 regulation requires the tradable shareholders to vote separately on submitted equity offering proposals, the denominator of all three ownership variables is the total outstanding tradable shares rather than the sum of the total outstanding tradable and non-tradable shares.²⁰

¹⁸ As a sensitivity check, we also follow Li et al. (2009) by including two additional control variables that are unique to China in the regression models of Tables 2 and 3: a dummy variable for state-controlled firms and a regional institutional development index developed by Fan and Wang (2004) and obtain similar inferences.

¹⁹ We do not break out foreign shareholder ownership because there were very few foreign investors during our sample period, which predated the launch of China's Qualified Foreign Institutional Investor Program.

²⁰ We do not further decompose each top 10 minority shareholder type (e.g., mutual funds) by investment horizon. This is because value decreasing equity offering proposals, if approved, would result in an immediate decline in stock prices. Therefore, both long-horizon and short-horizon independent top 10 minority shareholders would have an incentive to veto such proposals. In addition, the level of aggregate stock ownership by each top 10 minority shareholder type is very stable over our sample period (the AR(1) correlation is always greater than 70%), even though the investment horizons of individual shareholders within each top 10 minority shareholder type could vary.

We decompose the top 10 minority shareholders into individual investors and institutional investors because institutional investors are commonly believed to enjoy economy of scale, information advantage, and high level of sophistication. Therefore, institutional investors are expected to be more likely to participate in the voting and make more informed decisions than individual investors.

We further decompose institutional investors into mutual funds (open ended or close ended) and other institutional investors (e.g., securities firms, national social security trust funds, insurance companies, foreign institutions, etc) because the evidence from Brickley et al. (1988) and Chen et al. (2007) based on U.S. mutual funds suggests that mutual funds are more independent than other institutional investors. In our China context, relative to other Chinese institutional investors who may have existing or potential business relations with listed firms (e.g., insurance companies) or who may have non-value maximizing social objectives (e.g., national social security trust funds), Chinese mutual funds should be more independent because their primary business activity is fund management.²¹ Furthermore, the Chinese mutual fund industry is relatively competitive (see Ferreira and Ramos 2009, Table 11) and therefore a mutual fund that does not perform well faces the risk of losing its fund clients to competing mutual funds. One potential countervailing force is that investor protection in China is weak and Chinese mutual funds are typically controlled by state-related entities. Hence, they may not be as independent as those in the U.S. Because of these opposing economic forces governing mutual funds' behavior, we do not make any ex ante predictions on the differential effects of mutual funds versus other institutional investors.

²¹ Mutual funds may also have business ties with the firms in their investment portfolio, but Davis and Kim (2007) find no evidence that business ties negatively affect U.S. mutual funds' independence (see also Cremers and Romano (2007)). We are not aware of similar studies on Chinese mutual funds.

3.1.3. Results

Table 1 shows the descriptive statistics for the relevant regression variables of model (1). Approximately 0.9% of the firm months proposed value increasing equity offerings while 1% of the firm months proposed value decreasing equity offerings. The median size of the equity offerings (defined as the proposed dollar value of an offering scaled by the average market value of the tradable shares during the 20 calendar days before the equity offering announcement) is not significantly different over the pre- and post- regulation periods (untabulated).

Among the top 10 minority shareholders, the mean mutual fund ownership is 4.6% of the total outstanding tradable shares while the mean stock ownership of all the other institutional shareholders is 6.3% of the total outstanding tradable shares. These percentages are economically meaningful but are much lower than the mean total institutional ownership in listed U.S. firms. The mean individual shareholder ownership (INDIVIDUAL_OWN) is 2% of the total outstanding tradable shares, much smaller than that of MUTUAL_OWN or OTHERINST_OWN. This finding suggests that most individual investors are not large shareholders even though they dominate the Chinese stock market in terms of numbers.

The small aggregate ownership of the top 10 institutional investors raises an interesting question on the effectiveness of these institutional investors as monitors. We believe this is not a concern in our setting because under the 2004 regulation the equity offering proposals must be *separately* approved by the majority of minority shareholders who participate in the voting. We find in Section 4.1 that in the post-regulation period non-top 10 minority shareholders rarely participated in the voting of equity offering proposals while the majority of top 10 institutional investors did actively participate in the voting. Hence, the small aggregate ownership of the top

10 institutional investors could still have a substantial impact on the voting outcomes under the 2004 regulation.

Panel A of Table 2 shows the regression results of the multinomial logit regression model (1) for value increasing equity offering proposals and value decreasing equity offering proposals relative to the reference group of firms that do not have any equity offering proposals in a month. The coefficients on the control variables are generally consistent with our predictions though not always significant. The only exception is the coefficient on VOLATILITY for the value decreasing proposals.²²

The insignificant coefficient on AFTER for value increasing proposals suggests that there is no evidence that increasing minority shareholders' control over corporate decisions affects management's likelihood of submitting value increasing equity offering proposals. The coefficient on AFTER for value decreasing proposals is significantly negative, suggesting that management is less likely to submit value decreasing equity offering proposals in the post-regulation period.

Panel B of Table 2 shows the results of model (1) that allows the coefficient on AFTER to vary with the top 10 minority shareholder ownership variables. With respect to value increasing proposals, the coefficients on AFTER*MUTUAL_OWN and

²² To check whether the results in Table 2 are sensitive to the inclusion of too many firm months that did not announce equity offering proposals, we also redo the regressions in Table 2 using an industry and firm size matched sample. Specifically, for each firm that submitted an equity offering proposal in a month, we retain only the not-equity offering submitting firms in that month that are in the same industry as the submitting firm and whose total assets fall in the range of 90%-110% of the submitting firm's total assets. Results are similar if we use 80%-120% and 95%-105% as alternative cutoffs. While the sample size for this matched subsample drops to 3,399 (28.5% of the full sample in Table 2), the coefficient on AFTER for value decreasing proposals in Panel A of Table 2 is still significantly negative (two-tailed $p=0.033$) while the coefficient on AFTER*MUTUAL_OWN for value decreasing proposals in Panel B of Table 2 is significantly negative (two-tailed $p=0.005$) (untabulated).

AFTER*OTHERINST_OWN are both insignificant at the 10% two-tailed level, suggesting that management is not deterred from submitting value increasing proposals in firms with higher mutual fund or other institutional shareholders in the post-regulation period relative to the pre-regulation period. However, the coefficient on AFTER*INDIVIDUAL_OWN is negative and marginally significant (two-tailed $p=0.141$). Hence, there is weak evidence that management is less likely to submit value increasing proposals in firms with higher top 10 individual shareholders in the post-regulation period relative to the pre-regulation period.

With respect to value decreasing proposals in Panel B of Table 2, the coefficient on AFTER*MUTUAL_OWN is significantly negative but the coefficient on AFTER*OTHERINST_OWN isn't, suggesting that the presence of mutual fund ownership but not the presence of other institutional ownership helps deter management from submitting value decreasing proposals.²³ The coefficient on AFTER*INDIVIDUAL_OWN for value decreasing proposals is significantly negative. This result suggests that the presence of top 10 individual minority shareholders also helps deter management from submitting value decreasing proposals in the post-regulation period relative to the pre-regulation period.²⁴

Overall, the results in Table 2 suggest the following conclusions. First, management is less likely to submit value decreasing but not value increasing equity offering proposals in the post-regulation period than in the pre-regulation period in firms with higher mutual fund ownership. Second, there is no evidence that management's incentive to submit value increasing

²³ It is unlikely that the significant interaction effect for AFTER*MUTUAL_OWN can be explained by mutual funds' stock picking ability. If this were the case, the coefficient on MUTUAL_OWN should be significantly negative rather than insignificant for the pre-regulation period for value decreasing proposals in Table 2, Panel B.

²⁴ As firms that have proposed equity offerings in the recent past may be less likely to submit new equity offering proposals in month t , we also include in model (1) a dummy variable indicating the firms that have proposed at least one equity offering in the previous 12 months. None of our inferences in Table 2 is affected.

or value decreasing proposals is changed over the pre- and post-regulation periods in firms with higher other institutional ownership. Third and surprisingly, management is less likely to submit both value decreasing and value increasing equity offering proposals in the post-regulation period than in the pre-regulation period in firms with higher individual ownership.

