Political Party and Firm Value, Evidence from Control Shift in SOEs

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Abstract

An important reform of state-owned enterprises (SOEs) in China stipulates that all SOEs must shift control of the board or corporate decision making from the administrative agencies to the party. We exploit this reform and study how firm value is affected due to the significant shift in corporate power. The event-study analysis shows that stock price experiences significant abnormal losses for SOEs listed on both A-share and Hong Kong stock exchanges. However, sound governance practices such as auditor quality, board independence, shareholder protection structure and transparent accounting disclosure standards help mitigate the deadweight loss in the market value caused by the heightened political control of firms.

(JEL, G32, G38, P2)

1. Introduction

The extraordinary rise of China's economy has made understanding Chinese firms and their control/governance an issue of global importance. As China's largest controlling shareholder, the Chinese Communist Party's (CCP's) undoubtedly has a significant role to play in corporate governance. However, the CCP's role as the architect, and both direct and indirect controlling shareholder of SOEs in China has received little attention from academia. As Megginson (2017) succinctly states, the form and value of political control in Chinese SOEs are not well understood. This lack of understanding in CCP's role in SOEs may partially stem from the fact that its presence in SOE's board was minuscule before 2017. Although the ruling party indirectly has a say on the appointment of top executives in SOEs (Cao, et al., 2019), it does not have a direct influence on the board or decision making. This is because the government administrative agency, not the ruling party who often own the non-tradable block shareholdings and directly oversees its management. Thus, any analysis of Chinese SOEs that does not explicitly consider the ruling party's role is at best incomplete.

In this paper, we exploit a far-reaching government policy change in 2017 on the control of SOEs to evaluate the ruling party's role in the economy. On May 3rd, 2017, the government (State Council) passed a regulation that effectively transferred the control of decision making in SOEs from governmental agencies to the CCP itself. The State Council of China issued Rule #36, outlining the most significant

control/governance reform of SOEs to date,[1] mandating that the local CCP chapter secretary should be appointed as the chairperson of the board and the every major board decision should need approval from the party secretary first.[2] This policy change raised substantial concerns about the state enterprises as to what extent such a salient shift in power control within SOEs would affect managerial decision making and firm governance.

In this sense, we are testing Shleifer and Vishy (1994)'s assertions on whether politicians have a grabbing or helping hand for firms general. The existing academic literature offers two schools of thought. According to Aghion and Tirole (1997), if the ruling party's objective is to maximize firm value, direct control of corporate decision making can have a positive effect. Active participation by the ruling political party in the firm itself will help align interests and enhance monitoring. The increase in control as well as monitoring as suggested by Jensen and Meckling (1976) and Qian (1995, 1996), will in turn increase firm value through improvement in decision making efficacy and reduction of agency costs. On the other hand, increase of political control may lead to inefficiency, because political parties not only prioritize political interest over economic benefits but also expropriate firms' resources with "grabbing hand".[3] SOEs are shown to be less efficient compared to privately owned

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[1] Rule #36 is officially known as "*Notice to Further Improve Corporate Governance in SOEs*" (The State Council Announcement [2017] #36). The announcement of the Rule #36 was made at 5 pm after the market closed trading. Detailed information can be found in the following web link: http://www.gov.cn/zhengce/content/2017-05/03/content_5190599.htm.

[2] Prior to Rule #36, it was the Chinese government's administrative agencies that play a central role in overseeing SOEs while the ruling party takes the back seat (Gan, Guo, and Xu (2015)).

[3] La Porta, Lopez-de-Silanes, and Shleifer (1999) find state ownership and political control in publicly listed companies are widespread internationally. For these state-owned enterprises, Bortolotti and

firms in terms of performance, productivity, and profitability ((Megginson et al. (1994), D'souza and Megginson (1999), Dwenter and Malatesta (2001), and Megginson and Netter (2001)). However, Acemoglu and Robinson (2006) caution that one must be careful with the implications of these results because they argue that political control and firm value are endogenous outcomes that reflect self-selection.

We consider Rule #36 as an exogenous change of the control for SOEs. More precisely, it is a power shift from Chinese government agencies to CCP as the ruling party. We conduct standard event studies to examine stock market reactions to the announcement of this policy. The analysis shows that SOEs' three-day cumulative abnormal return (CAR) surrounding the announcement is negative and statistically significant at the 1% level. In terms of economic impact, the difference in the three-day CAR between SOEs and non-SOEs is approximately -1% in the A-share market, implying an aggregate market value loss of at least 300 billion RMB or 50 billion USD. A similar statistically significant negative CAR is also documented for Chinese SOEs listed in the Hong Kong Stock Exchange (HKSE). The difference in the three-day CAR between Chinese SOEs and non-SOEs in the HKSE is approximately -2% and is statistically significant at the 1% level.

Next, we explore the cross-sectional impact of Rule #36 on SOEs. Since the passage of Rule #36 has a direct impact on the board composition, we investigate whether corporate governance factors may mitigate the negative market perception of Rule #36. Fauver et al. (2017) suggest that larger number of independent directors can

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Faccio (2009) document evidence suggesting that after the largest wave of privatizations, government control is still commonly retained in these privatized firms.

contribute positively to firm value. Firth et al. (2007) find evidence suggesting larger supervisory board size helps improve earnings quality. Consistent with Fauver et al. (2017) and Firth et al. (2007), we find SOEs with higher numbers of independent directors, and larger supervisory board help moderate the negative stock market impact of Rule #36.[4] Consistent with Guedhami et al. (2014), Coffee (1999) and Doidge et al. (2004), we find the CARs for SOEs that are audited by the Big Four auditing firms to be less negative,and those dual-listed in Hong Kong or with B-shares, are not as negatively affected by the Rule #36.[5]

Overall, our research contributes to the growing literature on the economic role of political entities on firm value.[6] To the best of our knowledge, this may possibly be the first study to capture the impact of a decisive shift in political control from the state (administrative agencies) to the ruling party in China. Second, unlike the previous literature that relies on indirect measures of political control (Chang and Wong (2004); Cull and Xu (2005); Borisova et al. (2012); Gan et al. (2015)), the announcement of Rule #36 allows us to directly measure the decision making content of a decisive shift in control from the administrative agencies to party. Finally, this study contributes to the research on the relationship between corporate governance

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[4] Listed companies in China, are required by the China Security Regulatory Commission (CSRC) to establish a two-tier board structure, both a board of directors and a supervisory board. The supervisory board plays an advisory role to the main board.

[5] B-shares are stocks issued with U.S. dollar or Hong Kong dollar and often held by foreign investors.

[6] Shleifer and Vishny (1994), Boycko, Shleifer, and Vishny (1996), Shleifer (1998), Johnson and Mitton (2003), Faccio (2006), Lin et al. (2016), and Liu et al. (2017) are papers on political entities and firm behaviors. For research on political connections, see Fisman (2001), Khwaja and Mian (2005), Fan et al. (2007), Li, et al. (2008), and Berkman et al. (2010).

and firm value.[7] Overall, our findings suggest that while increased political control may affect firm value negatively, the negative effect can be partially mitigated by sound corporate governance practices.

The reminder of the paper proceeds as follows. Section 2 provides institutional background of Chinese SOEs, details of Rule #36, and develops the hypotheses. Section 3 summarizes the data and describes the sample. Section 4 reports the main findings, and conclusion is in Section 5.

2. Background and Hypothesis

A. *Reform and Governance of SOEs in China*

As of 2017, listed companies controlled by the central government represent 20.66 percent of the total market capitalization in the Shanghai and Shenzhen Stock Exchanges.[8] By international standards, the size of SOEs in China are massive. For example, the Fortune 500 firms in 2017 by revenue include 115 Chinese firms, and 66 of them are SOEs. The story was very different 25 years ago when most SOEs were not listed and little was known about them.

Starting from 1997, the Chinese leadership restructured SOEs under the mantra of

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[7] See Yermack (1996), Gompers, Ishii, and Metrick (2003), Villalonga and Amit (2006), Chhaochharia and Grinstein (2007), Bebchuk, Cohen, and Ferrell (2008), Bae et al. (2012), Cremers and Ferrell (2014), Fauver et al. (2017), and Schmidt and Fahlenbrach (2017).

