

The reform of split share structure in China and its effects on the
capital market: An empirical study¹

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Abstract

This paper investigates the market response to reform of the Chinese split (A-)share structure using a sample of companies included in the China Securities Index 300. We find the three-day cumulative abnormal returns (CAR) to be negative and significant around government announcement of the reform on 29 April 2005, but not significant around individual companies' decision to implement the reform. We attribute this change in market sentiment to the release of information during company announcement that the reform will feature some type of consideration to existing shareholders of tradable A-shares. Our results also show that existing holders of tradable A-shares require higher returns when companies pay in warrants or combination methods. However, we find no relation between the level of consideration and CAR suggesting that investors perceive the consideration to be adequate based on the company's financial and operating conditions at the time of the reform.

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1. Introduction

The process of transforming China from a centrally planned economy to a market economy has involved the development of a number of features designed to maintain central control while enabling the market to enhance the efficiency of resource allocation. This resulted in many listed companies having a complicated share structure. For instance, at one stage there existed, among others, the following different classes of shares; A-shares (mainland listed), H-shares (Hong Kong listed) and even N shares for shares listed in New York. Moreover, the A-share class was subdivided into tradable shares – those held by normal investors – and non-tradable shares – those held by state controlled entities. The non-tradability of the latter was the means by which central control (direct or indirect) was maintained by the Chinese authorities.

Over recent years, the Chinese authorities have undertaken a process to streamline and unify the various share classes. We investigate one part of this process – the unification of the tradable and non-tradable A shares into a homogenous class or what is commonly referred to as the reform of split share structure. This unification transformed the non-marketable shareholdings of state-owned enterprises and other central government nominees into liquid assets. It is clear from the mechanics of the reform that this liquidity was viewed as valuable. Moreover, the acquisition of liquidity by holders of non-tradable A-shares was viewed as occurring to the detriment of the holders of the tradable shares: a fundamental aspect of the reform was the issue of compensation to the latter.

In this paper, we examine three research questions. Firstly, we consider the share market reaction to the general announcement of the reform on 29 April, 2005; secondly, we consider market reactions to reform announcements made by companies, which occurred at different times after the general announcement; and thirdly, we investigate the determinants of the market reaction, such as type and amount of the liquidity compensation.

Using a sample of 208 companies included in China Securities Index (CSI 300) we find that the three-day cumulative abnormal return (CAR) around the government announcement is negative and significant. In contrast, the three-day CAR around the company's announcement is non-zero. These results indicate that the company's announcement of the details of the reform (e.g. consideration payment) strongly swayed the investors to accept the split share reform by the state. By regressing CAR around the company's announcements on the type of consideration and the level of consideration, the results reveal that the type of consideration has a significant impact on CAR. Investors appear to require higher returns when paying in warrants or combination method but indifferent to the level of consideration.

This paper contributes to the current literature by providing comprehensive evidence on the impact of the split share structure reform and its determinants. The results of this paper will provide both policy makers and market participants with some insights into China's transition from a regulatory to a market economy. Specifically, the subsequent positive impact of the reform, after the market was aware of the consideration component of the reform, only highlights the need for policy makers to pay attention to the protection of investors' interests. The findings of this paper are also of assistance to market participants who have interests in the Chinese capital market, in that it assists them to better understand the institutional arrangements in this emerging market.

2. Background and Hypotheses Development

The Chinese capital market was established in early 1990s with the opening of the Shanghai Stock Exchange (SSE) in December 1990 and shortly thereafter the Shenzhen Stock Exchange (SZSE). Both the SSE and the SZSE are under the supervision of the China Securities Regulatory Commission (CSRC), a ministry-level organization under direct control of the state council. To-date there are approximately 1300 companies listed on the Chinese Stock Exchange (800 companies in SSE and 500 companies in SZSE). This section will discuss the unique institutional arrangements of the Chinese capital market, specifically, the coexistence of the two classes of A-shares (the split share structure), its history and drawbacks. We also discuss prior evidence on partial privatisation of China's state-owned enterprises (SOEs) and how the split share structure reform of 2005 is intended to overcome the negative effects of earlier reforms. Finally, this section will put forward several hypotheses that we utilise to test and address our research questions.

2.1 Institutional basis of the split share structure

Prior to the reform investigated by us, the share structure of China's typical listed company was comprised of non-tradable A-share capital (accounting for more than 60% of all issued shares) and tradable A-, B-, H- and N-shares. The coexistence of two classes of A-shares having the same voting and dividend rights except that one class is tradable and the other is not is often referred to in the literature as split share structure. This structure evolved when the state decided to take some SOEs public while seeking to maintain voting control.

Non-tradable A-shares were either "state-owned" shares or "legal-person" shares.³ State-owned shares could only be transferred privately to other government agencies, legal entities, and foreign investing firms subject to state approval (SAMB, 1997). The transfer price was typically based on net book value per share, return on equity (ROE), return on investment (ROI), recent market price, or a reasonable price-to-earnings ratio. Moreover, the transfer price was required to be higher than the net book value per share in order to prevent loss on sale of state assets. On the other hand, legal-person shares were held by domestic corporations and other non-individual entities. Although these legal entities had a mixed ownership structure with both private and government stakes, they were usually indirectly controlled by the government. Hence, like state-owned shares, legal-person shares could not be traded on the stock market but their transfer did not require government approval and their pricing was not subject to specific rules.

Tradable shares consist of A-shares, B-shares, H-shares and N-shares. A-shares and B-shares are traded in the domestic capital market with the former traded in local currency, renminbi (RMB), and the latter traded in US dollars.⁴ The B-share market is much smaller than the A-share market both in terms of market capitalization and trading volume due to lack of interest from the market participants and lack of quality companies (Walter and Howie, 2006). H-shares are issued by the companies listed on Hong Kong Stock Exchange (HKSE) and

³ See Chen and Wang (2005) for a detailed description of shareholder identities in China's listed companies.

⁴ A-shares were initially available to domestic investors (excluding investors from Hong Kong, Taiwan and Macau) only, while B-shares were originally intended for foreign investors. These restrictions were deregulated where domestic investors were allowed to trade in the B-share market on 19 February 2001 and Qualified Foreign Institutional Investors (QFII) were allowed to trade in the A-share market on 1 December 2002.

traded in Hong Kong dollars while N-shares are listed in the New York Stock Exchange and traded in US dollars. Due to strict currency control and regulatory measures, these markets operate independently.

2.2 Economic role of the split share structure

Initially, companies in China were wholly controlled by the state under the regulatory economy system. Gupta (2002) points out two problems arising from state ownership. First, political interference distorts and confuses the company's goal of maximizing firm value. Second, state ownership often induces lack of managerial discipline and incentives. The lack of managerial autonomy and absence of the benefits achieved in the agency-incentive selling may result in low efficiency of SOEs (Groves, Hong, McMillan and Naughton, 1994; Qian, 1996; Qian and Roland, 1996). In addition to the changes in socio-political ideologies in China with a strong desire to raise money for Chinese enterprises and at the same time reduce state subsidies, the state also has a goal of achieving greater economic efficiencies by establishing a "modern enterprise system" (Chen, Firth and Rui, 2002). This led to the privatisation of small SOEs and corporatisation large SOEs in early 1990s (Cao, Qian and Weingast, 1999; Lin and Zhu, 2001). The corporatised SOEs were later publicly listed creating firms that in theory, is independent of state decision-making with diverse ownership structure (Lin and Zhu, 2001).

However, the state still retained ultimate control of the semi-privatised SOEs because it wanted to ensure an orderly and gradual process of privatisation so as not to overwhelm the fledgling stock market (Chen et al., 2002). Thus, ostensibly, listed companies have nominal autonomy, but in reality, the state controls the voting rights (with non-tradable A-shares comprising 60% of the share capital). With this structure, the government can still influence management to take courses of action to achieve political and social gains but not necessarily improving firm value.