3.2. Quality of submitted equity offering proposals before versus after the 2004 regulation

Given that the 2004 regulation helps deter value decreasing equity offering proposals as shown in Table 2, we should also expect the average quality of *submitted* equity offering proposals to be higher in the post-regulation period than in the pre-regulation period. We test this prediction by comparing the average magnitude of CAR across the pre- and post-regulation periods. We expect the average CAR to be more positive in the post-regulation period. It is important to note that we cannot automatically infer the results in Table 2 based on the confirmative evidence in Table 3. This is because Table 3 does not distinguish value decreasing versus value increasing proposals. For example, the increase in CAR across the two periods in Table 3 could be caused by the increase in the number of value increasing proposals but there could be no change in the pattern of value decreasing proposals in the two periods.

Panel A of Table 3 shows the results of CAR for the pre- and post- regulation periods. The results suggest that proposal quality is higher in the post-regulation period. The mean and median CAR are both significantly negative in the pre-regulation period using the t-test and rank-sum test. In contrast, the mean and median CAR are both positive in the post-regulation period and significantly different from zero using the t-test. In addition, the mean and median CARs are significantly different over the two time periods using either a t-test or rank-sum test.

Panel B of Table 3 provides further evidence on the impact of the top 10 minority shareholder composition on the quality of submitted proposals across the two time periods.²⁵ Since management had absolute control over equity offering decisions in the pre-regulation period, it may not be surprising to observe that none of the coefficients on MUTUAL_OW, OTHERINST_OW, and INDIVIDUAL_OW is significant. Consistent with the evidence in Table 2, the coefficient on AFTER*MUTUAL_OW is significantly positive, suggesting that mutual fund shareholders play an effective governance role in the post-regulation period by improving the quality of submitted proposals. There is no evidence of an improvement in proposal quality over the two time periods in firms with higher other institutional or higher individual shareholder ownership. Overall, the results in Tables 2 and 3 provide fairly mixed evidence on the effects of individual investor ownership on the quality of managerial equity offering proposals. For this reason, we do not draw any strong conclusion on the effect of individual investor ownership in our overall inference.²⁶

3.3. Robustness checks

In this section we perform a series of robustness checks to rule out alternative explanations for the regression results in Tables 2 and 3.

²⁵ For both Panels A and B of Table 3, we do not control for the firm characteristics in Table 2 because any improvement in CAR in the post-regulation period is due to the change in the types of firms that propose equity offerings. Thus, controlling for these firm characteristics would take away a portion of the effect we wish to capture. However, the results in Table 3 are robust to controlling for these firm characteristics (untabulated).

²⁶ Given that the 2004 regulation helps reduce management's incentive to propose value decreasing equity offerings in firms with higher mutual fund ownership, one may wonder whether the 2004 regulation also encourages mutual funds to increase their investment in firms with greater managerial agency problems so that they can capture the stock price gain from vetoing value decreasing managerial proposals in such firms. Using the amount of inter-corporate loans from the listed firm to its parent company (see Jiang et al. 2010) or the average CAR of equity offering proposals submitted prior to the 2004 regulation as a proxy for the extent of managerial agency problems, we find no supporting evidence for the above prediction (results untabulated).

3.3.1. Potential limitations of CAR as a proxy for proposal quality

While there exist potential alternative proxies for proposal quality (e.g., firm characteristics such as growth opportunities), we believe that CAR is the most comprehensive and direct measure of proposal quality for two main reasons. First, CAR aggregates all value relevant information possessed by all stock market investors. Second, CAR directly reflects the change of minority shareholders' cash flow rights resulting from a proposed equity offering.

However, we acknowledge that CAR could suffer from several potential limitations as a proxy for proposal quality. First, CAR could be nonzero for volatile stocks even when the announcement of an equity offering proposal suggests no evidence of managerial agency problems. Hence, our classification of value decreasing versus value increasing proposals based on the sign of CAR in Table 2 could be noisy. To deal with this concern, we create a standardized CAR (denoted as SCAR), which is defined as $\frac{CAR}{\sqrt{N}\sigma}$, where N is number of trading days in the CAR window, and σ is standard deviation of daily market-adjusted returns over the [-280,-31] trading days prior to the equity offering proposal announcement date. Then we redefine an equity offering proposal to be value decreasing if its SCAR is below -1.65, value increasing if its SCAR is above +1.65, and value neutral if its SCAR falls between -1.65 and +1.65. The cutoff 1.65 is the critical T value for the two-tailed significance level of 10%. Panel A of Table 4 replicates the multinomial logit regression in Panel B of Table 2. The results for value decreasing proposals are qualitatively similar to those in Table 2 using this alternative definition of value decreasing versus value increasing proposals. For value increasing proposals, there is no evidence that any of the three top 10 minority shareholders deters management from submitting value increasing proposals. Interestingly, the coefficient on AFTER*INDIVIDUAL_OWN is significantly negative for value neutral proposals. Panel B of Table 4 replicates the OLS

regression in Panel B of Table 3 using SCAR as the dependent variable. The inferences in Panel B of Table 4 are qualitatively similar to those in Panel B of Table 3.

Second, even if management continues to submit a large number of value decreasing equity offering proposals in the post-regulation period, CAR may not be negative due to the stock market's anticipation of minority shareholders' vetoing of value decreasing proposals. However, this anticipation effect does not appear to be severe in our sample because as shown in Section 4.2, only a small number of equity offering proposals were vetoed by minority shareholders in the post period.

Third, Myers and Majluf (1984) show that CAR could be negative in the presence of information asymmetry between insiders and outside investors. Hence, even if the true underlying quality of the proposed equity offerings does not improve in the post-regulation period, the average CAR could be still less negative in the post-regulation period if corporate insiders have the incentive to provide more information about the proposed equity offerings and therefore the degree of information asymmetry between insiders and outside investors is smaller in the post-regulation period than in the pre-regulation period. We do not believe that our results in Tables 2 and 3 can be attributed to this alternative explanation for several reasons. The first reason is that Myers and Majluf's information asymmetry hypothesis cannot explain why the average CAR in the post-regulation period is significantly positive as shown in Table 3. The second reason is that the prices of all equity offerings are determined based on the prevailing stock prices prior to the offerings. Hence, we expect corporate insiders to have equal incentives in both time periods to provide information to outside investors in order to avoid the dilution of their own equity ownership in the firm. The third reason is that the CSRC did not change the mandatory disclosures that are required to be contained in equity offering proposals during our

sample period. The final reason is that we find no evidence that the information contained in the equity offering proposals differs between the pre-regulation period and the post-regulation period. Specifically, we perform a formal regression analysis by using the number of words contained in an equity offering proposal as a proxy for the disclosure quality of the proposal. As shown in Table 5, we find no evidence that the proposal's disclosure quality differs significantly across the two time periods for any type of minority shareholders.²⁷

Fourth, CAR could be affected by confounding corporate announcements that occurred during the CAR measurement window. To deal with this issue, we use the following regression model to remove the effect of two most common firm-specific announcements that occurred during the CAR measurement window, earnings surprises and dividend surprises (where *i* and *t* are proposal and time indicators, respectively):

$$CAR_{it} = a + b * E_NEWS_{it} + c * E_SURPRISE_{it} + d * D_NEWS_{it} + e * D_SURPRISE_{it} + \varepsilon_{it} \quad (2)$$

E_NEWS is a dummy variable that is 1 if there is an earnings announcement during the CAR measurement window, and zero otherwise. *E_SURPRISE* is the earnings surprise for *E_NEWS*=1 observations and zero otherwise. The earnings surprise is defined as earnings in quarter *t* minus earnings in quarter *t*-4 divided by the market value of equity at the fiscal quarter end *t*. For 8 confounding earnings news, we do not have the data on the quarter *t*-4 earnings and thus the earnings surprise is defined using the earnings at quarter *t*-1. For one confounding earnings announcement, the quarterly earnings are missing and thus the earnings surprise is defined using the available semiannual earnings (i.e., the semiannual earnings for the quarters *t*-1 and *t* minus the semiannual earnings for quarters *t*-3 and *t*-2 divided by the market value of equity at the quarter end *t*). To make all the earnings surprises comparable, we annualize all

²⁷ This finding also suggests that the provision (b) noted in footnote 8 is ineffective in inducing corporate insiders to disclose more information.

earnings surprises by multiplying the quarterly earnings surprises by four and semiannual earnings surprises by two. If there are multiple earnings surprise announcements for different fiscal horizons in the CAR measurement window, we sum up the multiple earnings surprises. D_NEWS is a dummy variable that equals 1 if there is a cash dividend announcement during the CAR measurement window, and zero otherwise. $D_SURPRISE$ is a dummy variable that equals 1 if $D_NEWS=1$ and there is a dividend initiation or increase, 0 if $D_NEWS=1$ and there is no dividend change, -1 if $D_NEWS=1$ and there is a dividend omission or decrease, and 0 for all $D_NEWS=0$ observations. Our definitions of dividend initiation and dividend omission follow Dhillon and Johnson (1994).