[8] These are firms where the state owns a majority of the shares and are directly under the supervision of an administrative agency that was created for this purpose. In this paper, SOEs are defined as firms that are under the direct supervision of the State-owned Asset Supervision and Administration Commission (SASAC). There are other firms that are listed in the Chinese stock market which the state is a minority shareholder but these firms are not in the list of companies that are directly under the control of SASAC.

"seize the large and abandon the small" by listing financially stronger firms through share issue privatization in the Chinese stock market. The partial privatization reform resulted in a large number of listed SOEs in which the state owned a majority equity stake. Inevitably, the partial privatization give rise to the need to monitor these newly listed SOEs. This is the fundamental issue in corporate governance resulting from the separation of ownership and management (Claessens et al. (2000); Dewenter and Malatesta (2001); Megginson and Netter (2001); Claessens et al. (2002); Wei et al. (2005); Cao et al. (2019)).

First, SOEs like other publicly listed entities in China, are required by the China Security Regulatory Commission (CSRC) to establish a two-tier board of directors and supervisory board structure, like the Germanic-Japanese model. The supervisory board in Chinese firms are advisory in nature and oversees disciplinary affairs of employees such as corruption and violation of labor laws. Chinese SOEs follow international practices by adopting modern governance structures that allow for checks and balances between shareholders and management. This includes practices such as having independent directors and setting up board committees for nomination, remuneration, strategy, and audit.

Second, there is the issue of delegated monitoring of these newly created SOEs by the ruling party. In 2003, the State-owned Asset Supervision and Administration Commission (SASAC) was established by the State Council as the agency to oversee SOEs. The ownership stake of most SOEs were reassigned from the various line ministries to the SASAC. Under this framework, the control and oversight of major

SOEs is carried out by the SASAC with a fiduciary duty to protect and manage state assets. Although the SASAC is not involved in the day-to-day business operations, it possesses the authority to replace senior management such as CEO and other executives with just an endorsement from the board. In addition, there are local SASACs at the provincial, municipal, and county level, with roles running in parallel to that of the central (federal) SASAC.

The third feature is the CCP's role in SOEs, which is important but largely ignored in prior academic research. Following the passage of Rule #36, the ruling party was rendered the authority to establish a local CCP chapter within each SOE. Each local CCP chapter consists of three tiers: party committee, party group, and party subgroup.[9] The main functions of the local CCP chapters within the SOEs are defined in the CCP Constitution. The local CCP chapters should (1) act as the political nucleus and contribute to the operation of the enterprise; (2) pledge and ensure the implementation of principles and policies of the CCP; (3) participate in decision making on major issues of the enterprise.[10]

Not surprisingly, the previous reforms on ownership and governance of SOEs were largely implemented by the government's administrative agencies, thereby reducing the role played by the CCP. However, in recent years, political control of SOEs by the party was emphasized, culminating in 2017, whereby the CCP formally

[9] The party committee, party group, and party subgroup are known as "dangwei", "dangzu" and "dangzhibu" respectively.

[10] See Wang (2014) for more details about CCP organization.

institutionalized its governance function of SOEs.[11] On May 3rd, 2017, Chinese government officially released the most far-reaching regulatory reform on the governance of SOEs. The 2017 Rule #36 regulation explicitly stipulates the CCP's role in the governance of SOEs. Rule #36 or "*Notice to Further Improve Corporate Governance in SOEs* (The State Council Announcement [2017] #36)" explicitly mandates that the ruling party has the authority to appoint local CCP chapter leader as the chairman of the board of directors in SOEs. Rule #36 in essence transfers control of SOEs from the state's administrative agencies to the political party itself.[12]

B. *The Mandates of Rule #36*

The main contents of Rule #36 that are related to the CCP's role in the governance of SOEs are summarized as follows:

(1) Basic principles: SOEs must adhere to the leadership of the CCP. SOEs should abide by the following principles: (1) unify party's leadership and corporate governance; (2) clarify the legal status of CCP organization within the SOEs; (3) enable the local CCP chapter to be the political core; (4) empower the local CCP

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[11] The first regulatory reform by the new administration, "*Guiding opinions of the CCP Central Committee and the State Council on deepening the reform of state-owned enterprises*" (the CCP Central Committee and the State Council Announcement [2015] #22) was issued in May 2015. It was followed by "*Several opinions on adhering to the party's leadership and strengthening the party's construction during the reform of state-owned enterprises*" (the CCP Central Committee Announcement [2015] #44) in September 2015.

[12] Based on a large-scale nationwide survey of Chinese firms in 2006, with a question asking the importance of various decision makers in corporate decision-making, i.e., appointment of top management, employment, investment, financing, distribution of profits etc., Gan, Guo, Xu (2015) document that party committee at the firm has less control rights than CEOs, board of directors and shareholder meetings in SOEs.

chapter to take charge of direction, manage state of affairs, and guarantee the implementation of policies.

(2) *Main objectives*: The CCP organization should have a robust legal status within the corporate governance structure of SOEs. The firm's article of association should include the role of the local CCP chapter. Participation of chapter leaders should be the cornerstone of corporate governance.

(3) *Measures*: SOEs should clarify the responsibility of the local CCP chapter leadership in decision-making, operation, and supervision. To ensure managerial decision is aligned with the political direction of CCP, the secretary of the local CCP chapter is to hold the position as the chairman of the board of directors. Other leaders in the local CCP chapter shall serve as members of either the board of directors, supervisory board, or be part of the management team. Central SOEs need to appoint the deputy secretary to serve on its board of directors. To execute the CCP's supervisory responsibilities, the high-ranking CCP chapter officials shall appoint the leader of the Discipline Inspection Commission Secretary to attend board meetings. The board of directors, supervisory board, and management in SOEs must regularly file progress reports to the CCP.

C. *Hypotheses Development*

We develop two main hypotheses, *monitoring effect* and *politicking (grabbing hands) effect* to further understand the impact of a shift in control from state's governmental agencies to the ruling party on firm value. We also develop hypotheses

pertaining to the mitigating effects of sound corporate governance practices. Based on Jensen and Meckling (1976), the *monitoring effect* hypothesizes that the new role of the CCP in the board of SOEs will increase the efficacy of monitoring. Thereby reducing the agency conflict-of-interest problems and will improve the quality of managerial decision making. According to Shliefer and Vishy (1994), the *politicking or grabbing hands effect* posits that party leaders as Board Chairs may prioritize political instead of firms' interest in decision making. This may result in increasing the political risk of, and economic burden to the SOEs. Such politicking behavior may reduce the overall efficiency and will result in a negative impact on firm value.

C1. *Monitoring Effect Hypothesis*

Qian (1996) and Chang and Wong (2004) find evidence suggesting that governmental agencies are, to a certain extent, effective in monitoring SOEs and controlling agency costs. Furthermore, Cao et al. (2019) find evidence showing political promotion, for example from local chapter leadership to being a mayor of a city, can help overcome weak incentive problems of SOEs' management. They find local chapter leaders aspiring for higher office may be more diligent in monitoring the managers. Prior to Rule #36, the monitoring and control of SOEs was under the purview of the SASAC, an agency established by and under the jurisdiction of the State Council. After Rule #36, the CCP can directly exercise control and oversight of SOEs through the local CCP chapters, in essence bypassing the SASAC.

The State Council of China in passing Rule #36 reasoned that direct control of

SOEs by the party will enhance corporate governance and improves monitoring of managerial decisions. This is in line with Aghion and Tirole (1997) which suggest that monitoring of SOEs should be delegated to subordinate agency with close participation in the organization. Before Rule #36, the SASAC is the sole agency with the delegated monitoring role, but itself faces agency conflicts and lacks power to intervene in the firms' managerial decisions. Hence it is costly for the SASAC to acquire relevant information to achieve effective monitoring. After Rule #36, the local CCP chapter within SOEs will have direct interactions with management. This arrangement will facilitate a more direct and effective monitoring of managers. To reflect this possibility, we form the following hypothesis:

Hypothesis 1 (Monitoring effect): Shifting from the state to political party's role in the board will increase firm value through the reduction of agency problems.