2.3 Economic effects of the split share structure

Although the intended purpose of the partial privatisation was to improve the performance of SOEs, extant literature provide evidence to the contrary (Wang, Xu and Zhu, 2001; Chen, Firth and Rui, 2002). Wang et al. (2001) investigate the impact of public listing of SOEs in China by comparing the pre- and post-listing financial and ownership information of the listed companies in SSE and SZSE. They find that company's performance in the post-listing years is sharply lower than their levels in both the pre-listing years and the initial public offering year. They attribute these results to the increase in agency costs and the exaggeration of pre-listing performance. Chen et al. (2002) also find that the economic performance (in terms of profitability and efficiency) of publicly listed SOEs deteriorated after the partial privatisation. They argue that the privatisations have been unsuccessful due to the half-hearted nature of the enterprise reform and lack of good corporate governance structures.

These problems may have been the consequence of the differences in ownership and liquidity between two types of A-shares. For instance, the unique ownership arrangements in China results to classical agency problems such as divergence-of-interest and entrenchment. Divergence-of-interest theory (Jensen and Meckling, 1976) suggests that a company's performance will decrease with the degree of separation between ownership and control. In the

case of split share structure, non-tradable shareholders and tradable shares are both owners so that the separation between ownership and control does not appear to apply. But under a socialist economy, directors and senior management of SOEs who are government appointees are agents of the people (Lin, 2001). In China's partial privatisation, the divergence-of-interest not only exists between principals and agents, but also between tradable shareholders and non-tradable shareholders. Tradable shareholders desire to maximise the share price of the firm while non-tradable shareholders are indifferent to share prices since they cannot sell the shares on the open market. Hence, non-tradable shareholders may try to seek maximize their benefit in other ways (usually through private transactions) often at the cost of the minority shareholders. Thus, the divergence-of-interest theory implies a decline in performance of China's public listing companies under the split share structure. (See Chen et al, 2002).

China's agency problem is also consistent with entrenchment theory (Demsetz, 1983; Fama and Jensen, 1983). This theory suggests that corporate assets are less valuable when managed by someone free from checks and control. China's pre-reform setting where non-tradable shares dominate tradable shares suggest that the securities market cannot effectively supervise the performance of the management who are appointed by the state and legal persons that retain the control rights of the SOEs. Similarly, the members of the board of directors are appointed by the state, which suggests poor corporate governance. Hence, entrenchment results when management of SOEs is free from pressure and supervision from internal governance and market discipline.

The difference in liquidity is another reason why the split share structure is problematic. First, when shares cannot be traded on the market, non-tradable shareholders cannot diversify away the firm-specific risk (Chen and Yuan, 2006). Thus, they will charge a risk premium. Further, in order to transfer non-tradable shares to other parties, non-tradable shareholders may need to pay higher transaction costs. For instance, they need to hire security companies to evaluate the value of their shares and hire legal firms for professional advice. This suggests that non-tradable shareholders will require a higher return which increases the cost of equity capital of the company. Indeed, Chen and Xiong (2001) show that the average price discount for restricted non-tradable state shares is 78% based on auctions and 86% based on private transfers.

To overcome the negative effects of split share structure, the China Securities Regulatory Commission (CSRC) announced a major institutional reform on 29 April 2005 (Circular No. 32) encouraging publicly listed firms to convert non-tradable A-shares into tradable A-shares.

2.4 Consideration for the liquidity premium

One distinguishing feature of the 2005 reform was the payment of consideration to shareholders of tradable shares. The negative effects on the capital market of the smaller scale reform held in 1999 and 2001 highlight that CSRC is aware that the success of this reform is through the setting out of basic principles and strategies that will protect the interests of public investors.

There are several theoretical views that explain why it is necessary to provide consideration to pre-reform owners of tradable shares. From a financial perspective, paying consideration is

intuitive to keep shareholders' wealth constant before and after the reform (Cha 2006; Yang and Li, 2006; Yao and Gao, 2006). Under the split share structure, tradable A-shares are priced with the expectation that non-tradable A-shares can not be traded in the open market. Hence, the former trades at a premium which represents the value of liquidity. After the reform, when non-tradable A-shares become tradable, there is an expectation that the pricing will improve this type of shares at the expense of shareholders of tradable A-shares. To avoid the inequitable transfer of wealth, shareholders of tradable A-shares must be compensated.

From a legal perspective, consideration is cost to shareholders of non-tradable A-shares in order to revise the terms of their contract with tradable shareholders (Niu and Zhou, 2006; Wang, 2005; Yang and Li, 2006). Wang (2005) argues that the contractual relationship between investors and the company can be traced back at initial public offering (IPO) where the terms/conditions of the prospectus indicate that the state and legal person shares are not to be traded. Under the split share reform, arguably there is a breach of the terms/conditions indicated in the IPO prospectus. Therefore, the party that wants to alter the contract terms (i.e. non-tradable shareholders) should give corresponding "consideration" to the other party (tradable shareholders).

An alternative view is that "consideration" is a kind of compensation (Niu and Zhou, 2006; Yao and Gao, 2006). In contrast to earlier explanations, this view focuses on the future interest allocation between tradable shareholders and non-tradable shareholders and the fairness of past interest allocation. Historically, tradable shareholders purchase the company's shares at a higher price than non-tradable shareholders. To illustrate, when SOEs list, the state-owned and LP shares are converted into shares of a listed company based on the NAV (Chen and Yuan, 2006). In order to prevent the loss of state assets, it is required by CSRC that one RMB of net asset be converted into at least a 0.65 share. This implies that state-owned shares and LP shares cost less than 1.54 RMB ($1/0.65$) per share, while tradable shares are bought and sold on the open market with a premium to the net asset value whose price is usually much higher than that of non-tradable shares. Hence, two types of shareholders purchase shares having the same voting and dividend rights, but each type uses a different pricing mechanism. The difference in price is the abnormal spillover which is induced by the restrictions on liquidity. In order to regain liquidity for these shares, non-tradable shareholders should compensate tradable shareholders for their prepaid abnormal spillover (Niu and Zhou, 2006; Yao and Gao, 2006).

2.5 Hypotheses Development

The reform process was gradual and occurred in 64 batches. Over 1,251 companies⁵ have either completed or is in the reform process on 8 March 2007 comprising over 95% of the market capitalization of the combined Shanghai and Shenzhen Stock Exchanges. The success of this reform is vital to China's acceptance as the most promising of the emerging markets. Appendix 2 provides a summary of the reform process.

The reform of split share structure was carried out in order to mitigate the agency problems and liquidity problems highlighted above, as well as carrying out the government's intention for the state to play a less important role in the management of SOEs. As a consequence, it was

⁵ Among the 1251 companies, 796 companies are listed on SSE and 455 companies are listed on SZSE.

expected that – for example – post-reform, board members would be selected according to professional expertise rather through government appointments. Corporate governance was thus expected to improve after the reform. Consistent with entrenchment theory (Demsetz, 1983; Fama & Jensen, 1983), the companies were therefore expected to be more valuable post-reform, with management being monitored by an effective board and well functioning capital markets after the reform.

Moreover, the enhancement of liquidity as a consequence of unifying the A-share class would be expected to reduce the cost of capital through enhanced liquidity and consistent valuation across all A-shares. If these potential benefits of the reform of split share structure were perceived as beneficial outcomes to the market, a positive market reaction would be expected to the release of information about the reform. However, given the government's track record (failure at earlier attempts to reform), a company's inclusion in a new reform plan could be viewed as value destroying. Thus, it is expected that investor reaction to the government announcement of the reform on 29 April 2005 will be non-zero. Hence, we hypothesise that:

H1: CAR around government announcement (29th April, 2005) is non-zero.

One feature of the 2005 reform is that it was carried out gradually to maintain the smooth functioning of the capital market and the potentially deleterious effect of a sudden and massive increase in tradeable shares. The government generally selected the listed firms allowed to undertake the reform as pilot firms but it was left to individual companies to make their own announcement of the intention to reform when the board had approved the details of the reform program. We argue that, subject to appropriate consideration being offered for liquidity, the announcement of the reform by a particular company would lead to a positive market reaction, in view of the benefits of the reform discussed above. We thus hypothesise that:

H2: CAR around the company's announcement of the reform is significantly positive.