Untabulated regression result of model (2) shows that the coefficient on $D_SURPRISE$ is significantly positive at the 10% level while the coefficients on the other independent variables are insignificant at the 10% level. We replicate the analyses in Panel B of Tables 2 and 3 using the residual (including the intercept) from regression model (2) as an alternative proposal quality proxy (denoted as RCAR). As shown in Table 6, none of our inferences is affected using this alternative proposal quality proxy.

3.3.2. The confounding effect of the Split share reform

We examine whether the results in Tables 2 and 3 are due to management's anticipation of future securities regulations that occurred after December 7, 2004. The most significant securities reform in China following the 2004 regulation is the split share structure reform in 2005. The CSRC announced the first pilot batch of four companies for the reform in April 2005 and another pilot batch of 42 companies in May 2005, but the reform was expanded to all listed firms by August 2005 (Li et al. 2010). Although the split share reform was launched fairly

suddenly, some corporate managers might have anticipated the launch of the reform, which in turn might have affected their incentive to submit equity offering proposals. There are two potential effects of the anticipated reform. The first effect is that the CSRC will cease processing equity offering proposals upon the launch of the reform and therefore management may have a lower incentive to announce equity offering proposals in the post-regulation period (both value increasing and value decreasing). This prediction is not supported in Table 2 because we find different results for value increasing and value decreasing proposals. In addition, our results in Table 2 are robust to excluding the 46 pilot firms from our sample or excluding the 2nd quarter of 2005, which is more likely subject to the anticipation effect of the reform.

The second effect of the split share structure reform is that the increased liquidity of non-tradable shares post the reform should help align the interests between controlling shareholders (especially those with a larger ownership of non-tradable shares) and minority shareholders and therefore controlling shareholders of A share firms may have a weaker incentive to expropriate minority shareholders (e.g., announcing value decreasing equity offering proposals) in our post-regulation period, which predates the completion of the reform. To rule out this alternative explanation, we rerun the regressions in Tables 2 and 3 after including NONTRADE_OWN (defined as the stock ownership of all non-tradable shareholders) and its interaction with AFTER. To the extent that the documented results in Tables 2 and 3 are due to this alternative explanation, the coefficient on AFTER*NONTRADE_OWN for value decreasing proposals should be significantly negative for the model in Table 2 and the coefficient on AFTER*NONTRADE_OWN should be significantly positive for the model in Table 3. In addition, including AFTER*NONTRADE_OWN would reduce the effect of AFTER*MUTUAL_OWN in Tables 2 and 3.

As shown in Table 7, the coefficient on AFTER*NONTRADE_OWN is never significantly different from zero, suggesting no evidence of an anticipation effect of the reform. More importantly, the coefficient on AFTER*MUTUAL_OWN for value decreasing proposals in Panel A of Table 7 remain significantly negative. In addition, the coefficient on AFTER*MATUAL_OWN remains significantly positive in Panel B of Table 7. These results suggest no evidence that our results in Tables 2 and 3 are driven by management's anticipation of the split share restructure reform.

3.3.3. General improvement in investor protection

One may wonder whether the results in Tables 2 and 3 could be explained by China's gradual improvement in investor protection during our sample period. While we are not aware of any competing regulation issued around the passage of the segmented voting regulation that would *directly* limit management's ability to submit value decreasing proposals, we cannot rule out the possibility that there are competing regulations that may have an *indirect* effect on management's incentive to expropriate minority shareholders. For example, even the segmented voting regulation contains four additional minor investor protection provisions (see footnote 8).

We perform several types of analyses to rule out this alternative explanation. First, we examine whether there is a time trend in the mean/median CAR over our sample period. To the extent that our results in Tables 2 and 3 are due to China's gradual improvement in investor protection, we should observe similar findings even for the period prior to the 2004 regulation. As shown in Figure 1, there is no evidence of a time trend in the mean/median CAR over our sample period except for the jump in CAR coincident with the 2004 regulation.

Second, we replicate the interaction effects regressions in Tables 2 and Table 3 using a pseudo *AFTER* over the following three alternative 18-month time periods prior to the 2004 regulation: (a) January 2003-June 2004; (b) April 2003-September 2004; and (c) July 2003-November 2004.²⁸ As the regulation took effect on December 7, 2004, the last pseudo period contains only 17 months. We choose a gap of 3 months between the starting months of the three pseudo periods. Similar to the definition of *AFTER*, the pseudo *AFTER* is zero for the first 11 months and one for the remaining months. The results are shown in Table 8. For brevity, Table 8 only shows the coefficients for the relevant interaction terms. For all the replications using the three alternative time periods, we find no results similar to those in Tables 2 and 3. Overall, these sensitivity results suggest no evidence that the results in Tables 2 and 3 are due to a gradual improvement in investor protection.

Third, we examine whether the investor protection provision (c) noted in footnote 8 explains the results of Table 2. As provision (c) prohibits listed firms that have not paid any cash dividends in the past three years from issuing new equity, it will directly affect the sample of eligible firms for our Table 2. We do not believe that this provision is binding because management can easily circumvent provision (c) by paying a nominal amount of dividends before issuing new equity. Nevertheless, we rerun the regressions in Table 2 by restricting our sample firms to those that paid cash dividends in at least one of the past three years. Our inferences are not changed (untabulated). This may not be surprising because this restriction only results in a small reduction in our sample from 11,924 to 10,317.

²⁸ As minority shareholder ownership data are unavailable before the fourth quarter of 2003, we assume that the values of *MUTUAL_OW*N, *OTHERINST_OW*N, and *INDIVIDUAL_OW*N for the months prior to the 4th quarter of 2003 are equal to those at the end of the 4th quarter in 2003. This is a reasonable assumption because the top-10 minority shareholder ownership is very stable in our sample period (see footnote 20).

Fourth, we conduct a falsification test by examining whether there is a decline in the extent of inter-corporate loans from A share firms to their controlling shareholders in the post-regulation period. Jiang et al. (2010) show that inter-corporate loans are a common tunneling mechanism that controlling shareholders use to expropriate minority shareholders of publicly traded A share firms. While a general improvement in investor protection (e.g., the four minor investor protection provisions of the 2004 regulation noted in footnote 8, especially provisions (a) and (d)) may reduce controlling shareholders' incentive to expropriate minority shareholders using both inter-corporate loans and value decreasing equity offering proposals, the segmented voting regulation does not directly limit management's ability to expropriate minority shareholders using inter-corporate loans. Therefore, to the extent that the results in Tables 2 and 3 are due to a general improvement in investor protection rather than the segmented voting regulation, we should also observe a similar decline in the extent of outstanding inter-corporate loans post the 2004 regulation in our sample period. We use the following OLS regression model to test this prediction:

$$OREC_{it} = \beta_i + \beta_1 * AFTER + \beta_2 * LNNTA_{it} + \varepsilon_{it} \quad (3)$$

where i and t are firm and quarter indicators, respectively. OREC (defined as gross other receivables deflated by year-end total assets) is a proxy for the inter-corporate loans per Jiang et al. (2010).²⁹ AFTER is equal to one for the fiscal quarters after the 4th quarter of 2004 and zero otherwise. Because OREC is scaled by total assets, we include LNNTA (defined as the natural logarithm of year-end total assets) to control for size effects. The model includes firm fixed effects, but inference is similar without the firm fixed effects. To determine whether minority

²⁹ Inference is similar if OREC is defined using other receivables net of the allowance for bad debt expense. We prefer to use gross other receivables because the reporting for the allowance for bad debt expense is subject to considerable managerial discretion.

shareholder composition affects the coefficient on AFTER, we also allow the coefficient on AFTER to vary with MUTUAL_OWN, OTHERINST_OWN, and INDIVIDUAL_OWN.

Table 9 shows the regression results of OREC for all publicly traded A share firms over our sample period 1/1/2004-6/30/2005.³⁰ Inference is similar if the sample in Table 9 is limited to firms whose OREC at the 2003 year-end is above the median or only the firms included in Table 2. To avoid alternative explanation resulting from a change in the mix of the sample firms over time, we require each firm to have non-missing observations in each of the 6 quarters over our sample period. This sample restriction results in a loss of 740 firm quarters in column (1) and 641 firm quarters in column (2). As shown in column (1), the coefficient on AFTER is significantly positive. In addition, the coefficients on the interaction terms between AFTER and the three minority shareholder ownership structure variables are insignificant. These results are inconsistent with the alternative hypothesis that the level of controlling shareholders' expropriation using inter-corporate loans declined after the 2004 regulation. Overall, the results in Table 9 reduce the concern that our results in Tables 2 and 3 are due to a general improvement in investor protection over our sample period. Our results are consistent with Jiang et al. (2010) who find that the inter-corporate loan problem was not resolved until November 7, 2006 when eight Chinese government ministries issued a joint announcement that would hold the top management of controlling shareholders personally accountable for failing to pay back inter-corporate loans to A share firms.