C2. *Politicking or Grabbing Hand Effect Hypothesis*

Studies have shown that in SOEs, a major governance concern is the existence of conflicts of interests between the state owners and minority shareholders (Morck et al. (2005)). Shleifer and Vishny (1994, 1998, 2002) postulate that the government may intervene in state-owned firms' management decisions to pursue political or social objectives at the firms' cost. Previous literature on privatization confirms Shleifer and Vishny (1994, 1998, 2002) by showing that governmental shareholders are inefficient in maximizing shareholder value.[13]

[13] Megginson and Netter (2001), Djankov and Murrell (2002), Estrin et al. (2009), and Liao et al. (2014).

Rule #36 effectively enhances CCP's governance role and control power over SOEs. The new regulation is designed with the intention to safeguard the interest of the CCP, and to ensure the implementation of the ruling party's policies. However, according to Shleifer and Vishny (1994), increased political control may negatively affect firm value. With the party directly controlling the board, it is plausible that SOEs' decision-making autonomy may be compromised. Therefore, according to Shleifer and Vishny (1994), a shift in control from state's governing agencies to party may result in higher political cost. This in turn will have a negative impact on SOEs' stock prices. Hence, our second hypothesis is as follows:

Hypothesis 2 (Politicking or Grabbing hand effect): Shifting from the state to political party's role in the board will decrease firm value because of an increase in agency conflict-of-interest problems.

C3. *Mitigating Factors: Internal and External Governance*

Gilson (2003) shows that a system of sound corporate governance mechanisms can mitigate agency problems between the controlling and minority shareholders. As such, we conjecture that any economic impact resulting from an increase in political presence in the board of SOEs needs to be jointly considered with the quality of the firm's corporate governance practices and external legal environment. For example, Fauver et al. (2017) find evidence suggesting that larger number of independent directors can contribute positively to firm value. According to China Security Regulatory Commission (CSRC) and Company Law (*Gongsi Fa*) of China, publicly

listed firms are required to organize their board to have at least one third or more independent directors. Given the extant literature, we expect firms with more independent directors, that is, more than the required one third ratio to be more effective monitors.

Firth et al. (2007) provide evidence showing larger supervisory board size helps improve earnings quality. Unlike practices in developed economies, supervisory board in Chinese companies cannot directly appoint or evaluate managers. However, after the enactment of the amended Corporate Law framework in 2005, supervisory boards of Chinese companies have more monitoring power than before.[14] Since CSRC and Company Law (*Gongsi Fa*) require supervisory board to have at least three members, we expect firms with more than three members will have stronger internal oversight.

Shleifer and Vishny (1986) find large shareholders usually have strong incentives and power to monitor managerial behavior. Extending their findings to Chinese SOEs as defined in this study, it is plausible that magnitude of share concentration held by the second to fifth largest blockholders may increase the efficacy of monitoring. We expect that firms with higher ownership concentration will have stronger internal oversight.

External institutions can also serve as effective monitors of firm's executives. It is well documented that legal protection for minority shareholders matters for firms (La Porta et al. (1997), (1998), (1999), (2000); Doidge et al. (2007)). This is confirmed by

[14] For example, supervisory boards have the power to propose dismissal of directors and managements for wrongdoings, and these board members can attend board meeting to oversee the decision making process.

studies documenting evidence that cross-listing in stock market with strict legal regulation and more frequent financial reporting can reduce agency problems and increase firm value (Coffee (1999); Doidge et al. (2004)). Firms listed in the HKSE are subject to stricter shareholder protection regulations and more transparent accounting disclosures. Chinese firms with B-shares that are available to foreign investors are subject to stricter financial reporting and information disclosure requirement (Gul, Kim, and Qiu (2010)). Moreover, firms with B-shares or H-shares tend to face more scrutiny from foreign investors.

There are also empirical evidence suggesting that reputable auditors can serve as important gatekeepers by facilitating information transmission and reducing managerial opportunistic behaviors (Becker, et al. (1998); Fan and Wong (2005)). Furthermore, Guedhami et al. (2014) find the hiring of Big Four accounting firms helps align politically connected insiders' interests to that of all shareholders.

Research has shown that significant institutional investors can also serve in mitigating agency problems by them voicing their opinions. For example, being able to discuss matters with management and directors, or exiting by selling their stake in the company.[15] Shleifer and Vishny (1986) and McCahery et al. (2016) further add that the effectiveness of investors' threats depends on the size of the investor's equity stake. Hence, firms with higher institutional investors' equity stake may be cushioned from the negative wealth effect of Rule #36. However, institutional investors especially short-term institutions, may choose to exit rather than voicing their opinion

[15] See Hirschman (1970), Jensen (1986), Shleifer and Vishny (1986), and Edmans (2009).

regarding the shift in political control resulting from Rule #36.

In summary, existing studies have shown that internal governance mechanisms such as numbers of independent directors, size of supervisory board, and amount of non-state shareholdings can affect firm value. Similarly, external governance factors achieving the same mitigating effects include legal protection for minority shareholders, reputation of auditors, and size of institutional investors' holdings. Therefore, we develop the following hypothesis to test the mitigating effects of both internal and external governance:

Hypothesis 3a: Internal governance quality can mitigate the impact of a shift in political control from agencies to party.

Hypothesis 3b: External oversight can mitigate the impact of a shift in political control from agencies to party.

3. Data, Model Specification and Summary Statistics

A. *Data*

Firms' daily stock return and financial information are collected from the China Stock Market and Research Database (CSMAR) database. We include only A-share stocks traded on two mainland stock exchanges, the Shanghai and Shenzhen Stock Exchange. Financial firms are excluded from our sample because they are subjected to different disclosure regulations. Since Rule #36 was announced at 5 pm on May 3rd, 2017, which is an off-trading period for both exchanges, we identify May 4th, 2017 as

the event day. To be included into the sample, we require firms to have trading data within the five trading-day window centered on May 4th, 2017. To avoid contaminating our event study from any confounding information, we delete firms with these concurrent corporate announcements during the event period: disclosure of quarterly, semi-annual, or annual report, and/or announcement of related party transactions and acquisitions.

To assemble ownership data needed for the study, we combine several widely used databases including CSMAR, China Centre for Economic Research (CCER), and WIND Database. Ownership structure information is collected from CSMAR's ownership database. To ensure data integrity, we manually check them for errors. Our final sample consists of 2,306 firms, of which 812 are SOEs. We also assemble from the CSMAR dataset a sample of Chinese SOEs and non-SOEs that are traded in the Hong Kong Stock Exchange (HKSE). The criteria for inclusion into our HKSE sample is the same those we use for our main sample from the Shanghai and Shenzhen exchanges. The final HSKE sample consists of 1580 stocks and they fall into three categories: 224 Chinese SOEs, 541 Chinese non-SOEs and 815 other listed firms.

[Insert Table 1 Here]

The list of provincial versus central governmental-controlled SOEs is manually collected from the SASAC websites. Table 1 reports the geographical distribution of

SOEs that are traded in the Shanghai and Shenzhen exchanges. From the table, there are 89 SOEs that are under the direct control of the central SASAC in Beijing. The corresponding numbers of non-SOEs domiciled in Beijing are 115. The other provinces with significant numbers of SOEs are Shanghai and Guangzhou with 77 and 73 respectively. These SOEs like those in smaller provinces are under the jurisdiction of provincial SASACs. The concentration of non-SOEs is found in provinces such as Guangdong (270), Zhejiang (226), and Jiangsu (193). In Panel B, we report the distribution of SOEs and non-SOEs by industries. Most of the numbers of SOEs are in the Industrials, Materials, and Consumer Discretionary industries, with 243, 151, and 138 firms respectively. In terms of percentages, there are more non-SOEs in the Information Technology and Health Care industries (262 and 167) as compared to SOEs (55 and 48).