When individual companies announce the reform plan for public consultation, they commonly indicate the type and level of consideration payable to existing shareholders of tradable A-shares. While paying consideration was a common feature of the reform, there was some variety in the type of consideration; variously, individual companies used shares, cash, warrants, or any combination of the these methods.⁶ There is no compelling evidence to suggest that a particular type of consideration is superior over the other, as tradable shareholders have different investment preference and tax position (Luo, 2006). For example, institutional investors pressured to pay bonuses are likely to prefer cash consideration. In contrast, individual investors may prefer shares because they are concerned about firm value and perhaps prefer that the company retain cash for reinvestment. Therefore, how a company provides consideration to tradable shareholders is likely to affect investors' perception of the company's reform since it signals the importance the company attaches to safeguarding the interests of tradable shareholders. We test this conjecture through the following hypothesis:

⁶ See Yao and Gao, 2006 for a detailed discussion of the merits and drawbacks of each type.

H3: CAR around announcement of the reform plan is a function of the type of consideration.

The level of consideration also varies across companies. The Reform Prospectus usually discloses both the theoretical level of consideration and the actual level of consideration. We argue that the actual consideration level is more likely to affect investors' perception of the reform rather than the theoretical one.

Some studies argue that when determining the actual consideration level, companies need to consider factors other than those considered in the reform proposal. For instance, firm performance may also affect the consideration level (Cha, 2006). Cha argues that share price is composed of two parts: company's performance and the abnormal spillover. *Ceteris paribus* companies that perform well have abnormal spillover. Therefore, shareholders of better performing firms will reduce their requirements for consideration than poorly performing firms suggesting a negative relationship between company performance and consideration level. Whether the actual consideration level is influenced by company specific factors, is an empirical question. Furthermore, actual consideration level signals the company's willingness to protect tradable shareholders. This in turn will perhaps help align the interests of tradable shareholders with non-tradable shareholders. Companies that give higher levels of consideration signal that they are more willing to protect tradable shareholders' interest, thus, the association between consideration level and tradable shareholders' reaction to the company's announcement of the reform could be positive. When consideration is offered in the form of shares, the new shares may be issued by the company or may be provided out of the holding of the non-tradable shareholders. So, when consideration is in the form of shares, the relative effects of dilutions versus outright transfers in the sample could result in a negative (or zero) impact on valuation. Accordingly, we hypothesise that:

H4: CAR around announcement of the reform plan is related to the level of consideration.

3. Research Design

3.1 Event study

We examine the effects of the reform announcements using an event study methodology (Thompson, Olsen, and Dietrich, 1988) and identify two events: 1) general announcement of the reform on 29 April 2005; and 2) company announcement of the reform. In all cases, after the company's announcement of the reform, there is a suspension period (usually 20 trading days).

We divide the reform process into two phases: Phase One covers the announcement on how the company will be reformed, in particular, the amount and type of consideration to holders of tradable A-shares. Phase 2 involves the actual payment of consideration to holders of tradable A-share, signalling the completion of the company's reform process. Our study is focused on Phase One, because we argue that most information released at this stage have been assimilated by the market. Hence, no new information about the reform process will be revealed in Phase

Two. See Appendix 2 for a detailed description of the reform process.

We utilise a three-day window to calculate cumulative abnormal returns (CAR). The abnormal return (AR_{it}) for security i at event date t is the actual daily return (R_{it}) minus expected daily return (R_{Eit}), expressed as follows:

$$AR_{it} = R_{it} - R_{Eit} \quad (1)$$

Where

$$R_{it} = (P_t - P_{t-1})/P_{t-1} \quad (2)$$

and P_t is the adjusted closing price for security i at event date t . Expected daily return (R_E) is:

$$R_{Eit} = \hat{\alpha}_i + \hat{\beta}_i R_{Mit} \quad (3)$$

where R_{Mt} is market return for event day t . The CSI 300 index is used to proxy for market returns.^{7,8} We also capture the daily cumulative market return during the company's suspension period. The coefficients $\hat{\alpha}$ and $\hat{\beta}$ are the ordinary least squares (OLS) estimates of the intercept and slope of the market model, respectively. The estimation period for the market model is 120 trading days prior to the event, (i.e. -120, -1).

The cumulative abnormal return for security i over event window from day t_1 to t_2 is calculated as follows:

$$CAR_i(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_{it} \quad (4)$$

Then one-sample t-tests are used to examine whether the CAR around the government announcement (H1) and the CAR around company's announcements of the reform (H2) are significantly different from zero.

⁷ CSI 300 has been calculated since 8th April, 2005. The government announcement of the reform of split share structure was carried out on 29th April, 2005. Hence, it is impossible to obtain CSI 300 for 120 trading days before the government announcement.

⁸ Given our sample selection method, the performance of the index will be highly correlated with the performance of the sample. This effectively biases against our results.

3.2 Regression Models

We use ordinary least-squares (OLS) regression to examine the impact of the type of consideration after the company's announcement of the reform (H3). The model (Model 1) is specified as follows:

$$\begin{aligned} \text{CAR} = & \alpha + \beta_1 \text{CONSTYPE_Dum} + \beta_2 \text{SOEs_Dum} + \beta_3 \text{P/B} + \beta_4 \text{DTA} + \beta_5 \text{LNTA} \\ & + \beta_6 \text{PESURPRISE_Dum} + \beta_7 \text{NESURPRISE_Dum} + \beta_8 \text{AUDIT_COMMITTEE} \\ & + \beta_9 \text{NONTRADE} + \beta_{10} \text{AUDITOR_Dum} + \beta_{11} \text{SPONSOR_Dum} + \beta_{12} \text{TIMING} \\ & + \beta_{13} \text{SUSPENSION} + \varepsilon \end{aligned}$$

(See Appendix 1 for definition of variables)

The variable of interest is type of consideration (CONSTYPE_Dum), a dummy variable is equal to one if the company gives shares to tradable shareholders from non-tradable shareholders as consideration. CONSTYPE_Dum is coded as zero if the company uses other payment methods as consideration, such as, warrants, cash, share buy-back or a combination of these methods.

In the model we control for various company (Chen, Kan and Anderson, 2003) and reform characteristics. For instance, SOEs_Dum is used to proxy for state ownership. The model also controls for size (LNTA), company performance (P/B) and risk (DTA).⁹ The size of the audit committee (AUDIT_COMMITTEE) captures the quality of the company's corporate governance.¹⁰ Since the reform affects the share structure of the company significantly, it is also necessary to control for the percentage of non-tradable shares (NONTRADE) prior to the reform. The share performance may also be affected by the signal provided by companies hiring reputable auditors or sponsors. In this regard, AUDIT_Dum captures whether the company hires the big 4 or the local top 5 auditors and SPONSOR_Dum indicates whether the company hires the top 10 sponsors (underwriters). Furthermore, some companies release their annual report during the event period. Thus, earnings announcement may confound share price performance during this period. To control for any earnings surprise, we track whether the company was subjected to a positive earnings surprise (PESURPRISE_Dum), a negative earnings surprise (NESURPRISE_Dum) or no earnings surprise during the event period. Earnings surprise is obtained by current year's net profit minus last year's net profit. We exclude no earnings surprises to avoid multicollinearity problems. Finally, we also control for the timing of the reform (TIMING) and the number of days that share trading were suspended (SUSPENSION).

⁹ We also utilize return on assets (ROA) and price to earnings (P/E) ratios for company performance but the result do not differ significantly from what we report in this paper.

¹⁰ Ideally, the percentage of independent directors is a better proxy for a company's corporate governance. However, as shown in the following descriptive statistics (Table 3), the variation of this measure is very small. As an alternative, the size of an AUDIT_COMMITTEE is used.