4. Minority shareholders' voting behavior in the post-regulation period

³⁰ Jiang et al. (2010) also find that the level of OREC is negatively associated with the listed firm's future earnings performance. This negative relation holds in our sample as well. In addition, the negative relation is similar for both the pre- and post-regulation periods, suggesting that the nature of OREC is similar over the two time periods.

In this Section we use the detailed minority shareholder voting data available in the post-regulation period to address two questions. First, we examine the factors that affect a minority shareholder's incentive to participate in the voting of submitted proposals (Section 4.1). Second, conditional on the equity offering proposals submitted to shareholders' meetings for approval, we examine whether minority shareholders' likelihood of vetoing a proposal is negatively correlated with proposal quality, especially in firms with higher mutual fund ownership (Section 4.2).

4.1. Determinants of minority shareholders' participation in the voting

We consider the importance of two factors in affecting a minority shareholder's incentive to participate in the voting: a) the minority shareholder's ownership level; and b) the minority shareholder's identity (i.e., mutual fund, other institution or individual shareholder).³¹ Panel A of Table 10 shows the descriptive statistics on minority shareholders' participation rate. PARTICIPATE_ALL is the number of tradable shares that participated in the voting as a fraction of all the outstanding tradable shares on the voting date. Recall that minority shareholders in this paper refer to tradable shareholders. The other participation rate variables are defined similarly except that they are defined for different subsets of tradable shareholders. For example, PARTICIPATE_MUTUAL is defined as the number of tradable shares owned by mutual funds who are among the top 10 tradable shareholders on the voting date and participated in the voting as a fraction of the total number of tradable shares owned by mutual funds who are among the top 10 tradable shareholders on the voting date. We have all the data needed to compute PARTICIPATE_ALL, but we cannot directly compute the other participation rate variables due

³¹ We find no evidence that proposal quality CAR is a significant determinant of minority shareholders' voting participation decision (untabulated).

to lack of data on the top 10 tradable shareholders on the voting date. Therefore, we use the algorithm explained in the notes to Table 10 to infer the top 10 tradable shareholders who are eligible to vote on the voting date.

As shown in Panel A of Table 10, the median participation rate is only 13.3% for all minority shareholders as a whole. This low rate is largely driven by non-top 10 minority shareholders as evidenced by the very low median participation rate of 4.4% for non-top 10 minority shareholders. The median participation rate for the top 10 minority shareholders is 62.8%, much higher than that of non-top 10 minority shareholders. This finding is consistent with the economic intuition that minority shareholders with lower ownership benefit less from the voting participation. Among the top 10 minority shareholders, institutional investors' participation rates are much higher than individual shareholders' participation rate. The median participation rate is 65.6%, 48.8%, and 18.3% for mutual funds, other institutions, and individual shareholders, respectively. The top 10 individual shareholders' median participation rate is surprising low, suggesting that they do not actively exercise their voting rights.

Panel B of Table 10 directly models the determinants of voting participation using all the top 10 minority shareholders who are eligible to vote on the voting date. As expected, minority shareholders with lower stock ownership are less likely to vote. However, even after controlling for stock ownership, it is interesting to observe that both mutual funds and other institutions are still more likely to vote than individual shareholders. The coefficient on *MUTUAL* is also significantly different from the coefficient on *OTHERINST* (two-tailed p -value=0.025), suggesting that mutual funds are more actively participating in the shareholder voting than other institutions. These results are consistent with the findings in Tables 2 and 3.

4.2. Proposal quality and minority shareholders' voting behavior

In this Section we examine the relation between proposal quality and minority shareholders' voting decisions. This analysis helps reconcile our finding in Tables 2 and 3 with the mixed results on mutual funds' governance role in the U.S. literature (e.g., Davis and Kim 2007; Cremers and Romano 2007). This U.S. literature shows that U.S. mutual funds often side with management in proxy voting, suggesting that they are not active in corporate governance. We argue that it is difficult to draw any strong inference about minority shareholder monitoring from an insignificant relation between proposal quality and minority shareholders' voting decisions. First, if minority shareholders are not independent and thus will not exercise their veto power (e.g., other institutions), managers will continue to submit value decreasing proposals and such proposals will be always approved. Second, if minority shareholders (e.g., mutual funds) are truly independent and thus will veto value decreasing managerial proposals, we expect rational managers not to submit any value decreasing proposals in the first place. Accordingly, in equilibrium we should not expect minority shareholders' voting decisions to be systematically correlated with proposal quality either. Because of these two reasons, it is difficult to use the relation between proposal quality and minority shareholders' voting decisions to draw a strong inference about the corporate governance role of minority shareholders.

With this caveat in mind, we now proceed to use the following logit model to examine the empirical relation between proposal quality and minority shareholders' voting in the post-regulation period:

$$VETO_{it} = a + b * DCAR_{it} + \varepsilon_{it} \quad (4)$$

where i and t are proposal and date indicators, respectively. $VETO$ is a dummy variable that equals 1 if a proposal is vetoed by minority shareholders in the post-regulation period, and zero

if it is passed by minority shareholders in the post-regulation period. DCAR is a dummy variable that is equal to one if for value increasing equity offering proposals (i.e., $CAR > 0$) and zero otherwise. We also allow the coefficient on DCAR to vary with the level of stock ownership by each of the three types of top 10 minority shareholders. *MUTUAL_OWN*, *OTHERINST_OWN* and *INDIVIDUAL_OWN* are measured at the fiscal quarter end immediately before the proposal voting date.

Regression model (4) is different from regression model (1) in that we do not compare the regression coefficients across the pre- and post-regulation periods. As corporate insiders had an absolute say on the equity offering decision in the pre-regulation period, any proposals submitted by management would be passed without exception. Therefore, it is not meaningful to run regression model (4) in the pre-regulation period (i.e., the coefficient on DCAR should be always zero).

We use DCAR rather than CAR as a proxy for proposal quality for two reasons. First, the relation between CAR and VETO is unlikely to be a linear function. While minority shareholders should care about whether a proposal is value increasing or value decreasing (i.e., the sign of CAR), they should be less concerned about the magnitude of proposal quality (i.e., the magnitude of CAR). For example, two value decreasing proposals' CARs could differ significantly (e.g., -10% versus -20%), but we expect minority shareholders to veto both with equal likelihood. Thus, we believe that using DCAR is more appropriate for regression model (4). Second, CAR could be subject to greater endogeneity than DCAR due to stock price's anticipation of minority shareholders' voting outcomes in the post-regulation period. Brickley et al. (1988) argue that DCAR can be used as an exogenous instrument for the endogenous CAR. While the magnitude of CAR could be affected by the stock market's anticipation of the

likelihood of minority shareholders' voting outcome, it is likely that CAR is still negative (positive) for value decreasing (increasing) proposals considering the fact that there is still some uncertainty on the eventual voting outcome by minority shareholders. Thus, DCAR should have the ability to separate value increasing ($CAR > 0$) proposals from value decreasing ($CAR < 0$) proposals and thus could serve as a valid (though may not be a perfect) exogenous instrument for proposal quality.

There are 82 equity offering proposals that were voted on by minority shareholders in the post-regulation period. We exclude three proposals withdrawn prior to minority shareholder voting dates. Results are similar if we treat the withdrawn proposals as vetoed proposals. Ten out of the 82 proposals (12%) were vetoed by minority shareholders (untabulated).

It is interesting to analyze the voting behavior of the three types of top 10 minority shareholders for the ten vetoed proposals. Top 10 mutual fund shareholders are present in six of the ten vetoed proposals, top 10 other institutional shareholders are present in seven of the ten vetoed proposals, and top 10 individual shareholders are present in eight of the ten vetoed proposals. The mean (median) ratio of the number of shares that voted in favor of the management relative to the total number of shares that participated in the voting is 68% (64%) for mutual funds, 33% (0%) for other institutions, and 25% (0%) for individual shareholders. Hence, on average mutual funds side with the management in the voting, a finding consistent with the results from existing research on U.S. mutual funds. However, as we cautioned at the beginning of this Section, this finding itself does not imply that mutual funds are not active or less active than other minority shareholders in corporate governance.