B. *Model Specification and Summary Statistics.*

To measure stock market reactions to the announcement of Rule #36, we use the standard event study methodology. we construct both three and five trading-day event windows centered on May 4, 2017. The abnormal return over these windows is calculated using the market model. We estimate the following regression:

(1) $$R_{i,t} = \alpha_i + \beta_i R_{M,t} + \varepsilon_{i,t},$$

where $R_{i,t}$ and $R_{M,t}$ are the individual firm's stock return and return of the value-weighted market return on day *t*, respectively. The value-weighted market

returns are computed using all the A-share stocks in both the Shanghai and Shenzhen stock exchanges. For the analysis of the announcement effect of Rule #36 on firms traded in the HKSE, we use the Hang Seng Index (HSI) as the proxy for the market portfolio. The market model is estimated using data from t - 210 to t - 11 trading days before May 4, 2017. We require each firm to have data for at least 100 trading days in the estimation window to calculate fitted coefficients of $\widehat{\alpha}_i$ and $\widehat{\beta}_i$. The abnormal return is calculated as $\mathrm{AR}_{i,\tau} = R_{i,\tau} - (\widehat{\alpha}_i + \widehat{\beta}_i R_{M,\tau})$ for each firm over the event windows ($\tau = -1, 0, +1$ or $\tau = -2, \ldots, +2$) surrounding the announcement date. The cumulative abnormal returns (CAR) are calculated for event windows [-1,+1] and [-2,+2], as $CAR_{(-1,+1)} = \sum_{-1}^{+1} AR_{i,\tau}$, $and\ CAR_{(-2,+2)} = \sum_{-2}^{+2} AR_{i,\tau}$, respectively.

[Insert Figure 1 Here]

As shown in Figure 1, CARs of both SOEs and non-SOEs in both the Shanghai and Shenzhen exchanges are increasing before the announcement of Rule #36. After the announcement, the CARs of SOEs declines significantly. The difference in CARs between SOEs and non-SOEs becomes noticeably larger after the announcement of Rule #36. After the announcement, we find the CARs of SOEs are negative while the non-SOEs are not.

[Insert Table 2 Here]

Table 2 reports the summary statistics of all the variables used in this paper to test our main hypotheses. Panels A and B report the descriptive statistics of CARs and variables used in our univariate analysis and multiple regression models for data from the Shanghai and Shenzhen exchanges. From Panel A, the average CAR [-1,+1] and CAR [-2,+2] of SOEs are -0.33% and -0.68%, and both are statistically significant at the 1% level. However, the corresponding average CAR [-1,+1] and CAR [-2,+2] for non-SOEs are 0.67% and 0.89%, and both are also statistically significant at the 1% level. The difference in the average CAR [-1,+1] and CAR[-2,+2] between SOEs and non-SOEs are 1.00% and 1.57% respectively. Both differences are statistically significant at the 1% level (t = -6.69 and -7.24). Panel B reports the summary statistics of control variables used in our multivariate regressions.[16] In panel C, we report statistics on variables for our cross-sectional analysis. The average percentage of independent directors for SOEs and non-SOEs are relatively similar. SOEs has a larger supervisory board size at 4.20 as compared to non-SOEs at 3.21. Percentage of SOEs engaging Big 4 firms as auditors is 10 percent as compared to 3 for non-SOEs. Percentage of institutional ownership are higher at 53% for SOEs than non-SOEs at 31 percent. All variables in Table 2 are defined in detail in Appendix A.

[Insert Table 3 Here]

[16] The control variables are all winsorized at 1% and 99%.

Table 3 Panels A and B report the descriptive statistics of CARs and variables used in our univariate analysis and multiple regression models for the firms listed in the Hong Kong stock exchange. From Panel A, the average CAR [-1,+1] and CAR [-2,+2] of Chinese SOEs listed in the HKSE are -2.63% and -2.73%, and both are statistically significant at the 1% level. However, the average CAR [-1,+1] and CAR [-2,+2] for Chinese non-SOEs are lower at -0.63% and -0.73%. These estimates are also statistically significant at the 1% level. The average CAR [-1,+1] for non-Chinese firms listed in the HKSE is -0.56% and is significant at the 1% level. However, the average CAR[-2,+2] for these firms are statistically insignificant at any conventional levels. Panel B of Table 3 shows the control variables used in our multivariate regressions for the HKSE sample.

4. Empirical Findings

A. *Main Results*

In the regression analysis, non-SOEs, that are not directly affected by Rule #36, are chosen as control group in the counterfactual analysis. The specification is as follows:

$$CAR_i = \beta_0 + \beta_1 SOE_i + \beta_2 X_i + \gamma_j + \delta_k + \epsilon_i \quad (2)$$

Where CAR_i is the cumulative abnormal return of each firm over the event window

[-1,+1] and [-2,+2], respectively.[17] The *i*, *j*, *k* denotes firm, industry and province, respectively. SOE_i is an indicator variable that identifies whether a firm is a state-owned entity and X_i represent all the control variables in the regression models. Following Liu, Shu, and Wei (2017), our regression models control for logarithm of firm size (LnSZ), liabilities to assets (Leverage), book to market value (B/M), previous price run-up (BHR), and idiosyncratic volatility (Ivol). Both province and industry fixed effects are included, and standard errors are adjusted for clustering at the industry level.

[Insert Table 4 Here]

The results from Table 4 are consistent with Hypothesis H2, but not H1. The estimated coefficients of *SOE* are negative and statistically significant at the 1% level for the baseline Models (1) and (3) and 5% level for the full Models (2) and (4) respectively. These results suggest market participants react negatively to Rule #36, indicating a negative market perception of CCP's formal involvement in the board of SOEs. These findings support the *politicking or grabbing hands effect* of political control as suggested by Shleifer and Vishny (1994 and 2002). From Models (2) and (4) we find SOEs generally experience 0.6% to 1.1% drop in abnormal returns over the three-day and five-day window surrounding the announcement. From Columns 2 and

[17] The result remains robust for the alternative measure of CAR calculated with excess return over the value-weighted market return as the benchmark.

4, we find firm size and idiosyncratic volatility are negatively associated with CAR, while book-to-market ratio is positive. In the next sections, we offer evidence to corroborate and support our main results. First, we use an alternative measure of CAR instead of the market model. Second, to mitigate against possible selection bias, we use the propensity score matching method to identify comparable firms.

B. Robustness Check #1: Alternative measures of CAR

The CAR in previous section is based on the standard market model to calculate abnormal returns. Alternatively, we calculate the market-adjusted return over the same event period to serve as a robustness check on our main results in Table 4. One advantage of this approach is the mitigation of estimation error introduced by the market model regression. The results are reported in Columns 1 and 2 of Table 5. The estimated coefficients of *SOE* are negative and statistically significant at the 10% level for Model (1) and 5% level for Model (2). These results are consistent with those in Table 4. These results suggest that our findings are robust to different measures of CAR.

[Insert Table 5 Here]

C. *Robustness Check #2: Using Propensity Score Matching to identify comparable firms*

To mitigate against any potential selection bias in our main results, we use the propensity score matching (PSM) methodology to further ensure SOEs (treatment group) are comparable to non-SOEs (control group). We match each SOE with nearest propensity score to non-SOE without placement, and requiring the common support in the distribution. All the control variables in our regression models are used as covariates in our probit regression to calculate the propensity score. We report the second regression results for the propensity-score-matched firms in Columns 3 and 4 of Table 5. CAR [-1,+1] is the dependent variable for Model 3 and Model 4's is CAR [-2,+2]. The estimated coefficients of the *SOE* dummy variables for Models 3 and 4 are -0.60% and -1.20% and are statistically significant at the 5% level. These results are qualitatively similar to our main results in Table 4. Together with the results from using alternative measure of CAR (Models 1 and 2), these results lend support for the *Politicking (Hand Grabbing) Effec*t hypothesis.