Model 2 captures how alternative types of consideration affect investor's perception of the reform. This is different from Model 1 in that we include only those companies that utilize payment methods other than share only methods. Model 2 is specified as follows:

$$\begin{aligned} \text{CAR} = & \alpha + \beta_1 \text{SHARE2_Dum} + \beta_2 \text{CASHWARR_Dum} + \beta_3 \text{COMBINATION_Dum} \\ & + \beta_4 \text{SOEs_Dum} + \beta_5 \text{P/B} + \beta_6 \text{DTA} + \beta_7 \text{LNTA} + \beta_8 \text{PESURPRISE_Dum} \\ & + \beta_9 \text{NESURPRISE_Dum} + \beta_{10} \text{AUDIT_COMMITTEE} + \beta_{11} \text{NONTRADE} \\ & + \beta_{12} \text{AUDITOR_Dum} + \beta_{13} \text{SPONSOR_Dum} + \beta_{14} \text{TIMING} + \beta_{15} \text{SUSPENSION} + \varepsilon \end{aligned}$$

(See Appendix 1 for definition of variables)

H4 predicts that the impact of the reform is likely to be affected by consideration level as well. The hypothesis is tested by running Model 3 where the variable of interest is CONSLEVEL_Shares using the most conventional measure¹¹ of consideration level (Su, 2006). CONSLEVEL_Shares equal the number of shares given per 10 tradable shares.¹² We specify Model 3 as follows:

$$\begin{aligned} \text{CAR} = & \alpha + \beta_1 \text{CONSLEVEL_Shares} + \beta_2 \text{SOEs_Dum} + \beta_3 \text{P/B} + \beta_4 \text{DTA} + \beta_5 \text{LNTA} + \\ & \beta_6 \text{PESURPRISE_Dum} + \beta_7 \text{NESURPRISE_Dum} + \beta_8 \text{AUDIT_COMMITTEE} + \beta_9 \text{NONTRAD} \\ & \text{E} + \beta_{10} \text{AUDITOR_Dum} + \beta_{11} \text{SPONSOR_Dum} + \beta_{12} \text{TIMING} + \beta_{13} \text{SUSPENSION} + \varepsilon \end{aligned}$$

(See Appendix 1 for definition of variables)

3.3 Sample data

The initial sample is taken from the largest 300 companies listed on the combined SSE and SZSE which are included in the China Securities Index 300 (CSI 300). Event dates and characteristics of the split-share structure reform are hand collected from the Reform Prospectus posted by the companies on the stock exchange websites. Financial data of the sample companies are obtained from the China Center for Economic Research (CCER), while the share price data are sourced from Datastream.

We exclude the first four pilot companies and another three companies with missing data to arrive at 293 companies available to test of H1. To examine H2, the company must have completed the reform process, hence, companies whose reform program is not complete before 31 December 2006 (48 companies) are deleted from the sample. We also exclude firms when the reform plan was rejected, when they have a special reform plan and those with special trading suspension rules. Another 17 pilot companies were eliminated from the sample because their reforms have different characteristics from the rest. Finally, after removing the companies with missing data, 208 companies remain in the sample to test H2 and H3. However, H4, we only test for firms whose consideration payment was in shares to existing holders of tradable A-share by holders of non-tradable A-shares, leaving a sub-sample of 136 companies.

¹¹ The measure is widely used in Chinese literature of the reform and the company's Prospectus of the Reform.

¹² We also used alternative measures of consideration such as RMB amounts and adjusted consideration level but the results are not significantly different from what is shown.

3.1 Sample distribution

Panel A of Table 1 reports our sample descriptives. Industry distribution is no different between SSE and SZSE where concentration is on firms in the production and materials sector representing 26% and 21% of the total sample, respectively. Majority of the companies (86%) in our sample are controlled by the state at the time of the reform. Top 10 security companies have acted as advisers to 64% of our sample firms.¹³ However, the reform process does not appear to value the certification of Big 4 or local Top 5 accounting firms, where only 31% were involved in the reform process. Only 18% of our sample companies have B-shares or H-shares on issue.

Most companies choose to give shares as consideration, among which, 65% give shares from non-tradable shareholders directly, while 11% of companies give shares from capital reserves or retained profits (Table 2 Panel F). Giving cash and warrants are rarely used with only eight companies using these types of consideration. Moreover, 42 firms utilise combination methods. Panel G indicates that most companies in the sample (92%) revised their reform plan after the initial announcement.

Some of the companies set escrow period and escrow price in the Reform Prospectus. Escrow period is a lock-up period where holders of the newly converted tradable A-shares cannot be sold until after the expiry of lock-up period. Escrow price is the pre-determined share price below which non-tradable shareholders cannot sell their shares after the reform. By setting these restrictions on the selling of non-tradable shares, companies try to avoid an instant increase of supply of shares on the market which may depress the share price. Panel H shows that 70% of the companies set an escrow period.

[Table 1]

3.2 Descriptive statistics

We use a sample of 208 companies in our main tests and report the sample descriptives in Table 2.¹⁴ Our sample firms are generally large firms with mean total assets of 1.41 billion RMB (median 470 million RMB). We use natural logarithm of total asset in our analysis as our sample appeared to be skewed in this aspect. The sample companies have a mean and median debt-to-asset ratio (DTA) of 46%. The company's performance is captured using three variables: ROA, P/E ratio and P/B ratio. The sample companies have a mean ROA of 5%, a mean P/E ratio of 44.62, and a mean P/B ratio around 2. The sample companies have 57% non-tradable shares. 45% shares are controlled by the largest shareholder. The board is usually made up of 10 directors, among which about 32% are independent directors. This reflects CSRC's requirement that listed companies have to hire more than one third independent directors on the board. Listed companies are required to establish an audit committee to monitor the board. In the sample, the mean (median) size of the audit committee is 4.5 (5).

¹³ We created a league table to determine the top ten sponsors using our sample of 208 companies.

¹⁴ We also obtained the descriptive statistics separately for SSE and SZSE and find no significant difference between the two stock exchanges except for total assets.

In addition to financial and corporate governance characteristics, Table 2 also describes the characteristics of the reform in general. Companies took 23 to 64 weeks from the general announcement date (refer to as TIMING variable) to commence the reform process. It takes an average of 21 days to work out a final reform plan (SUSPENSION) and about 9 weeks to complete the reform (DURATION).

Companies give 2.9 shares (2.26 shares after adjustment) on average for every 10 tradable A-shares owned (refer to CONSLEVEL_Shares). This consideration amounts to 17.5 RMB for every ten shares held by holders of tradable A-shares (refer to CONSLEVEL_RMB). The satisfaction about the reform plan is shown in the approval ratio (87%) of holders of tradable A-shares (87%).

[Table 2]

4. Results

4.1 Market reaction to government announcement

We find that the three-day CAR is significant and negative (mean of -0.0095 and median -0.0064) for the whole sample and the sub-sample of SSE and SZSE (See Table 3). This non-zero is consistent with our prediction in H1. The negative response in market reaction suggests the dominant effects of investors putting more weight on the drawbacks of the reform and the negative results of the 1999 and 2001 reforms. During the government announcement, investors were unaware that this reform would include some consideration to existing shareholders of tradable A-shares. Accordingly, their response was dominated by the probability that this newest round of reform was also likely to fail.

[Table 3]

4.2 Market reaction to company announcement

H2 investigates whether investors react differently to the launch of the reform by individual companies and predicts a positive CAR around a company's announcement of their intention to reform. We find and report in Table 4 (Panel A) that CAR around the company's announcement is not significant suggesting a change in investor sentiment when they were made aware of the compensation component but the reaction is not enough to induce significant positive effects.

[Table 4]

In summary, the results reported in Table 3 and Table 4 suggests that at the time of reform was launched, investors appear reluctant to the government's attempt to reform the split share structure in China, but as more information about the reform process becomes known to the market, specifically the type and level of consideration, investors appear to react positively to the reform.

4.3 Determinants of the type of consideration

As mentioned in the previous section, one distinguishing feature of the 2005 reform is the payment of consideration holders of tradable A-shares presumably to compensate for the short-run loss expected to occur after the reform and this feature was vital for investors to favour the reform. How the type of consideration affects investor's reaction is an empirical question that we address and test in H3.

We report in Panel A, Table 5 that the most common method of consideration is for companies to give shares directly from non-tradable shareholders (65%) while the remainder of the sample utilized other methods such as, shares from capital reserves or retained profits, warrants, cash or a combination of these methods. We also show evidence that companies that use other methods of consideration earn higher abnormal returns with three day CAR at 0.0414 compared with companies giving shares whose three-day CAR is 0.0161.