Table 11 shows the results of regression model (4). As shown in model 1 of Table 11, on average there is no association between proposal quality and minority shareholders' voting

decisions. Model 2 in Table 11 reports the logit regression coefficients of model (4) that allows the coefficient on DCAR to vary with MUTUAL_OWN, OTHERINST_OWN, and INDIVIDUAL_OWN. The coefficient on DCAR*MUTUAL_OWN is significantly negative (two-tailed $p=0.035$). Thus, there is evidence that minority shareholders are more likely to veto value decreasing proposals in firms with higher mutual fund ownership. However, this finding is not very robust when we replace the dichotomous dependent variable VETO with a continuous AGREE (defined as the number of tradable shares that agreed with the managerial proposal as a fraction of the total number of tradable shares that voted on the proposal). Untabulated Tobit's regression results show that the coefficient on DCAR in model 1 remains insignificant but the coefficients on MUTUAL_OWN and DCAR*MUTUAL_OWN in model 2 become insignificant.³²

Overall, at best there is weak evidence of a negative association between proposal quality and minority shareholders' vetoing of submitted equity offering proposals in firms with higher mutual fund ownership. Though counterintuitive, the mixed finding in Table 11 is consistent with the equilibrium model discussed at the beginning of this Section.

5. Conclusion

The objective of this study is to examine whether a Chinese regulation that requires managerial equity offering proposals to seek the separate approval of the majority of voting tradable shareholders (referred to as minority shareholders) helps improve the quality of equity

³² Despite its limitations discussed above, we also replicate the regressions in Table 11 using CAR (untabulated). Consistent with the results in Table 11, the coefficient on CAR is insignificant for model 1 while the coefficient on CAR*MUTUAL_OWN for model 2 remains significantly negative (two-tailed $p=0.003$). However, there is evidence that the coefficients on CAR*OTHERINST_OWN and CAR*INDIVIDUAL_OWN become significantly negative (two-tailed $p=0.073$ and 0.037 respectively).

offering proposals. We find that the regulation helps deter management from submitting value decreasing equity offering proposals in firms with higher mutual fund ownership but not in firms with higher ownership by either other institutional investors or individual investors. In addition, the mean CAR for the *submitted* proposals is significantly more positive in the post-regulation period than in the pre-regulation period for firms with higher mutual fund ownership but not for firms with higher other institutions' ownership or higher individual investor ownership. We also find weak evidence that proposal quality is negatively related to minority shareholders' veto decisions in firms with higher mutual fund ownership but not in firms with higher ownership by either other institutions or individual shareholders. Overall, our results suggest that the regulation helps improve the quality of equity offering proposals but only in firms with higher mutual fund ownership.

Our study provides valuable information to the debate on the costs and benefits of granting minority shareholders direct control over corporate decisions. Our results are directly relevant to the Chinese securities regulator (CSRC) who faces a daunting task of protecting minority shareholders' interests and developing the country's domestic financial market. Given China's poor record of investor protection and weak law enforcement, it is a comfort and also a surprise to find that the 2004 regulation worked remarkably well in reining in value decreasing equity offerings proposals. To our knowledge, we are the first study to show how strengthening minority shareholders' direct control over corporate decisions affects the quality of corporate decisions in firms with concentrated share ownership. Our results should be of interest to investors and regulators in other countries who are contemplating proposals that would strengthen minority shareholders' control over corporate decisions.

Our study also suggests several possible avenues for future research. First, it would be interesting to examine how the 2004 regulation affects management's incentives to explore alternative methods of expropriation. This question is relevant to assessing the overall (direct and indirect) effects of the regulation on shareholder value. The evidence in Table 9 is a good starting point but more research is warranted to understand the full magnitude of such indirect effects. Second, it is interesting to examine how the 2004 regulation affects the total combined gain of both minority shareholders and controlling shareholders. It is possible that the 2004 regulation merely represents a wealth transfer from controlling shareholders to minority shareholders without improving the overall economic efficiency of the firm. Nevertheless, given that government regulations often fail to achieve their intended effects, demonstrating the direct effect of the 2004 regulation on the quality of equity offering proposals is a necessary first step in our quest to understand the overall efficiency effects of any regulatory change to the firm and the economy.

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Appendix. The procedures used to identify the firms eligible to propose equity offerings

We rely on the following regulations issued by the Chinese Securities Regulatory Commission (CSRC) to identify the firms that are eligible to propose an equity offering (a general offering, a rights offering, or a convertible bond offering): a) Measures for the Administration of New Share Issuance by Listed Companies (Order No. 1 [2001] of the CSRC); b) Notice on the Administration of New Share Issuance by Listed Companies (Order No. 43 [2001] of the CSRC); c) Implementation Measures for Listed Companies' Issuing Convertible Corporate Bonds (Order No. 2 [2001] of the CSRC); d) The Interim Measures for the Administration of Convertible Corporate Bonds (Order No. 16 [1997] of the Securities Committee of the State Council; e) Notice on the Administration of Convertible Corporate Bond Issuance by Listed Companies (Order No. 115 [2001] of the CSRC); f) Notice on the Conditions for the Additional Issuance of Securities by Listed Companies (Order No. 2 [2002] of the CSRC); and g) Notice of the China Securities Regulatory Commission on Several Issues Concerning Major Purchases, Sales and Exchanges of Assets by Listed Companies (Order No. 105 [2001] of the CSRC). Under these regulations firms that wish to propose an equity offering are required to meet several qualitative and quantitative requirements. Though the quantitative requirements are generally straightforward, most qualitative requirements are subjective and difficult to measure using publicly available data. Hence, we rely on the quantitative requirements to determine a firm's equity offering eligibility. Specifically, a firm is deemed eligible to propose a *rights offering* if it satisfies the following two conditions: a) the average return on equity (ROE) over the past three years is no less than 6%; and b) the firm has not conducted any rights offering in the previous year. A firm is deemed eligible to propose a *general offering* if it satisfies the following two conditions: a) the average ROE (based on an unknown formula specified by the CSRC) over the past three years is no less than 10%;³³ and b) the ROE in the previous year is no less than 10%. However, under the CSRC regulations a firm is also deemed eligible to propose a general offering if it experiences a "significant" restructuring in any of the previous three years. A restructuring is deemed significant if the restructuring's deal value is no less than 50% of the firm's gross total assets. A firm is deemed eligible to propose a *convertible bond offering* if it

³³ As we do not have access to the CSRC's ROE formula, we define ROE as annual net income divided by the average shareholder's equity.

satisfies the following two conditions: a) the average ROE over the past three years is no less than 10% or the average ROE based on net income excluding non-recurring items over the past three years is no less than 6%; and b) the firm does not report a loss in any of the previous three years. Again, under the CSRC regulations a firm is also deemed eligible to propose a convertible bond offering if it experiences a “significant” restructuring in any of the previous three years.

A firm year is excluded from our sample of eligible firms if it does not satisfy the eligibility requirements for a general offering, a rights offering, or a convertible bond offering. If we literally follow the above eligibility requirements, a significant number of firm years that did propose equity offerings would be excluded. As a result, we relax the quantitative thresholds by reducing the 10% threshold to 9%, the 6% threshold to 5%, and the 50% threshold to 40%. With those relaxed thresholds, all but one equity offering proposals are retained in our final sample.