D. *Evidence from Hong Kong: Market reactions to Rule #36 for stocks traded in the Hong Kong Stock Exchange*

We further check the robustness of our main results in Table 4 by examining market reactions for Chinese SOEs versus non-SOEs stocks that are traded on the HKSE. First, following Lin et al. (2016), we estimate portfolios' cumulative returns using returns of major indices in the Hong Kong market centered on the event date.

The indices include Hang Seng Index (HSI) and Hang Seng Red-Chip Index (HSCCI). The HSCCI consists significant numbers of listed SOEs from mainland China. All indices are normalized to 100% at the beginning of the five-day event window surrounding the event date. As shown in Figure 2, prices of the HSCCI drop upon the announcement of Rule #36 while the overall Hong Kong market (HSI) does not.

[Insert Figure 2 Here]

Second, we perform cross sectional regression analyses of stocks listed in the HKSE with dependent variable CAR [-1,+1] in Model 1 and CAR [-2,+2] in Model 2. The sample excludes financial firms and those with confounding corporate events, such as dividend payment, taking place within five trading-day window centered on May 4th, 2017. We divide the sample of HKSE stocks into three groups: Chinese SOEs, Chinese non-SOEs and other listed firms. Since Rule #36 only applies to Chinese SOEs, these SOEs listed in the HKSE will be directly impacted. Chinese non-SOEs may be indirectly affected while other listed firms in the HKSE will be the least likely to be affected by the regulatory change. The CARs for all the firms listed in HKSE are calculated using the standard event study market model. We use the Hang Seng Index (HSI) returns as a proxy for the market portfolio in equation (1). We assign two key dummy variables to identify Chinese SOEs and Chinese non-SOEs.

[Insert Table 6 Here]

In these specifications, we replace province fixed effect by country registration fixed effect to rule out time-invariant home country risks. We also include industry fixed effect. Standard errors are adjusted for clustering at industry level. Results for Models 1 with CAR [-1,+1] as dependent variable and CAR [-2,+2] for Model 2 are summarized in Table 6. The Chinese SOE dummy variables for Models 1 and 2 are -1.40% and -1.60% and they are statistically significant at the 10% and 5% level respectively. The results suggest Chinese SOEs are negatively affected by Rule #36 as compared to either Chinese non-SOEs or non-mainland listed firms in the HKSE. In other words, Chinese SOEs listed in HKSE experience approximately 1.4% to 1.6% value depreciation as measured by three-day and five-day CARs, respectively. In contrast, Chinese non-SOEs do not experience any pronounced price decline, nor do other non-Chinese listed firms. The coefficients of Chinese non-SOEs dummy are close to zero and are statistically insignificant at conventional levels. The results from the HKSE strongly confirm Rule #36 affects only Chinese SOEs regardless of marketplaces.

E. *Internal Governance's Mitigating Effect (Hypothesis 3a)*

A system of effective corporate governance mechanisms can increase the efficacy in monitoring management and may will lead to the reduction of conflict of interests among stakeholders. To mitigate agency problem between manager and shareholders,

corporate governance design, such as the numbers of independent director, size of supervisory board and significant amount of blockholders, may contribute to some extent. We test the Hypothesis 3a by examining whether sound internal governance practices can partially mitigate the negative impact of a shift in political control on firm value.

We estimate the regressions similar to equation (2) to test the efficacy of internal governance mechanisms as mitigants to the negative market reactions of SOEs to Rule #36. In our tests, we define $More_i$ to take the value of one for firm with stronger internal oversight from (1) independent directors, which is defined as more than the required one third ratio; (2) supervisory board that is greater than the three members that is required by regulation; and (3) large blockholders which is measured by shares held by the second to fifth largest blockholders relative to the median of share concentration in the full sample. The dummy variable $Less_i$ is defined as 1 - $More_i$. The key variables to test Hypothesis 3a are ($SOE_i \times More_i$) and ($SOE_i \times Less_i$). The results are reported in Table 7.

[Insert Table 7 Here]

From Columns 1 and 2 of Table 7, the estimated coefficients of ($SOE_i \times More_i$) are statistically insignificant at conventional levels. These results

indicate that SOEs with numbers of independent directors greater than the one third requirements by regulators, do not experience significant price change. In contrast, the coefficients of ($SOE_i \times Less_i$) are negative and statistically significant at the 1% level. These results show that SOEs with independent directors making up exactly one third of the board are associated with 0.8% and 1.6% drop in valuation over the three-day and five-day event windows respectively. They suggest that independent directors do play important monitoring roles in mitigating the perceived negative effect caused by a shift in political control. These findings are consistent with Dahya et al. (2003), Black and Kim (2012), Liu et al. (2015) and Fauver et al. (2017).

Similarly, consistent with Firth, Fung, and Rui (2007), we find in Columns 3 and 4, the estimated coefficients of ($SOE_i \times Less_i$) are negative and statistically significant at 5% and 1% levels respectively. That is, SOEs with smaller supervisory board size are associated with larger price decline as compared to SOEs with larger supervisory boards. These findings suggest that larger supervisory board size does play an important monitoring role and helps to mitigate against the negative stock market reactions to Rule #36. Note that large non-state shareholders or ownership concentration do not cushion the SOEs from the negative impact of Rule #36 (see Columns 5 and 6). One possible explanation is the limited monitoring role or power of blockholders with respect to the controlling state-owned shareholders.

F. *External Institutions' Mitigating Effect (Hypothesis 3b)*

External institutions can serve as important monitors to discipline managers. Clearly elucidated shareholder rights, engaging reputable auditors, and having foreign and institutional investors may help decrease the potential shareholder welfare loss due to political control. First, we test the effectiveness of legal protection of shareholder rights and foreign shareholders in mitigating the wealth effects of increased political control. Second, we re-examine auditors' monitoring role in the relationship between firm value and increased political control. Third, we test whether institutional investors with large shareholdings have the power to monitor management and the board.

Using similar regression specifications in equation (2), we estimate the coefficients of each entity that may serve as an external monitoring mechanism. These entities are foreign investors, auditors, and institutional investors. We define $More_i$ equals to one for firm with (1) stronger external oversight, which are shares that are cross-listed in the A-share and H- or B-shares market; (2) higher reputation Big 4 auditors; and (3) large institutional shareholdings, that is SOEs with institutional ownership above the median level of institutional holding in the full sample. The dummy variable $Less_i$ is defined as 1 - $More_i$. The key variables to test Hypothesis 3b are ($SOE_i \times More_i$) and ($SOE_i \times Less_i$). The regression results are reported in Table 8.

[Insert Table 8 Here]

Comparing the estimated coefficients of the two interaction terms $(SOE_i \times More_i)$ and $(SOE_i \times Less_i)$, we find in Table 8 Columns 1 to 4 that SOEs held by more foreign investors and engaging reputable auditing firms are associated with less negative stock price reaction to the announcement of Rule #36. The estimated coefficients of $(SOE_i \times More_i)$ for SOEs with either H- or B-shares are statistically insignificant at conventional levels. In contrast, SOEs with only A-shares are associated with negative CAR that is statistically significant at the 5% level. These findings confirm the importance of legal protection of shareholder rights (La Porta et al. (1997), (1998), (1999), (2000)). The results are also consistent with existing literature on cross-listing and bonding (Coffee (1990); Doidge et al. (2004); Leuz and Wysocki (2016)). SOEs audited by the Big Four auditors do not show a pronounced negative price impact upon the announcement of Rule #36 while those audited by low-quality auditors do. These findings are consistent with Becker et al. (1998), Fan and Wong (2005), and Guedhami, Pittman, and Saffar (2014) that show the effective monitoring role of qualified auditors.

However, we fail to find evidence to suggest that institutional investors are effective external monitors of the firm. Columns 5 and 6 of Table 8 show that SOEs with higher institutional ownership, as captured by $(SOE_i \times More_i)$, have

estimated coefficients that are negative and significant at 10% and 1% levels for the CAR [-1,+1] and CAR [-2,+2] respectively. In contrast, SOEs with lower institutional ownership have smaller negative stock price reaction but the estimated coefficients are statistically insignificant at conventional levels. These results suggest institutional investors have "no say" and voicing their opinion does not seem to work in SOEs.