To investigate whether there are significant differences in company characteristics that influence the type of consideration, we partition the sample into two groups namely: a) companies that give shares from non-tradable shareholders; and b) companies that use other methods.¹⁵ In Panel B, we report that the higher the proportion of non-tradable shares to issued capital (NONTRADE) and the higher percentage of shares held by the controlling shareholder (SHARESCONTROL) the more likely these firms will provide shares to tradable shareholders. However, companies announcing the reform at a later date (TIMING) are more likely to use other consideration methods. We argue that companies attempt to reduce dilution effects when ownership is more concentrated. However, as the reform matures and becomes more acceptable to the securities market, companies are able to utilize other methods of consideration that is more suitable to the company's financial condition and the needs of its shareholders.

We test H3 using the OLS regression (Model 1) and we find and report in Panel C that the coefficient of CONSTYPE_Dum is significantly negative (-0.0270) and our model explains 12% of the movements in CAR. Consistent with the results in Panel A, companies that use other methods of consideration have slightly higher CAR than those giving shares from non-tradable shareholders even after controlling for company specific characteristics. This results show evidence that investors prefer companies to give warrants, cash or shares from capital reserves/retained profits or any combination of these methods.

To determine whether there is a specific type of consideration from the other methods that influence our results, we also investigate the effects of other types of consideration payment by including dummy variables for other types of consideration as shown in Model 2. The coefficients for two out of the three variables of interest as reported in Panel D are positive and significant but the overall explanatory power is similar. This reinforces our findings that investors prefer companies offering consideration by giving shares from capital reserves and

¹⁵ We combine other methods of consideration used other than payment of shares from tradable shareholders in our analysis in Panel A to Panel C, because there were only a small number of firms that utilized the other consideration methods making it difficult to make some meaningful comparison. However, in our regression in Panel D we coded each type separately.

retained profits, cash and warrants or using a combination of these methods. We argue that the consideration type provides a positive signal that these companies are financially sound to be able to issue new shares to existing shareholders. We also suggest that investors believe that companies giving consideration by cash or by warrants are better performing, hence investors react positively to such consideration types.

For both Model 1 and Model 2 the coefficient for control variables, LNTA, DTA and SOEs_Dum is significant and in the expected direction. This suggests that it is necessary to control for company's size, risk and ownership. The coefficient for length of the reform, SUSPENSION, is also significantly positive, which indicates that companies that take a longer period to reform generate a higher CAR. These results indicate that the market has more time to assimilate the information provided to implement the reform plan.

[Table 5]

4.4 Market effects of the consideration level

In addition to the type of consideration, the amount of consideration (hereafter referred to as consideration level) is another aspect of the reform that could potentially affect investors' perception of the reform.

To better understand the determinants of consideration level, we regress consideration level on company institutional, financial and corporate governance characteristics. Panel A of Table 6 shows what attributes of the company influence consideration level. Consistent with Su (2006), the coefficient for SOEs_Dum is significantly positive which suggests that SOEs are likely to give a higher level of consideration. In addition, companies that issue B-shares and smaller companies tend to give more consideration. The coefficient of ROA is significantly negative, which is consistent with the prediction of Cha (2006) that investors will reduce their requirement of consideration for companies with good performance. The regression also reveals a positive relationship between percentage of non-tradable shares and consideration level which is similar to Luo (2006). We attribute these results to dilution effects after reform. Finally, the timing of the reform affects consideration level as well. The significant negative coefficient for TIMING suggests that companies that undertake the reform early tend to give more consideration. Overall, the model for the determinants of consideration level is well specified with an adjusted R^2 32%.

However, when we regress CAR on level of consideration (as shown in Model 3) we do not find support for H4 as shown in Panel B of Table 6. Most control variables except for LNTA and AUDIT_COMMITTEE are not significant in the regression. Perhaps this is not surprising considering that the variation of consideration level is trivial (Std. Dev = 0.65, reported in Table 2). Alternatively, we utilized two other measures to capture consideration level, namely in RMB amounts and the use an adjustment factor but the results do not materially alter our earlier findings. The failure to find significant coefficient of consideration level probably suggests that investors thought that the overall level of consideration is fair and reasonable based on companies' different conditions or if the level of consideration proposed is perceived to be less, chances are the reform will be rejected by tradable shareholders. As discussed in

Appendix 2 it is necessary to obtain two thirds approval of pre-reform tradable shareholders.

[Table 6]

5. Conclusion

The objective of this study is to better understand the characteristics of one of China's major reforms since the turn of the century. The reform is expected by the government to bring substantial benefits to the development of the capital market, e.g. improved liquidity of in the A-share market, a uniform valuation basis of the company's shares, to mitigate the divergence of interest between different classes of shareholders and to improve the company's corporate governance structure. We investigate investor's perceptions of the reform by observing the share returns around milestone announcements of the reform. The study is also a comprehensive survey of the factors that may affect investors' reaction to the reform.

Our results show that investors held a negative view of the 2005 reform at government announcement, probably due to the fear of a dilution effect based on past experience during earlier attempts to reform the split share structure in China, in 1999 and another in 2001. After more information about the reform became known to the market and as the reform continues, investors changed their initial view and reacted positively to the individual company's announcements. To examine the factors that may change an investor's view of the reform, two features of the 2005 reform are identified - the type and level of consideration. The OLS regression results suggest that the type of consideration will significantly affect investor's reaction to the reform. Investors prefer payment of shares from capital reserves or retained profits or cash or warrants or any combination of these methods. As for the level of consideration, the regressions fail to find an obvious impact on CAR. The possible explanation is that investors think that the consideration level is fair and reasonable according to company's financial and operating conditions at the time of the reform.

We contribute to the literature by providing empirical evidence on the effect of the reform of split share structure. The study also makes a contribution by linking the consideration plan to the company's share price performance around the reform. These findings can help policy makers in China and market participants better understand the Chinese capital market.

Inevitably, the paper has its limitations. For instance, our study is confined to the short-term effects of the reform. Early studies do find that SOEs that were partially privatised generally experience deterioration in their profitability and efficiency after going public. For instance, Chen, Firth and Rui (2003) attribute this failure to the substantial holdings of the state and poor corporate governance. Whether there is a turnaround for these companies after the reform is an area for future research. We confine our analysis to share returns but it would be worthwhile to examine trading volume performance and stock return volatility post-reform. Another limitation of our paper is the effects of the reform to shareholders of B-shares and H-shares which is an area for future research.

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Table 1 Sample Distribution

Panel A: Industry classification

Industry	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
Energy	5	4%	3	3%	8	4%
Material	21	18%	23	26%	44	21%
Industry/ Production	32	27%	23	26%	55	26%
Primary Consuming	7	6%	5	6%	12	6%
Optional Consuming	19	16%	13	14%	32	15%
Health Care	5	4%	1	1%	6	3%
Finance	9	8%	6	7%	15	7%
Information Technology	10	8%	10	11%	20	10%
Telecom	1	1%	0	0%	1	0%
Utility	9	8%	6	7%	15	7%
Total	118	100%	90	100%	208	100%

Panel B: Controller^a

Type of Controller	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
SOEs	101	86%	78	87%	179	86%
Private	13	11%	8	9%	21	10%
Foreign	0	0%	4	4%	4	2%
Not-for Profit	1	1%	0	0%	1	0%
Labor Union	3	3%	0	0%	3	1%
Total	118	100%	90	100%	208	100%

Panel C: Sponsor^b

Type of Sponsor	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
Top 10	64	54%	70	78%	134	64%
Others	54	46%	20	22%	74	36%
Total	118	100%	90	100%	208	100%

^a Controllers are the type of owners holding the largest shares of the company.

^b Sponsors are eligible security companies approved by CSRC to advice companies on the reform program. The ranking of security companies are based on their trading volume in RMB in 2005.