Table 1. Descriptive Statistics (N=11,924 firm-month observations)

Variable name	Mean	Std	Min	Q1	Median	Q3	Max
SUBMISSION=1	0.009	0.093	0.000	0.000	0.000	0.000	1.000
SUBMISSION=2	0.010	0.099	0.000	0.000	0.000	0.000	1.000
MUTUAL_OWN	0.046	0.081	0.000	0.000	0.004	0.055	0.851
OTHERINST_OWN	0.063	0.134	0.000	0.003	0.018	0.063	0.996
INDIVIDUAL_OWN	0.020	0.020	0.000	0.004	0.017	0.030	0.179
Q	0.574	0.357	-0.135	0.328	0.512	0.759	6.435
CASH	0.172	0.118	0.002	0.084	0.142	0.228	0.584
CFO	0.071	0.107	-0.354	0.017	0.072	0.126	0.426
LEV	0.466	0.188	0.056	0.340	0.467	0.588	2.685
VOLATILITY	0.023	0.011	0.002	0.018	0.021	0.025	0.288
AR12	0.018	0.302	-2.145	-0.160	-0.007	0.189	1.312
ASSETS	21.430	1.080	14.686	20.736	21.312	22.016	27.169

The sample covers the firm months that are eligible to issue new equity over January 2004 to June 2005. CAR is the market adjusted cumulative abnormal return over the [-2, +10] trading days around the equity offering proposal announcement date. SUBMISSION = 0 if a firm does not submit a proposal in month t, 1 if a firm submits a value increasing (i.e., $CAR > 0$) proposal in month t, and 2 if a firm submits a value decreasing (i.e., $CAR \leq 0$) proposal in month t. MUTUAL_OWN is the total stock ownership (as a percentage of the total outstanding tradable shares) of all the open ended and close ended mutual funds ranked among the top 10 minority shareholders at the end of the quarter prior to month t. OTHERINST_OWN is the total stock ownership (as a percentage of the total outstanding tradable shares) of all the other institutional investors ranked among the top 10 minority shareholders at the end of the quarter prior to month t. INDIVIDUAL_OWN is the total stock ownership (as a percentage of the total outstanding tradable shares) of all the individual investors ranked among the top 10 minority shareholders at the end of the quarter prior to month t. Q is the natural logarithm of a firm's Tobin's Q at the end of the quarter prior to month t. Q is defined as the market value minus the book value of shareholders' equity plus total assets divided by total assets. Results are similar if the market value of non-tradable shares is assumed equal to their book value in the Q definition. CFO is cash flows from operations over four quarters divided by the average total assets at the end of the quarter prior to month t. LEV is total debts divided by total assets at the end of the quarter prior to month t. CASH is cash and marketable securities divided by total assets at the end of the quarter prior to month t. ASSETS is the natural logarithm of total assets at the end of the quarter prior to month t. VOLATILITY is the standard deviation of daily stock returns over a one year period that ends in the beginning of month t. AR12 is the buy and hold equally weighted market adjusted abnormal return over a one-year period that ends at the beginning of month t.

Table 2. The effect of the 2004 regulation on management's incentive to submit value increasing and value decreasing equity offering proposals (N=11,924 firm-month observations)

Panel A. Main effects model

	SUBMISSION=1 (value increasing)		SUBMISSION=2 (value decreasing)	
	coefficient	p-value	coefficient	p-value
AFTER	0.188	(0.322)	-0.464	(0.016)
LEV	1.443	(0.001)	0.872	(0.040)
Q	-0.544	(0.160)	-0.100	(0.745)
CFO	0.991	(0.266)	1.464	(0.135)
VOLATILITY	-19.609	(0.346)	-26.365	(0.045)
AR12	1.602	(0.000)	0.596	(0.024)
CASH	-2.218	(0.024)	-3.690	(0.000)
ASSETS	-0.170	(0.162)	-0.110	(0.315)
Industry fixed effects			YES	
Pseudo R-square			0.0325	

Panel B. Interaction effects model

	SUBMISSION=1 (value increasing)		SUBMISSION=2 (value decreasing)	
	coefficient	p-value	coefficient	p-value
MUTUAL_OWN	0.635	(0.726)	1.480	(0.320)
OTHERINST_OWN	0.634	(0.529)	-0.354	(0.699)
INDIVIDUAL_OWN	3.907	(0.572)	9.867	(0.059)
AFTER	0.443	(0.246)	0.866	(0.078)
AFTER*MUTUAL_OWN	1.144	(0.595)	-10.438	(0.003)
AFTER*OTHERINST_OWN	-1.332	(0.414)	-2.016	(0.380)
AFTER*INDIVIDUAL_OWN	-18.277	(0.141)	-38.813	(0.037)
LEV	1.545	(0.001)	0.867	(0.068)
Q	-0.665	(0.110)	-0.036	(0.908)
CFO	0.869	(0.335)	1.625	(0.096)
VOLATILITY	-17.741	(0.373)	-25.892	(0.052)
AR12	1.415	(0.000)	0.755	(0.012)
CASH	-2.225	(0.027)	-3.611	(0.000)
ASSETS	-0.240	(0.112)	-0.057	(0.695)
Industry fixed effects			YES	
Pseudo R-square			0.0405	

The sample covers the firm months that are eligible to issue new equity over January 2004 to June 2005. AFTER is a dummy variable that is equal to one for the 7 firm-month observations after the regulation (i.e., December 2004 and after), and zero otherwise. See Table 1 for other variable definitions. Two-tailed robust p values are clustered at the firm level.

Table 3. The effect of the 2004 regulation on the quality of equity offering proposals

Panel A. The market reactions to announcements of equity offering proposals in the pre- and post- regulation periods

	mean (median) [S.D.]		Two-tailed p value on the test of the difference	
	CAR in the pre-regulation period N=147	CAR in the post-regulation period N=81	t-test	rank-sum test
		-0.014 (-0.018) [0.068]	0.014 (0.018) [0.066]	0.003
Two-tailed p value of one-sample t-test	0.012	0.069		
Two-tailed p value of one-sample rank-sum test	0.005	0.119		

Panel B. OLS regression result of CAR: interaction effects model (N=228)

	Coefficient	(p-value)
MUTUAL_OWN	0.007	(0.933)
OTHERINST_OWN	0.009	(0.790)
INDIVIDUAL_OWN	0.070	(0.703)
AFTER	-0.006	(0.748)
AFTER*MUTUAL_OWN	0.368	(0.002)
AFTER*OTHERINST_OWN	0.032	(0.602)
AFTER*INDIVIDUAL_OWN	0.355	(0.615)
Industry fixed effects		YES
Adjusted R-square		0.101

The sample contains the equity offering proposals announced over the period 1/1/2004-6/30/2005. All the variables are defined as in Tables 1 and 2 except that they are measured at the end of the quarter prior to the equity offering proposal announcement date. Two-tailed robust p values shown in Panel B are clustered at the firm level.

Table 4. The effect of the 2004 regulation on the quality of equity offering proposals: Alternative definitions of proposal quality (N=11,924 firm-month observations)

Panel A. Replication of the multinomial regression in Panel A of Table 2

	SUBMISSION=1 (value increasing)		SUBMISSION=2 (value neutral)		SUBMISSION=3 (value decreasing)	
	Coefficient	p-value	Coefficient	p-value	Coefficient	p-value
MUTUAL_OWN	4.795	(0.007)	0.245	(0.854)	3.514	(0.424)
OTHERINST_OWN	-3.882	(0.656)	0.062	(0.928)	0.143	(0.950)
INDIVIDUAL_OWN	-5.714	(0.815)	9.270	(0.041)	-19.781	(0.389)
AFTER	1.066	(0.382)	0.510	(0.088)	1.815	(0.061)
AFTER*MUTUAL_OWN	2.861	(0.531)	-2.214	(0.253)	-25.504	(0.033)
AFTER*OTHERINST_OWN	2.262	(0.820)	-1.504	(0.285)	-2.130	(0.471)
AFTER*INDIVIDUAL_OWN	-26.279	(0.550)	-24.755	(0.014)	-101.965	(0.001)
LEV	3.530	(0.026)	1.112	(0.003)	0.987	(0.522)
Q	-2.592	(0.012)	-0.185	(0.503)	-0.774	(0.393)
CFO	1.830	(0.537)	1.024	(0.164)	4.554	(0.015)
VOLATILITY	-267.045	(0.001)	-11.572	(0.295)	-101.137	(0.009)
AR12	0.009	(0.985)	1.075	(0.000)	1.435	(0.315)
CASH	-2.313	(0.575)	-2.972	(0.000)	-2.909	(0.328)
ASSETS	-1.048	(0.022)	-0.062	(0.574)	-0.805	(0.065)
Industry fixed effects	Yes		Yes		Yes	
Pseudo R-square			0.0498			

Panel B. Replication of the OLS regression in Panel B of Table 3: dependent variable is SCAR (N=228)

	Coefficient	(p-value)
MUTUAL_OWN	0.159	(0.915)
OTHERINST_OWN	0.343	(0.559)
INDIVIDUAL_OWN	1.487	(0.638)
AFTER	-0.076	(0.824)
AFTER*MUTUAL_OWN	5.731	(0.007)
AFTER*OTHERINST_OWN	0.723	(0.522)
AFTER*INDIVIDUAL_OWN	2.481	(0.831)
Industry fixed effects		YES
Adjusted R-square		0.070

The sample for Panel A covers the firm months that are eligible to issue new equity over January 2004 to June 2005. The sample for Panel B contains the equity offering proposals announced over the period 1/1/2004-6/30/2005. SCAR is defined as $\frac{CAR}{\sqrt{N}\sigma}$, where N is number of trading days in the CAR window, and σ is standard deviation of daily market-adjusted returns over the [-280,-31] trading days prior to the equity offering proposal announcement date. An equity offering proposal is defined as value decreasing if its SCAR is below -1.65, value increasing if its SCAR is above +1.65, and value neutral if its SCAR falls between -1.65 and +1.65. The cutoff 1.65 is the critical T value for the two-tailed significance level of 10%. See Tables 1 and 2 for other variable definitions. Two-tailed robust p values are clustered at the firm level.