IV. Conclusion

China provides an ideal context to study the economic value of political control and its relation to corporate governance and institutions. In China, administrative agencies used to play the major role in supervising SOEs. For example, SASAC under the State Council works as the delegated monitoring authority. Thus, little is known about the role of the CCP in corporate governance and control of SOEs, as prior studies has treated the government and the party as one entity under one-party state regime.

On May 3rd, 2017 the State Council issued Rule #36 that explicitly mandates the CCP to take the lead role in the board of SOEs. We use this announcement as an exogenous shock to study the impact of the shift in political control from the state (administration) to the party. We find that the policy mandate to elevate the CCP's role in the board of SOEs, are associated with significant negative market reactions. SOEs' stock price dropped broadly following the announcement of Rule #36 while non-SOEs do not. The significant value decrease of SOEs and insignificant value change of non-SOEs are confirmed in the Hong Kong market with non-Chinese

stocks as the benchmark. We also find the negative stock market reaction is more pronounced for SOEs with weaker internal governance and external oversight. Hence, we find evidence suggesting sound corporate governance mechanisms can help mitigates the negative impact of political control on firm value.

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APPENDIX A: VARIABLE DESCRIPTIONS

Variables	Descriptions	Source
CAR[-1,+1]	Three trading-day cumulative abnormal return centered on May 4th, 2017 from market model using value-weighted market return as benchmark.	CSMAR
CAR[-2,+2]	Five trading-day cumulative abnormal return centered on May 4th, 2017 from market model using value-weighted market return as benchmark.	CSMAR
SOE Dummy	A dummy variable that equals to one if the ultimate controller of a firm is a government-owned entity or central (provincial) government, and zero otherwise.	CSMAR
LnSZ	The natural logarithm of total assets at last fiscal year end.	CSMAR
B/M	Book-to-market ratio, constructed as the book value of equity at last fiscal year end divided by the market value of equity of two weeks before the announcement date (May 4th, 2017).	CSMAR
Leverage	Total liabilities divided by total assets at last fiscal year end.	CSMAR
BHR	Buy-and-hold stock return from two weeks to one week before May 4rd, 2017.	CSMAR
Ivol	Idiosyncratic volatility, which is defined as the standard deviation of the daily return residuals from the market model used to estimate the cumulative abnormal return.	CSMAR
Independent directors	The proportion of independent directors by the total number of directors in board at last fiscal year end.	CSMAR
Supervisors	The size of supervisory board at last fiscal year end.	CSMAR
Share concentration	The percentage of shares held by the 2th to the 5th largest shareholder at last fiscal year end.	CSMAR
Issues H- or B-shares	A dummy variable that equals to one if a firm issues H-shares or B-shares, and zero otherwise.	CSMAR
Big Four	A dummy variable that equals to one if a firm is audited by the Big Four auditing house at last fiscal year, and zero otherwise.	WIND
Institution Ownership	The ratio of institutional shares divided by outstanding shares at last fiscal year.	CSMAR

APPENDIX B: THE ANNOUNCEMENT DATE OF SOES AMENDING COMPANY CHARTERS TO COMPLY WITH RULE #36

The table reports a partial list of SOEs that amended the articles of association to legalize the status of CCP and its organization after the Rule #36. We rank the list according to firm's market capitalization at the end of 2017.

SOEs Name	Announcement Date	Market Capitalization In 2017 （Billion RMB）
Shanghai Pudong Development Bank Co., Ltd.	2017.06.13	370
New China Life Insurance Company Ltd.	2017.08.30	190
Guangzhou Automobile Group Co., Ltd.	2017.07.07	160
Shanghai International Port (Group) Co., Ltd	2017.10.31	150
Aluminum Corporation of China Limited	2017.08.18	110
Zhejiang Zheneng Electric Power Co., Ltd.	2017.11.09	72
Aecc Aviation Power Co, Ltd	2017.11.08	61
Jiangxi Copper Company Limited	2017.08.30	56
SDIC Capital Co., Ltd	2017.11.18	56
Shanxi Xinghuacun Fen Wine Factory Co.,Ltd	2017.07.05	49
China Shipbuilding Industry Group Power Co., Ltd	2017.10.24	43
Bank of Hangzhou Co., Ltd.	2017.08.26	42
Financial Street Holdings Co., Ltd.	2017.12.02	33
Shanghai Construction Group Co., Ltd.	2017.12.12	33
China Petroleum Engineering Co., Ltd.	2017.09.19	32
Fiberhome Telecommunication Technologies Co., Ltd.	2017.12.02	32
Shanxi Xishan Coal and Electricity Power Co., Ltd	2017.09.30	32
Zhejiang China Commodities City Group Co., Ltd.	2017.12.13	31
Tongling Nonferrous Metals Group Co., Ltd	2017.08.28	31
Bank of Guiyang Co., Ltd.	2017.06.27	31

Table 1: Distribution of SOEs and Non-SOEs by Province and Industry

Panel A reports the distribution of SOEs and non-SOEs listed in the Shanghai and Shenzhen stock exchanges across 31 provinces and 9 industries. Panel B show the distribution by CSIC level 1 industry classification.

Panel A: Province Level	SOEs	non-SOEs
Province	N	N
Beijing (Central)	89	115
Guangdong	77	270
Shanghai	73	98
Shandong	51	92
Jiangsu	44	193
Hubei	38	36
Anhui	34	39
Zhejiang	34	226
Hunan	32	33
Sichuan	29	57
Liaoning	27	34
Fujian	26	54
Shaanxi	26	11
Henan	22	39
Shanxi	20	11
Xinjiang	19	17
Tianjin	18	11
Hebei	18	21
Jiangxi	16	13
Jilin	15	15
Chongqing	15	17
Guangxi	14	11
Heilongjiang	14	15
Yunnan	13	8
Gansu	12	12
Guizhou	11	4
Hainan	8	13
Inner Mongolia	7	12
Qinghai	4	7
Ningxia	3	2
Tibet	3	8

Total	812	1494

Panel B: Industry Level	SOEs	Non-SOEs
CSIC Industry level 1	N	N
Industrials	243	414
Materials	151	234
Consumer Discretionary	138	253
Utilities	70	13
Consumer Staples	59	88
Information Technology	55	262
Health Care	48	167
Energy	38	25
Telecommunication Services	10	38

Table 2: Summary Statistics for Firms Listed in the Shanghai and Shenzhen Stock Exchanges

This table reports the summary statistics for variables used in this paper. Panel A shows the cumulative abnormal returns (CAR) calculated from the market model centered on May 4th 2017 for the Shanghai and Shenzhen Stock Exchanges. Summary statistics for control variables for main regressions are shown in Panel B. Corporate governance variables are summarized in Panel C. Detailed definition of these variables is provided in the Appendix A.

Panel A: China	SOEs		Non-SOEs		Difference	
	N	Mean (%)	N	Mean (%)	N	Mean (%)
CAR[-1,+1]	812	-0.33***	1,494	0.67***	2,306	-1.00***
CAR[-2,+2]	812	-0.68***	1,494	0.89***	2,306	-1.67***

Panel B: Control variables	N	Mean	S.D.	p25	p50	p75
SOE Dummy	2306	0.35	0.48	0.00	0.00	1.00
LnSZ	2306	22.23	1.24	21.37	22.11	22.92
B/M	2306	0.50	0.32	0.28	0.42	0.62
Leverage	2306	0.40	0.20	0.24	0.39	0.55
BHR	2306	0.05	0.09	0.00	0.04	0.09
Ivol	2306	0.02	0.01	0.01	0.02	0.02

	Full Sample		SOEs		Non-SOEs	
Panel C: Governance variables	N	Mean	N	Mean	N	Mean
Independent directors	2306	0.37	812	0.37	1494	0.38
Supervisors	2306	3.56	812	4.20	1494	3.21
Share concentration	2306	0.19	812	0.16	1494	0.21
H/B shares issued	2306	0.06	812	0.12	1494	0.02
Big Four	2306	0.06	812	0.10	1494	0.03
Institutional investor	2306	0.38	812	0.53	1494	0.31

Table 3: Summary Statistics for Firms Listed in the Hong Kong Stock Exchange

This table reports the summary statistics for variables used in this paper. Panel A shows the cumulative abnormal returns (CAR) calculated from the market model centered on May 4th 2017 for the mainland Chinese firms listed in the Hong Kong Stock Exchanges (HKSE). Summary statistics for control variables use in regression models using data from the HKSE are shown in Panel B. Detailed definition of these variables is provided in the Appendix A.