Panel D: Type of Auditor

Type of Auditor	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
Big 4 or Local Top 5	37	31%	27	30%	64	31%
Non-big 4 or Small local firms	81	69%	63	70%	144	69%
Total	118	100%	90	100%	208	100%

Panel E: Share Capital Structure

Type of Shares	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
A-share only	100	85%	71	79%	171	82%
A- and B-shares	8	7%	16	18%	24	12%
A- and H-shares	10	8%	3	3%	13	6%
Total	118	100%	90	100%	208	100%

Panel F: Type of Consideration^c

Type of Consideration	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
Shares	82	69%	54	60%	136	65%
Shares from capital reserves and retained profits	10	8%	12	13%	22	11%
Cash	3	3%	2	2%	5	2%
Warrants	1	1%	2	2%	3	1%
Combination	22	19%	20	22%	42	20%
Total	118	100%	90	100%	208	100%

^c Shares refer to the payment of consideration by holders of non-tradable A-share holders of tradable A-shares in proportion to the number of shares held by latter. Warrants include call warrants or put warrants as consideration in either American style or European style. If both call warrants and put warrants are given as consideration, it will be coded as a combination method. Combination refers to the use of two or more above types of consideration.

Panel G: Revision of the Reform Plan

Type of Consideration	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
Revise	106	90%	85	94%	191	92%
Not revise	12	10%	5	6%	17	8%
Total	118	100%	90	100%	208	100%

Panel H: Escrow Period and Escrow Price^d

Type of Consideration	SSE		SZSE		Total	
	No. of companies	Percentage (%)	No. of companies	Percentage (%)	No. of companies	Percentage (%)
Escrow Period	84	71%	61	68%	145	70%
Escrow Price	22	19%	20	22%	42	20%
Both Escrow Period & Price	18	15%	17	19%	35	17%
Neither Escrow Period or Price	30	25%	26	29%	56	27%
	118		90		208	

^d Panel H shows how many companies set escrow price and escrow period in their Prospectus for the reform.

Table 2
Descriptive Statistics
(n=208)

Variable ^a	Mean	Median	Standard Deviation	Min	Max	Skewness
LNTA	1.41E+10	4.65E+09	5.80E+10	1.02E+09	6.03E+11	8.32
DTA	46%	46%	0.18	3%	97%	0.01
ROA	5%	4%	0.05	-21%	21%	-0.43
P/E ratio	45.74	21.33	146.02	0	1960	11.30
P/B ratio	2.10	1.71	1.75	0.65	19.20	5.48
NONTRADE	57%	60%	0.14	15%	85%	-0.63
SHARE_CONTROL	45%	48%	0.17	7%	85%	-0.20
INDIR	32%	33%	0.05	0%	53%	-0.92
BOARDSIZE	10.99	10	2.67	4	20	0.66
AUDIT_COMMITTEE	4.50	5	1.78	1	13	1.35
CONSLEVEL_Shares (n=136)	2.95	3	0.65	0.7	5	-1.13
CONSLEVEL_RMB (n=136)	17.50	15.23	1.06	2.42	71.05	2.26
CONSLEVEL_Adjusted (n=136)	2.26	2.31	0.42	0.65	3.33	-1.66
APPROVE_FLOAT	89%	91%	0.08	67%	100%	-0.78
TIMING	40.12	41	10.01	23	64	0.23
SUSPENSION	20.78	17	10.73	9	66	1.68
DURATION	8.64	8	2.99	4	26	1.99

^a See Appendix 1 for definition of variables used.

Table 3
Three-day CAR around general announcement
of the Reform on 29 April 2005^a

	No. of observations	Mean	Median	Std. Deviation	T-statistic	Sig. (2-tailed)
Full sample	293	-0.0095	-0.0064	0.0559	-2.8934^{***}	0.004
SSE	172	-0.0091	-0.0067	0.0607	-2.2535^{**}	0.026
SZSE	121	-0.0099	-0.0064	0.0485	-1.9675[*]	0.051
Levene's Test for Equality of Variances				0.2032 (Sig. 0.6525)		
T-test for Equality of Means(Equal variances not assumed)				-0.1296 (Sig. 0.8969)		

^a CAR is calculated using the formula: $CAR_i(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_{it}$, where $AR_{it} = R_{it} - R_{Eit}$.

R_{it} is the actual daily returns for security i at event date t , equals $R_{it} = (P_t - P_{t-1})/P_{t-1}$. R_{Eit} is the expected daily returns for security i at event date t , calculated using the market model: $R_{Eit} = \alpha + \beta R_{Mt}$, where R_{Mt} is market return for event day t . The estimation period is 120 days before and after the event. SSE Composite Index is used to calculate market returns for listed SSE firms while SZSE Composite Index is used to calculate market returns for listed SZSE firm.

***, **, * significant at the 0.01 level, 0.05 level, 0.1 level, respectively (2-tailed).

Table 4
Three-day Cumulative Abnormal Returns^a around
Company's Announcement of the Reform

Panel A: Main Sample						
	No. of observations	Mean	Median	Std. Deviation	T-statistic	Sig. (2-tailed)
Full sample	208	-0.0059	-0.0027	0.0585	-1.4564	0.1468
SSE	118	-0.0064	-0.0005	0.0589	-1.1795	0.2406
SZSE	90	-0.0053	-0.0031	0.0583	-0.8574	0.3935
Levene's Test for Equality of Variances				0.0688 (Sig. 0.7934)		
T-test for Equality of Means(Equal variances not assumed)				0.1372 (Sig. 0.8910)		

^a CAR is calculated using the formula: $CAR_i(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_{it}$, where $AR_{it} = R_{it} - R_{Eit}$.

R_{it} is the actual daily returns for security i at event date t , equals $R_{it} = (P_t - P_{t-1}) / P_{t-1}$. R_{Eit} is the expected daily returns for security i at event date t , calculated using the market model: $R_{Eit} = \alpha + \beta R_{Mt}$, where R_{Mt} is market return for event day t . Daily cumulative market return during the company's suspension period is captured in R_{Mt} . The estimation period is 120 days before and after the event. SSE Composite Index is used to calculate market returns for listed SSE firms while SZSE Composite Index is used to calculate market returns for listed SZSE firm. ***, **, * significant at the 0.01 level, 0.05 level, 0.1 level, respectively (2-tailed).

Table 5
The Impact of Types of Consideration on Three-day CAR

Panel A: CAR by type of consideration

Type of Consideration	No. of Observation	Mean of CAR
Giving Shares only	136	-0.0106
Other Methods ^a	72	0.0032
T-test for Equality of Means (Equal variances not assumed)		1.6122

Panel B: Difference in Sample Characteristics by Type of Consideration^b

Characteristics	Type of Consideration	Mean	T-test for Equality of Means (Equal variances not assumed)
SOEs_Dum	Shares only	0.8905	1.6069
	Other Methods	0.8028	
BSHARE_Dum	Shares only	0.1095	-0.3603
	Other Methods	0.1268	
HSHARE_Dum	Shares only	0.0657	0.2689
	Other Methods	0.0563	
LNTA	Shares only	22.3554	-0.8785
	Other Methods	22.4744	
ESURPRISE	Shares only	4,617,673	1.2169
	Other Methods	-7,233,431	
ROA	Shares only	0.0511	-0.3855
	Other Methods	0.0539	
P/E	Shares only	35.3351	-0.9445
	Other Methods	62.5448	
P/B	Shares only	2.0388	-0.6616
	Other Methods	2.2079	
DTA	Shares only	0.4708	0.6600
	Other Methods	0.4532	
BOARDSIZE	Shares only	11.0876	0.7360
	Other Methods	10.7887	
INDIR	Shares only	0.3233	0.1455
	Other Methods	0.3223	
AUDIT_COMMITTEE	Shares only	4.5109	0.1802
	Other Methods	4.4648	
AUDITOR_Dum	Shares only	0.3066	0.1602
	Other Methods	0.2958	
NONTRADE	Shares only	0.5995	3.4704***
	Other Methods	0.5237	

^a Other methods include giving shares from company's capital reserve or retained profit only, giving cash only, giving warrants only, purchasing share back only, and combination methods.

^b See Appendix 1 for definition of variables.