Table 5. Disclosure quality of the equity offering proposals in the pre- and post-regulation periods (N=228)

Dependent variable = N_WORDS				
	Main effect		Interaction effect	
	Coefficient	p-value	Coefficient	p-value
MUTUAL_OWN			0.063	(0.555)
OTHERINST_OWN			0.028	(0.797)
INDIVIDUAL_OWN			0.166	(0.590)
AFTER	0.020	(0.122)	0.041	(0.125)
AFTER*MUTUAL_OWN			-0.028	(0.861)
AFTER*OTHERINST_OWN			-0.350	(0.146)
AFTER*INDIVIDUAL_OWN			-0.109	(0.879)
Industry fixed effects		yes		yes
Adjusted R-square		0.064		0.075

The sample contains the 228 equity offering proposals announced over the period 1/1/2004-6/30/2005. N_WORDS is the natural logarithm of the number of words contained in an equity offering proposal. All the other variables are defined as in Tables 1 and 2 except that they are measured at the end of the quarter prior to the equity offering proposal announcement date. Two-tailed robust p values reported in parentheses are clustered at the firm level.

Table 6. Re-estimation of the relevant regressions in Tables 2-3 using CAR that is free of confounding news

Re-estimation of the models in Table 2

	SUBMISSION=1 (value increasing)	SUBMISSION=2 (value decreasing)
Panel A. Main effect model		Coefficient (p-value)
AFTER	-0.2013 (0.549)	-1.0014 (0.001)
Panel B. Interaction effects model		Coefficient (p-value)
AFTER*MUTUAL_OWN	0.5275 (0.837)	-7.0689 (0.028)
AFTER*OTHERINST_OWN	-2.9660 (0.095)	-0.3616 (0.831)
AFTER*INDIVIDUAL_OWN	-35.5447 (0.030)	-28.7989 (0.043)

Re-estimation of the model in Panel B of Table 3 (dependent variable = RCAR)

	Coefficient (p-value)
AFTER*MUTUAL_OWN	0.3412 (0.006)
AFTER*OTHERINST_OWN	-0.0101 (0.842)
AFTER*INDIVIDUAL_OWN	0.1770 (0.764)

This table shows the key regression coefficients of the regression models in Tables 2-3 by replacing CAR with RCAR. RCAR is the residual (including the intercept) of regressing CAR on earnings surprises and dividend surprises that occurred in the CAR measurement window. See Section 3.3.1 for the details on the computation of RCAR.

Table 7. The effect of the 2004 regulation on management's incentive to submit value increasing and value decreasing equity offering proposals: Controlling for the effect of the 2005 split share structure reform (N=11,924 firm-month observations)

Panel A. Coefficients (p-values) of the key variables of interest in Panel B of Table 2

	SUBMISSION=1 (value increasing)		SUBMISSION=2 (value decreasing)	
	Coefficient	(p-value)	coefficient	(p-value)
AFTER*MUTUAL_OWN	0.827	(0.707)	-10.356	(0.004)
AFTER*OTHERINST_OWN	-1.108	(0.495)	-2.034	(0.365)
AFTER*INDIVIDUAL_OWN	-21.011	(0.104)	-38.898	(0.043)
AFTER*NONTRADE_OWN	1.598	(0.255)	-0.342	(0.804)

Panel B. Coefficients (p-values) of the key variables of interest in Panel B of Table 3

	Dependent variable=CAR	
	coefficient	(p-value)
AFTER*MUTUAL_OWN	0.374	(0.000)
AFTER*OTHERINST_OWN	0.062	(0.236)
AFTER*INDIVIDUAL_OWN	0.396	(0.569)
AFTER*NONTRADE_OWN	0.078	(0.285)

The Table shows only the coefficients for the relevant interaction variables from the regression models of Panel B of Table 2 and Panel B of Table 3 after adding NONTRADE_OWN and AFTER*NONTRADE_OWN. NONTRADE_OWN is the stock ownership of all non-tradable shareholders at the end of the quarter prior to month t. See Tables 1 and 2 for other variable definitions. The sample in Panels A covers the firm months that are eligible to issue new equity over January 2004 to June 2005. The sample in Panel B covers the equity offering proposals announced over the period 1/12004-6/30/2005. Two-tailed robust p values clustered at the firm level are reported in parentheses.

Table 8. Replication of the interaction effects models shown in Tables 2 and 3 using three alternative time periods prior to the 2004 regulation's effective date

Panel A. Replication of Panel B of Table 2 using pseudo AFTER: coefficients (p-values) of the key variables of interest

	January 2003 – June 2004		April 2003 – September 2004		July 2003 – November 2004	
	(AFTER=1 for December 2003–June 2004)		(AFTER=1 for March 2004–September 2004)		(AFTER=1 for June 2004 – November 2004)	
	SUBMISSION=1 (value increasing)	SUBMISSION=2 (value decreasing)	SUBMISSION=1 (value increasing)	SUBMISSION=2 (value decreasing)	SUBMISSION=1 (value increasing)	SUBMISSION=2 (value decreasing)
AFTER*MUTUAL_OWN	1.080 (0.761)	2.602 (0.290)	3.686 (0.283)	-0.162 (0.942)	-3.60 (0.321)	1.103 (0.675)
AFTER*OTHERINST_OWN	1.357 (0.422)	0.668 (0.700)	0.227 (0.899)	3.583 (0.019)	0.105 (0.959)	2.722 (0.057)
AFTER*INDIVIDUAL_OWN	11.177 (0.163)	12.033 (0.147)	18.766 (0.066)	3.467 (0.672)	-29.580 (0.165)	5.613 (0.561)

Panel B. Replication of Panel B of Table 3 using pseudo AFTER: the coefficients (p values) of the key variables of interest

	Coefficient (two-tailed p-value)		
	January 2003 – June 2004	April 2003 – September 2004	July 2003 – November 2004
	(AFTER=1 for December 2003–June 2004)	(AFTER=1 for March 2004–September 2004)	(AFTER=1 for June 2004–November 2004)
AFTER*MUTUAL_OWN	-0.029 (0.867)	0.079 (0.662)	-0.015 (0.932)
AFTER*OTHERINST_OWN	-0.011 (0.877)	-0.1406 (0.028)	-0.092 (0.128)
AFTER*INDIVIDUAL_OWN	0.551 (0.153)	-0.116 (0.833)	-1.178 (0.008)

The three alternative 18-month time periods are (a) January 2003-June 2004; (b) April 2003-September 2004; and (c) July 2003-November 2004, respectively. Since the 2004 regulation took effect on December 7, 2004, the last pseudo period contains only 17 months. Similar to the definition of *AFTER*, the pseudo *AFTER* is one for the first 11 months and zero for the remaining months. See Tables 2 and 3 for other variable definitions.

Table 9. The regression result of inter-corporate loans

	Dependent variable = OREC	
	(1) Coefficient (p-value)	(2) Coefficient (p-value)
AFTER	0.008 (0.000)	0.006 (0.035)
MUTUAL_OWN		0.010 (0.409)
OTHERINST_OWN		-0.020 (0.127)
INDIVIDUAL_OWN		-0.151 (0.065)
After*MUTUAL_OWN		-0.009 (0.504)
AFTER*OTHERINST_OWN		-0.001 (0.960)
AFTER*INDIVIDUAL_OWN		0.077 (0.412)
LNTA	-0.047 (0.005)	-0.047 (0.007)
Firm fixed effects	YES	YES
Adj. R-square	0.89	0.89
N	6,906	6,879

The sample in each column includes all A share firms that have nonmissing data in each of the 6 quarters over 1/1/2004-6/30/2005. OREC is gross other receivables divided by year-end total assets. LNTA is the natural logarithm of year-end total assets. AFTER is one for the quarters after 1/1/2005 and zero otherwise. All variables are winsorized at the 1% and 99% percentiles. See Table 1 for other variable definitions. MUTUAL_OWN, OTHERINST_OWN, and INDIVIDUAL_OWN are measured at the beginning of the quarter. Two-tailed robust p values clustered at the firm level are reported in parentheses.