Panel A: Hong Kong	SOEs		Chinese non-SOEs		Other Non-SOEs	
	N	Mean (%)	N	Mean (%)	N	Mean (%)
CAR[-1,+1]	224	-2.63***	541	-0.63***	815	-0.56***
CAR[-2,+2]	224	-2.73***	541	-0.73***	815	-0.38

Panel B: Control variables	N	Mean	S.D.	p25	p50	p75
SOE Dummy	1,580	0.142	0.349	0	0	0
Non-SOE Dummy	1,580	0.342	0.475	0	0	1
LnSZ	1,580	12.51	2.006	11.12	12.30	13.86
B/M	1,580	2.167	2.436	0.617	1.368	2.648
Leverage	1,580	0.442	0.258	0.240	0.419	0.609
BHR	1,580	-0.000	0.060	-0.020	0.00	0.020
Ivol	1,580	0.029	0.028	0.018	0.025	0.034

Table 4：Main Regression Results for Firms Listed in the Shanghai and Shenzhen Stock Exchanges

This table reports results from the regression analysis of cumulative abnormal return (CAR) over event windows [-1,+1] and [-2,+2] centered on May 4, 2017. The dependent variable is CAR which is calculated from the market model using value-weighted market returns. SOE dummy equals to one if the firm is under the direct control of the State-owned Asset Supervision and Administration Commission (SASAC), and zero otherwise. The detailed definition of other control variables is provided in Appendix A. We also include province and CSIC level 2 industry fixed effect. The robust standard errors reported in parentheses are clustered by industry. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels respectively.

	CAR from market model			
	(1)	(2)	(3)	(4)
	[-1,+1]	[-1,+1]	[-2,+2]	[-2,+2]
SOE Dummy	-0.009***	-0.006**	-0.014***	-0.011**
	(0.003)	(0.003)	(0.004)	(0.004)
LnSZ		-0.005***		-0.008***
		(0.001)		(0.002)
Leverage		0.001		0.001
		(0.003)		(0.008)
B/M		0.008***		0.012***
		(0.002)		(0.004)
BHR		0.026**		0.012
		(0.011)		(0.011)
Ivol		-0.496***		-1.330***
		(0.098)		(0.188)
Constant	0.015***	0.136***	0.022***	0.219***
	(0.003)	(0.025)	(0.004)	(0.043)
Province F.E.	Y	Y	Y	Y
Industry F.E.	Y	Y	Y	Y
N	2306	2306	2306	2306
Adj. R^2	0.040	0.062	0.052	0.099

Table 5: Robustness Tests – Alternative Event Study Methodologies

This table reports the results of two additional tests to corroborate our main results. In first two columns, CARs are calculated using the market-adjusted return method. In the Columns 3 and 4, we report the results of using propensity-score-match (PSM) methodology to match SOEs with non-SOEs. The dependent variable CAR is calculated using the market model. We also include CSIC level 2 industry fixed effect and province (country) fixed effect. The robust standard errors reported in parentheses are clustered by industry. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels respectively.

	CAR from market adjusted return		CAR from market model	
	Alternative Measures of CAR		PSM	
	(1)	(2)	(3)	(4)
	[-1,+1]	[-2,+2]	[-1,+1]	[-2,+2]
SOE dummy	-0.003*	-0.004**	-0.006**	-0.012**
	(0.001)	(0.002)	(0.003)	(0.005)
LnSZ	0.002*	0.004***	-0.005***	-0.007**
	(0.001)	(0.001)	(0.001)	(0.003)
Leverage	-0.011***	-0.018***	0.001	-0.001
	(0.002)	(0.004)	(0.005)	(0.011)
B/M	0.004	0.000	0.011***	0.015***
	(0.003)	(0.004)	(0.003)	(0.004)
BHR	0.008	0.007	0.050*	0.038*
	(0.008)	(0.011)	(0.024)	(0.021)
Ivol	0.076	-0.571***	-0.397***	-1.097***
	(0.076)	(0.099)	(0.105)	(0.213)
Constant	-0.047*	-0.086***	0.122***	0.191***
	(0.024)	(0.029)	(0.033)	(0.062)
Province/ Country F.E.	Y	Y	Y	Y
Industry F.E.	Y	Y	Y	Y
N	2306	2306	1200	1200
Adj. R^2	0.057	0.161	0.052	0.082

Table 6: Robustness Tests - Results from Hong Kong Stock Exchange

This table reports the results of additional tests to corroborate our main results. The sample of firms analyzed are listed in Hong Kong Stock Exchange (HKSE). The dependent variable is CAR which is calculated from the market model with the Hang Seng index as a proxy for the market. SOE Dummy in columns (1) and (2) indicates whether a mainland firm in the HKSE is stated-owned. Non-SOE Dummy in columns (1) and (2) indicates whether a mainland firm is a non-SOE. We also include CSIC level 2 industry fixed effect and province (country) fixed effect. The robust standard errors reported in parentheses are clustered by industry. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels respectively.

	CAR from market model	
	(1)	(2)
	[-1,+1]	[-2,+2]
SOE dummy	-0.014*	-0.016**
	(0.008)	(0.007)
Non-SOE Dummy	0.003	0.001
	(0.004)	(0.005)
LnSZ	-0.002**	-0.002**
	(0.001)	(0.001)
Leverage	-0.014**	-0.012*
	(0.006)	(0.007)
B/M	0.002	0.001
	(0.001)	(0.001)
BHR	-0.005	-0.047
	(0.056)	(0.039)
Ivol	-0.109	-0.231*
	(0.125)	(0.111)
Constant	0.024*	0.024*
	(0.012)	(0.014)
Province/Country F.E.	Y	Y
Industry F.E.	Y	Y
N	1580	1580
Adj. R^2	0.031	0.038

Table 7: Regression of CAR by Internal Governance Oversight

This table report the elasticity of cumulative abnormal returns (CAR) of state-owner enterprises (SOEs) by types of internal governance oversights. SOEs with strong internal oversight are classified as: (1) the proportion of independent directors in the board is above the required one-third; (2) corporate supervisory board consists of more than the required three members; (3) relative high concentration of shares in the hands of the 2nd to the 5th largest shareholders relative to the median of share concentration in the full sample. SOE × More equals to one if SOEs have strong internal oversight while SOE × Less equals to one if SOEs have weak internal oversight The dependent variable is CAR estimated from the market model based on value-weighted market returns. The detailed definition of other control variables is provided in Appendix A. We also include province and CSIC level 2 industry fixed effect. The robust standard errors reported in parentheses are clustered by industry. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels respectively.