SHARES_CONTROL	Shares only	0.4803	2.8929***
	Other Methods	0.4055	
TIMING	Shares only	38.9197	-2.3658**
	Other Methods	42.4366	
DURATION	Shares only	8.5766	-0.4127
	Other Methods	8.7605	
SPONSOR_Dum	Shares only	0.6350	-0.3848
	Other Methods	0.6620	

Panel C: Regression - Type of Consideration^c

Variable	Coefficient	T-statistics	Sig.
(Constant)	0.2396	2.266***	0.0246
CONSTYPE_Dum	-0.0286	-3.2646***	0.0013
SOE_Dum	0.0263	2.1395**	0.0336
LNTA	-0.0089	-1.774	0.0777
PESURPRISE_Dum	0.0246	1.2512	0.2124
NESURPRISE_Dum	-0.0115	-0.6532	0.5144
P/B	-0.0008	-0.3275	0.7436
DTA	0.061	2.4002**	0.0173
AUDIT_COMMITTEE	-0.0004	-0.1827	0.8552
AUDITOR_Dum	0.002	0.226	0.8214
NONTRADE	0.0016	0.0511	0.9593
TIMING	-0.0013	-3.2688***	0.0013
SUSPENSION	-0.0012	-2.9673***	0.0034
SPONSOR_Dum	0.0017	0.2031	0.8393
Adjusted R ²	11.60%		
No of observations	208		
F statistic	3.0897***		

^c Model used in this table follows: $CAR3 = \alpha + \beta_1 CONSTYPE_DUM + \beta_2 SOEs_Dum + \beta_3 P/B + \beta_4 DTA + \beta_5 LNTA + \beta_6 PESURPRISE_Dum + \beta_7 NESURPRISE_Dum + \beta_8 AUDIT_COMMITTEE + \beta_9 NONTRADE + \beta_{10} AUDITOR_Dum + \beta_{11} SPONSOR_Dum + \beta_{12} TIMING + \beta_{13} SUSPENSION + \varepsilon$

Panel D: Regression - Other methods of consideration^d

Variable	Coefficient	T-statistics	Sig.
(Constant)	0.2283	2.1399**	0.0336
SHARE2_Dum	0.0226	1.6097	0.1091
CASHWARR_Dum	0.0495	2.4448**	0.0154
COMBINATION_Dum	0.0279	2.6714***	0.0082
SOE_Dum	0.0260	2.1034**	0.0367
LNTA	-0.0099	-1.9408*	0.0537
PESURPRISE_Dum	0.0253	1.2837	0.2008
NESURPRISE_Dum	-0.0110	-0.6158	0.5388
P/B	-0.0008	-0.3529	0.7246
DTA	0.0638	2.4898**	0.0136
AUDIT_COMMITTEE	-0.0003	-0.1194	0.9051
AUDITOR_Dum	0.0008	0.0929	0.9260
NONTRADE	0.0063	0.1999	0.8418
TIMING	-0.0013	-3.1481***	0.0019
SUSPENSION	-0.0012	-2.9838***	0.0032
SPONSOR_Dum	0.0022	0.2664	0.7902
Adjusted R ²	11.35%		
No of observations	208		
F statistic	2.7662		

^d CAR = $\alpha + \beta_1$ SHARE2_Dum + β_2 CASHWARR_Dum + β_3 COMBINATION_Dum + β_4 SOEs_Dum + β_5 P/B + β_6 DTA + β_7 LNTA + β_8 PESURPRISE_Dum + β_9 NESURPRISE_Dum + β_{10} AUDIT_COMMITTEE + β_{11} NONTRADE + β_{12} AUDITOR_Dum + β_{13} SPONSOR_Dum + β_{14} TIMING + β_{15} SUSPENSION + ε

Table 6
The Impact of Consideration Level on Three-day CAR^{a,b}

Panel A: Determinants of Consideration Level^c			
Variable	Coefficient	T-statistics	Sig.
(Constant)	5.2646	3.5361***	0.0006
HOUSEHOLD_Dum	-0.2373	-1.8316*	0.0696
FINANCIAL_Dum	0.0468	0.2181	0.8277
INDUSTRIAL_Dum	0.0029	0.0206	0.9836
SOE_Dum	0.7341	4.0860***	0.0001
BSHARE_Dum	0.5275	2.6463***	0.0093
HSHARE_Dum	0.3788	1.5633	0.1208
LNTA	-0.1954	-2.5609**	0.0118
PESURPRISE_Dum	-0.3845	-1.4547	0.1485
NESURPRISE_Dum	-0.1218	-0.4254	0.6714
ROA	-3.0757	-3.1130***	0.0023
P/E	-0.0005	-0.5598	0.5767
P/B	0.0156	0.4763	0.6348
DTA	0.2375	0.6771	0.4997
BOARDSIZE	0.0016	0.0705	0.9439
INDIR	0.2426	0.2256	0.8219
AUDIT_COMMITTEE	-0.0085	-0.2889	0.7732
AUDITOR_Dum	-0.0943	-0.8678	0.3873
NONTRADE	2.7130	4.6152***	0.0000
SHARES_CONTROL	-0.0154	-0.0360	0.9714
TIMING	-0.0098	-1.8148*	0.0722
DURATION	0.0246	1.3563	0.1777
SPONSOR_Dum	-0.0620	-0.6037	0.5472
Adjusted R ²	32.22%	No.	136
No of observations	136		
F statistic	3.9168***		

^a See Appendix 1 for definition of variables used.

^b ***, **, * significant at 0.01, 0.05, 0.10, respectively (2-tailed).

^c Dependent variable is consideration level measured by shares received per 10 tradable shares.

Panel B: Regression - Consideration level in number of shares^d

Variable	Coefficient	T-statistics	Sig.
(Constant)	0.0810	0.8729	0.3844
CONSLEVEL_SHARES	0.0034	0.5389	0.5909
SOE_Dum	-0.0036	-0.2777	0.7817
LNTA	-0.0052	-1.1700	0.2443
PESURPRISE_Dum	-0.0125	-0.6449	0.5202
NESURPRISE_Dum	-0.0004	-0.0165	0.9869
P/B	0.0062	2.8318***	0.0054
DTA	0.0020	0.0915	0.9272
AUDIT_COMMITTEE	0.0007	0.3597	0.7197
AUDITOR_Dum	0.0096	1.2371	0.2184
NONTRADE	-0.0598	-1.9008*	0.0597
TIMING	0.0006	1.4934	0.1379
SUSPENSION	0.0001	0.2894	0.7727
SPONSOR_Dum	0.0104	1.4356	0.1537
Adjusted R ²	3.88%		
NO of observations	136		
F statistic	1.4191		

^d Model used in this table follows: $CAR3 = \alpha + \beta_1 \text{CONSLEVEL_Shares} + \beta_2 \text{SOEs_Dum} + \beta_3 \text{P/B} + \beta_4 \text{DTA} + \beta_5 \text{LNTA} + \beta_6 \text{PESURPRISE_Dum} + \beta_7 \text{NESURPRISE_Dum} + \beta_8 \text{AUDIT_COMMITTEE} + \beta_9 \text{NONTRADE} + \beta_{10} \text{AUDITOR_Dum} + \beta_{11} \text{SPONSOR_Dum} + \beta_{12} \text{TIMING} + \beta_{13} \text{SUSPENSION} + \varepsilon$

Appendix 1: Definition of Variables

APPROVE_FLOAT = floating approval ratio; calculated as approving votes of tradable shareholders divided by total votes owned by tradable shareholders;

AUDIT_COMMITTEE = size of audit committee; calculated as the number of members in audit committee before the reform starts;

AUDITOR_Dum = the type of auditor hired by the company; coded as 1 for big 4 and local top 5 audit firms, otherwise zero;

BOARDSIZE = board size; calculated as the number of directors before the reform starts;

BSHARE_Dum = companies that issue B-share; coded as 1 if the company issues B-share, otherwise zero;

CAR3 = cumulative abnormal returns; calculated using market model, 120 days estimation period and three-day event window;

CASHWARR_Dum = giving cash only or giving warrants only as consideration; coded as 1 if the company gives either cash or warrants; otherwise zero (include giving both cash and warrants);