Table 10. Minority shareholders' voting participation rate in the post-regulation period

Panel A. Descriptive statistics on minority shareholders' voting participation

Variable	N	Mean	S.D.	25%	50%	75%
PARTICIPATE_ALL	80	0.161	0.129	0.061	0.133	0.235
PARTICIPATE_TOP10	76	0.550	0.277	0.365	0.628	0.780
PARTICIPATE_NONTOP10	76	0.089	0.104	0.015	0.044	0.135
PARTICIPATE_MUTUAL	56	0.635	0.358	0.456	0.656	1.000
PARTICIPATE_OTHERINST	64	0.476	0.416	0.000	0.488	0.912
PARTICIPATE_INDIVIDUAL	51	0.270	0.307	0.000	0.183	0.409

Panel B. Determinants of top 10 minority shareholders' voting participation

Dependent variable = VOTE	
	Coefficient (p value)
MUTUAL	0.9648 (0.009)
OTHERINST	0.5107 (0.034)
OWN	0.2805 (0.000)
CONSTANT	-1.0431 (0.000)
Pseudo R-square	0.0930
N	751
Two-tailed p value for Ho: MUTUAL=OTHERINST	0.025

PARTICIPATE_ALL is the number of tradable shares that participated in the voting as a fraction of all the outstanding tradable shares on the voting date. The other participation rate variables are defined similarly except that they are defined for different subsets of tradable shareholders. For example, PARTICIPATE_MUTUAL is defined as the number of tradable shares owned by mutual funds who are among the top 10 tradable shareholders on the voting date and participated in the voting as a fraction of the total number of tradable shares owned by mutual funds who are among the top 10 tradable shareholders on the voting date. The top 10 tradable shareholders who are eligible to vote on the voting date are derived indirectly using the following algorithm. First, for each equity offering proposal voted in quarter t, we identify the top 10 tradable shareholders as disclosed at the beginning and end of quarter t and the top 10 voting tradable shareholders as disclosed in the voting outcome announcement. Second, if the voting date is exactly at the end of quarter t, we assume that the top 10 tradable shareholders as disclosed by the company's periodic report at the end of quarter t are the top 10 tradable shareholders eligible to vote on the voting date. Third, if the voting date falls during quarter t and a tradable shareholder is among the top 10 tradable shareholders either at the beginning or at the end of quarter t or both, we compare VOL1 (defined as all tradable shareholders' trading volume from the beginning of quarter t to the voting date) and VOL2 (defined as all tradable shareholders' trading volume from the voting date to the end of quarter t). If $VOL1 < VOL2$, we assume that the top 10 tradable shareholders at the beginning of quarter t have not sold their shares by the voting date and therefore are eligible to vote on the voting date. If $VOL1 \geq VOL2$, we assume that the top 10 tradable shareholders at the end of quarter t are the shareholders eligible to vote on the voting date. Fourth, we rank the tradable shareholders identified in step (2) through (3) above along with the top 10 voting tradable shareholders based on their stock ownership. It is important to include the top 10 voting tradable shareholders in the ranking because our steps (2) and (3) may miss some top 10 tradable shareholders who might have turned over their shares quickly around the voting date. Those who are ranked among the top 10 are assumed to be the top 10 tradable shareholders eligible to vote on the vote date. VOTE is a dummy variable that equals one if a minority shareholder voted in a submitted proposal and zero

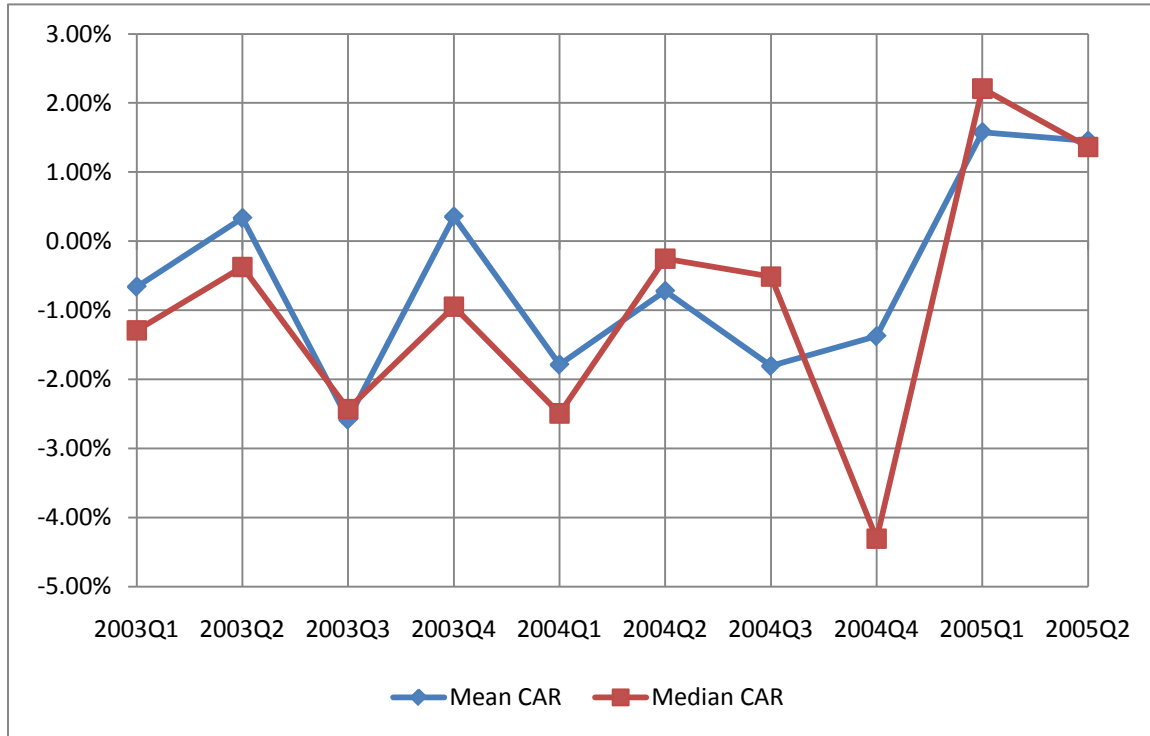
otherwise. MUTUAL is a dummy variable that equals one if the minority shareholder is a mutual fund. OTHERINST is defined similarly for other institutions. OWN is the percentage of tradable shares held by a minority shareholder. There are 82 proposals minority shareholders voted on in the post-regulation period, but the sample sizes in Panels A and B are smaller due to missing data. The unit of observation is a proposal in Panel A and a top 10 tradable shareholder in Panel B.

Table 11. Proposal quality and the likelihood of minority shareholders' veto in the post-regulation period (N=82 proposals)

	Model 1 (main effects)	Model 2 (interaction effects)
	Coefficient (p-value)	Coefficient (p-value)
CONSTANT	-1.576 (0.000)	-1.759 (0.077)
DCAR	-0.799 (0.255)	4.313 (0.129)
MUTUAL_OWN		0.116 (0.084)
OTHERINST_OWN		-0.026 (0.389)
INDIVIDUAL_OWN		-0.178 (0.544)
DCAR*MUTUAL_OWN		-0.634 (0.035)
DCAR*OTHERINST_OWN		-0.172 (0.107)
DCAR*INDIVIDUAL_OWN		-1.037 (0.313)
Pseudo R-square	0.023	0.254
Test of Hypotheses		
MUTUAL_OWN+DCAR*MUTUAL_OWN		-0.518 (0.075)
OTHERINST_OWN+DCAR*OTHERINST_OWN		-0.198 (0.053)
INDIVIDUAL_OWN+DCAR*INDIVIDUAL_OWN		-1.215 (0.213)

The sample contains the equity offering proposals that minority shareholders voted on in the post-regulation period. The dependent variable is VETO, a dummy variable that is 1 if a proposal is vetoed by minority shareholders, and zero if it is passed by minority shareholders. DCAR is a dummy variable equals to one if CAR>0 and zero otherwise. CAR is the market adjusted cumulative abnormal return over the [-2, +10] trading days around the proposal announcement date. MUTUAL_OWN, OTHERINST_OWN and INDIVIDUAL_OWN are defined as in Table 1 except that all of them are measured at the end of the fiscal quarter immediately prior to the proposal voting date. Two-tailed robust p values clustered at the firm level are reported in parentheses.

Figure 1. Stock market reactions to equity offering proposal announcements by calendar quarter



See Table 1 for the definition of CAR. The mean/median CAR is computed by calendar quarter. The proposals submitted on or after December 7 in the 4th quarter of 2004 are treated as proposals submitted in the 1st quarter of 2005.