	CAR from market model					
	Independent Director		Supervisory Board		Ownership Concentration	
	(1)	(2)	(3)	(4)	(5)	(6)
	[-1,+1]	[-2,+2]	[-1,+1]	[-2,+2]	[-1,+1]	[-2,+2]
SOE×More	-0.003	-0.005	-0.002	-0.003	-0.007*	-0.012***
	(0.004)	(0.004)	(0.004)	(0.005)	(0.004)	(0.006)
SOE×Less	-0.008***	-0.016***	-0.007**	-0.012***	-0.005**	-0.011***
	(0.003)	(0.005)	(0.003)	(0.003)	(0.002)	(0.003)
More	-0.001	-0.001	-0.004	-0.010*	0.001	-0.000
	(0.002)	(0.002)	(0.003)	(0.006)	(0.001)	(0.002)
LnSZ	-0.005***	-0.008***	-0.005***	-0.008***	-0.005***	-0.008***
	(0.001)	(0.002)	(0.001)	(0.002)	(0.001)	(0.002)
Leverage	0.002	0.001	0.002	0.001	0.001	0.001
	(0.003)	(0.008)	(0.003)	(0.008)	(0.003)	(0.008)
B/M	0.008***	0.012***	0.008***	0.012***	0.008***	0.012***
	(0.003)	(0.004)	(0.002)	(0.003)	(0.003)	(0.004)
BHR	0.025**	0.012	0.025**	0.011	0.026**	0.012
	(0.011)	(0.011)	(0.011)	(0.012)	(0.011)	(0.011)
Ivol	-0.495***	-1.328***	-0.494***	-1.321***	-0.496***	-1.326***
	(0.098)	(0.190)	(0.100)	(0.188)	(0.098)	(0.187)
Constant	0.140***	0.227***	0.135***	0.213***	0.136***	0.219***
	(0.026)	(0.044)	(0.025)	(0.040)	(0.025)	(0.043)
Province F.E.	Y	Y	Y	Y	Y	Y
Industry F.E.	Y	Y	Y	Y	Y	Y
N	2306	2306	2306	2306	2306	2306
Adj. R^2	0.063	0.102	0.062	0.101	0.061	0.099

Table 8: Regression of CAR by External Oversight

This table reports the elasticity of cumulative abnormal return (CAR) cross various windows by types of external institutional oversight. SOEs with strong external oversight are classified as: (1) SOEs with stronger legal protection for shareholder rights and have more foreign investors, measured by whether firms issue H-shares or B-shares; (2) SOEs audited by the Big Four auditing houses; (3) SOEs with institutional ownership above the median level of institutional holding in all sample. SOE×More equals to one if SOEs have strong external oversight while SOE×Less equals to one if SOEs have weak external oversight. The dependent variable is CAR derived from the market model based on value-weighted market returns. The detailed definition of other control variables is provided in Appendix A. We also include province and CSIC level 2 industry fixed effect. The robust standard errors reported in parentheses are clustered by industry. ***, ** and * represent statistical significance at the 1%, 5% and 10% levels respectively.

	CAR from market model					
	Shareholder Rights and Foreign Investor		Auditor Quality		Institutional Investor	
	(1)	(2)	(3)	(4)	(5)	(6)
	[-1,+1]	[-2,+2]	[-1,+1]	[-2,+2]	[-1,+1]	[-2,+2]
SOE×More	-0.004	-0.000	-0.003	-0.006	-0.006*	-0.010***
	(0.005)	(0.005)	(0.006)	(0.008)	(0.003)	(0.003)
SOE×Less	-0.006**	-0.012**	-0.006**	-0.011**	-0.003	-0.009
	(0.003)	(0.005)	(0.003)	(0.005)	(0.004)	(0.006)
More	-0.001	-0.005	0.001	0.000	-0.003*	-0.004*
	(0.004)	(0.005)	(0.006)	(0.008)	(0.002)	(0.002)
LnSZ	-0.005***	-0.008***	-0.006***	-0.008***	-0.005***	-0.007***
	(0.001)	(0.002)	(0.001)	(0.002)	(0.001)	(0.002)
Leverage	0.001	0.001	0.002	0.001	0.000	-0.000
	(0.003)	(0.008)	(0.003)	(0.009)	(0.003)	(0.008)
B/M	0.008***	0.012***	0.008***	0.012***	0.007**	0.010**
	(0.003)	(0.003)	(0.002)	(0.003)	(0.003)	(0.004)
BHR	0.026**	0.012	0.026**	0.013	0.024**	0.011
	(0.010)	(0.011)	(0.010)	(0.011)	(0.010)	(0.011)
Ivol	-0.497***	-1.335***	-0.503***	-1.338***	-0.504***	-1.339***
	(0.098)	(0.191)	(0.096)	(0.188)	(0.099)	(0.190)
Constant	0.137***	0.222***	0.142***	0.225***	0.123***	0.204***
	(0.027)	(0.049)	(0.029)	(0.052)	(0.026)	(0.044)
Province F.E.	Y	Y	Y	Y	Y	Y
Industry F.E.	Y	Y	Y	Y	Y	Y
N	2306	2306	2306	2306	2306	2306
Adj. R^2	0.061	0.099	0.062	0.099	0.064	0.100

Figure 1: Abnormal Returns and Cumulative Abnormal Return Surrounding Rule #36

This figure plots the abnormal returns and cumulative abnormal return centered on May 4, 2017. AR is the abnormal return estimated from the market model using value-weighted market returns from both the Shanghai and Shenzhen stock exchanges. CAR is the cumulative abnormal return starting from 2 trading days before May 4, 2017. We report both AR and CAR of SOEs and non-SOEs around event windows.

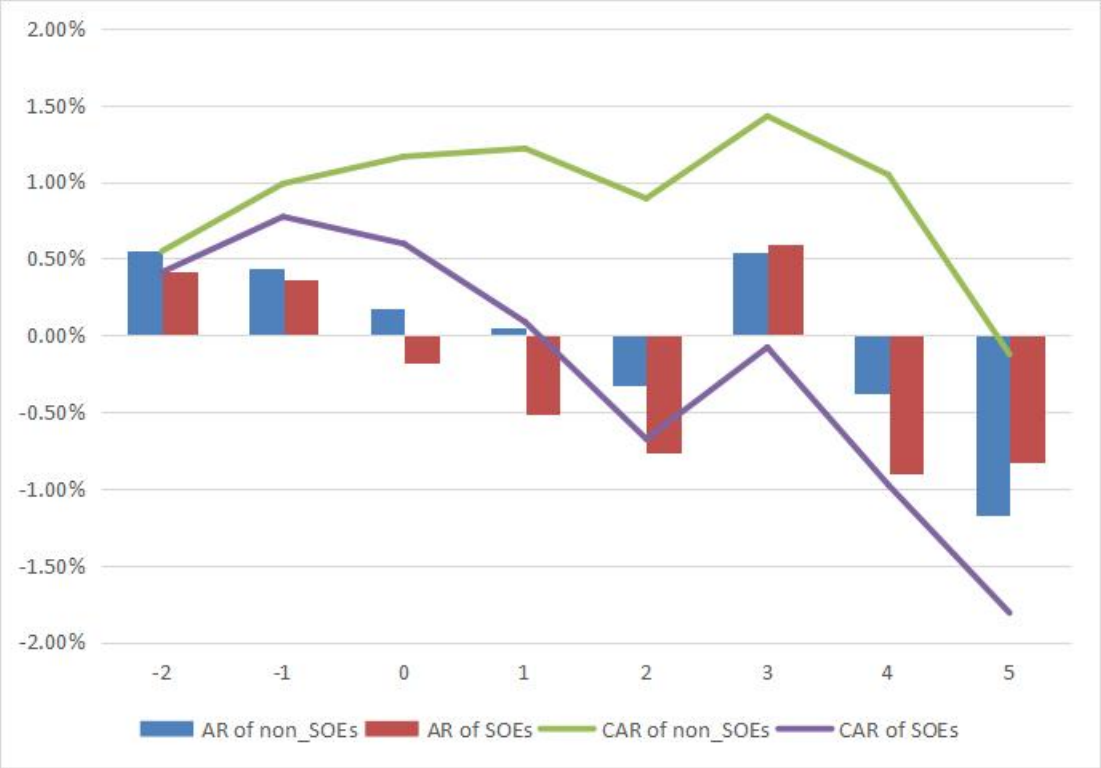

Figure 2: Mainland Chinese Firms versus Other Firms Listed in Hong Kong

This figure plots the cumulative total return of major indices in Hong Kong centered on the event date, May 4, 2017. The indices include HSI (Hang Seng Index) and HSCCI (Hang Seng Red-Chip Index). All indices are normalized to 100% at the beginning of the 11-day event window centered on the event date.