COMBINATION_Dum = using combination methods as consideration, coded as 1 if it is, otherwise zero; The combination methods are defined as using two or more types of consideration, i.e. giving shares from non-tradable shareholders, giving shares from company's capital reserve or retained profit, giving cash, giving warrants, and purchase back shares;

CONSTYPE_Dum = type of consideration; coded 1 for giving shares directly only, otherwise zero which include giving shares from capital reserve and retained profit, giving cash, giving warrants, purchase back shares and combination method;

CONSLEVEL_Shares = actual consideration level for giving shares from non-tradable shareholders only; calculated as the number of shares given for every 10 tradable shares;

CONSLEVEL_RMB = actual consideration level measured in RMB for giving shares from non-tradable shareholders only; calculated as $CONSLEVEL_Shares * Share\ Price\ before\ suspension$;

CONSLEVEL_Adjusted = adjusted actual consideration level for giving shares from non-tradable shareholders only; calculated as $CONSLEVEL_Shares * adjustment\ factor$. Adjustment factor = $P'/P = [(10 * P' + CONSLEVEL_shares * 0) / (10 + CONSLEVEL_shares)] / P = 10 / (10 + CONSLEVEL_shares)$;

DTA = total debt/total asset; using the data disclosed in the audited annual report before the reform starts;

DURATION = how long the reform takes; calculated as weeks from the company's announcement of the reform intention to the implementation of the reform;

ESCROWPERIOD_Dum = addition escrow restrictions about selling period; coded as 1 if the company set additional escrow restrictions about selling period for non-tradable shares other than the statutory requirements, otherwise zero;

ESCROWPRICE_Dum = escrow restrictions about selling price; coded as 1 if the company promise not to sell the non-tradable shares below a certain price within a certain period of time, otherwise zero;

FINANCIAL_Dum = whether the company is in financial sector; coded as 1 if it is, otherwise zero;

HOUSEHOLD_Dum = whether the company is in household sector; coded as 1 if it is, otherwise zero;

HSHARE_Dum = companies that issue H-share; coded as 1 if the company issues H-share, otherwise zero;

INDIR = percentage of independent directors on the board; calculated as the number of independent directors divided by the number of directors before the reform starts;

INDUSTRIAL_Dum = whether the company is in industrial sector; coded as 1 if it is, otherwise zero;

LNTA = natural logarithm of total asset; using the data disclosed in the latest audited annual report before the reform starts;

MANUFACTURE_Dum = whether the company is in manufacturing sector; coded as 1 if it is, otherwise zero;

NESURPRISE_Dum = negative earnings surprise; coded as 1 if companies have negative earnings surprise (net profit of 2006 is smaller than that of 2005); zero otherwise;

NONTRADE = percentage of non-tradable shares; calculated as number of non-tradable shares divided by total shares (include B-share and H-share) before the reform starts;

P/B = price per share/net asset per share; using the latest price and net asset disclosed in the latest audited annual report before the reform starts;

P/E = price per share/EPS; using the latest price and earning disclosed in the latest audited annual report before the reform starts;

PESURPRISE_Dum = positive earnings surprise; coded as 1 if companies have positive earnings surprise (net profit of 2006 is larger than that of 2005); zero otherwise;

REVISION_Dum = whether the company revise their reform plan; coded as 1 if the company revised the reform plan, otherwise zero;

ROA = net profit after tax/total asset; using the data disclosed in the latest audited annual report before the reform starts;

SHARES_CONTROL = percentage of shares owned by controlling shareholder; calculated as the number of shares owned by controlling shareholder divided by total shares (include B-share and H-share) before the reform starts;

SHARE2_Dum = shares given from company's capital reserve or retained profit, coded as 1 if it is, otherwise zero;

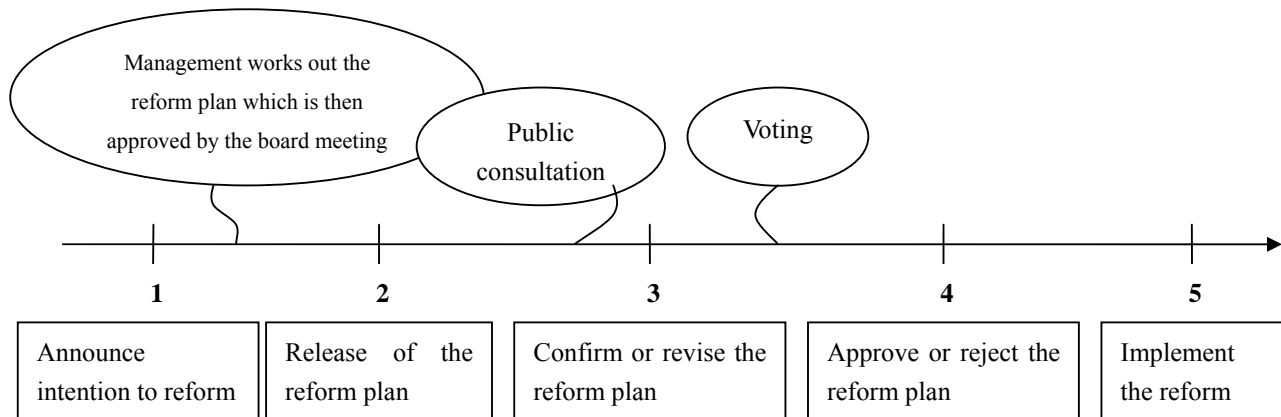
SOEs_Dum = whether the company is state-owned enterprises; coded as 1 if it is, otherwise zero;

SPONSOR_Dum = type of sponsor (underwriter); coded as 1 if the company hire Top 10 sponsors, otherwise zero;

SUSPENSION = how long announcement of the reform plan takes; calculated as days from the announcement of the reform intention (event 1) to the announcement of final reform plan (event 3);

TIMING = when the reform begins for individual company's; calculated as weeks from government announcement to company's announcement.

Appendix 2: Summary of important event dates during the Split Share Reform Process



The typical reform process of a company begins with its announcement of the intention to reform (Event 1). This is the first official announcement for public investors to be informed that the company will undergo the reform. Trading of the shares will be suspended from the date of announcement.

Then the board of the company shall engage a sponsor (or underwriter) to assist in formulating a reform plan (CSRC, 2005). After the board approval of the reform plan, the company must publish the documents relating to the reform plan within two days as required by CSRC (Event 2). The documents, at the minimum, should include: Resolution of the Board of Directors, Opinion of Independent Directors, Prospectus for the Reform, Opinion of the Sponsors, Notice of the Extraordinary General Meeting (the EGM) in connection with the Reform, and an application for share trading resumption. It will be the first time for the market to get to know how a specific company will be reformed. The reform plan is critical to the whole process since the consideration plan disclosed in the Prospectus for the Reform will determine how much the tradable shareholders can get benefit from the reform. More importantly, it signals that the company intends to safeguard the interest of tradable shareholders.

After the announcement of the reform plan, there will be a period for communication and negotiation between the company's non-tradable shareholders and tradable shareholders regarding the reform plan (more importantly to agree on the amount and types of consideration). The board will consider the information gained from such communications and decide whether to revise the initial reform plan or not. In general, if there is a revision, the non-tradable shareholders will increase instead of decrease the amount of consideration. The confirmation or revision of the initial reform plan will be announced within the two days after the board makes the decision (Event 3).

After the reform plan has been finalized and subjected to voting by shareholders through an EGM, the trading of the shares will be suspended again. The reform plan can only be approved by the agreement of more than two-thirds of tradable shareholders. The result of the voting, i.e. approval or rejection of the reform plan, should be announced within two days of the EGM (Event 4). The company can apply for share trading resumption at the announcement date.

The last step of the reform is an announcement from the company that the reform will be implemented and the consideration plan will be carried out (Event 5). On this date, the non-tradable shareholders will give shares, warrants or cash as consideration to tradable shareholders according to the consideration plan. The majority of the companies choose to give shares, which means that on the day of implementation, more shares will be traded on the stock market. However, the number of total shares of a company will not change. On the same day of implementation, the company's non-tradable A-shares will be classified as G-shares, which signals the completion of the company's split share structure reform.