The Role of Political Party in Curtailing Opportunistic Insider Sales: Evidence from China

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Abstract

The unique political system in shaping socio-economic policies in China calls for a detailed exploration of its precise effect on corporate governance. Using the mandatory establishment of a Chinese Communist Party (CCP) branch after 2018 as an exogenous shock, we find that the establishment of a CCP organization reduces opportunistic insider sales. Our paper contributes to the emerging literature on the role government plays in the business environment.

Keywords: Chinese Communist Party, opportunistic insider sales, corporate governance, shareholder protection
JEL classification: G30 G38 P34

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1. Introduction

The dominance of the Chinese Communist Party (hereafter CCP) cannot be overlooked due to China's distinctive political governance framework, particularly in the corporate realm. A growing body of literature highlights the influence of the CCP on corporate governance and decision-making (Bi, 2021). Given their crucial oversight role, a compelling question arises: How might a CCP branch prevent unethical behavior like opportunistic insider trading?

Insider trading occurs when affiliated individuals trade based on non-public information (Chung et al., 2019). This topic has received widespread attention from academics, practitioners, and regulatory authorities (Akbulut and Ucar, 2023). It is noteworthy that while insider trading may be often driven by the need for asset allocation and liquidity management (routine insider trading), opportunistic trading is typically the focal point of discussion given its association with speculation. Furthermore, opportunistic sales are more concerning to shareholders compared with insider purchases for reasons 1) the impact of opportunistic purchases is less direct due to it representing capital investment into companies and could signal prospective future, and 2) insider selling causes higher capital costs (Aboody et al., 2005) and heightened scrutiny by regulators as scholars have linked insider selling to increased legal risks (Billings and Cedergren, 2015). In the context of China, opportunistic trading remains a significant concern given waves of insider sales have continued to be prevalent in recent years (Huang, 2013).[1]

The impact of the establishment of a CCP committee on opportunistic insider sales can be double-edged. On the one hand, it is likely that the CCP branch enhances internal monitoring and leads to decreased opportunistic insider sales. The CCP committee can create an environment less

[1] Also see examples of waves of opportunistic sales in China: https://bnn.network/breaking-news/china-launches-investigation-into-shareholder-transaction-rattling-obscure-furniture-maker/ and China's regulator gets tough on insider trading as it metes out record penalty on wrongdoers in the financial markets (yahoo.com).

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conducive to unlawful or unethical activities (Huang and Yang, 2023), aligning with China's 'harmonious society' (a slogan from the Hu Jintao era) concept that emphasizes transparency (See, 2009). On the other hand, it is also likely that government intervention could unintentionally incubate speculating behaviors within the corporate sector due to the misalignment of interests of the government and firms. For example, Rithmire (2023) suggests that CCP efforts to restore discipline[2] may foster distrust between the state and business, potentially exacerbating issues like opportunistic insider trading. Therefore, the impact of a CCP committee on insider sales merits further investigation.

Using a recent reform in 2018 mandatorily requiring public-listed firms to establish a CCP committee as an exogenous shock (details see Appendix A), we find through the difference in difference (DID) estimator a negative association between the establishment of a CCP branch and opportunistic insider selling after 2018. Such correlation is significantly stronger for firms that are not owned by the state government and those that were not audited by the Big Four (e.g., Deloitte, PwC, E&Y, and KPNG) firms. This implies the noticeable corporate governance role of CCP on weak governed companies.

2. Data and methodology

We collect information on insider selling transactions for Chinese listed firms during the period of 2007 to 2021 from CSMAR. We follow previous studies (Liu et al., 2023) and employ the event study approach using the market model to define opportunistic insider sales. Insider sales are categorized as opportunistic if the predicted cumulative abnormal return is negative one month after the event date. In addition, we gather details on the establishment of a CCP committee and whether the firm is state-owned from CSMAR. Other firm-level controls are also acquired from

[2] It is worth noting that "restore discipline" means measures taken by the CCP to address perceived lapses in obedience to party policies, regulations, or ideological guidelines.

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CSMAR. We exclude firms in financial and utility sectors[3] and special treatment (ST) shares.[4] Appendix Table B1 presents variable descriptions and Table B2 reports summary statistics.

Our empirical difference-in-difference (DID) framework is specified as:

$$Y_{it}= \lambda_0+\lambda_1 Treat*Post+\lambda_2 X_{it}+\delta_{it}+\varepsilon_{it} \qquad (1)$$

where Y_{it} is the outcome variable, *Treat* is an indicator for a company having a CCP committee, and *Post* is an indicator for years greater or equal to 2018. The X_{it} represents a vector of firm-level control variables. We include firm-fixed effects to account for time-invariant firm characteristics and year-fixed effects to control secular trends that affect all firms.

3. Results

3.1. Baseline results

Table 1 Panels A shows our baseline estimations. Across all outcome measures, we find supporting evidence that having a CCP branch leads to a significant reduction in opportunistic insider sales after the implementation of the new policy in 2018. For instance, the formation of a CCP committee is connected to a decrease in insider sales by 3.78% (column 1) after 2018, corresponding to a 17% reduction relative to its sample mean.[5] This indicates an enhanced corporate oversight resulting from the establishment of the Party branch, leading to the deterrence of opportunistic selling.

Table 1. CCP and opportunistic insider selling

	(1) Indicator for opportunistic sale	(2) Opportunistic sale frequency	(3) Opportunistic sale amount
*Treat*Post*	-0.0378***	-0.3547***	-0.6896***
	(0.0141)	(0.0994)	(0.2130)
Operating cash flow	0.0694**	0.6152***	1.0772**

[3] These industries typically exhibit high levels of leverage and are subject to significant regulation.
[4] The special treatment (ST) Shares represent companies with abnormal financial conditions (details see Bank of China (Hong Kong) Limited (etnet.com.hk) and Shanghai Stock Exchange brings in new delisting rules |Economy |chinadaily.com.cn).
[5] This is calculated as 3.78%/0.2228(mean of *Indicator for opportunistic sale* in Table B2)=17%

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	(0.0343)	(0.2090)	(0.4716)
Return on assets	0.0763**	0.4431	1.2951**
	(0.0389)	(0.2736)	(0.5591)
Total assets	0.0249***	0.1315***	0.3949***
	(0.0049)	(0.0290)	(0.0685)
Leverage	-0.1083***	-0.6273***	-1.5379***
	(0.0209)	(0.1258)	(0.2925)
Firm age	0.2340***	1.0438***	3.3740***
	(0.0085)	(0.0556)	(0.1239)
State-owned shares	0.0173	-0.0214	0.3150
	(0.0167)	(0.0947)	(0.2189)
Independent%	0.0803	0.4926	1.4129
	(0.0676)	(0.4374)	(0.9553)
Board size	0.0061**	0.0334*	0.0751**
	(0.0027)	(0.0171)	(0.0377)
FE	Year/Firm	Year/Firm	Year/Firm
Observations	37,643	37,643	37,643
R-squared	0.3225	0.3055	0.3544

Standard errors are in parentheses. ***$p < 0.01$, **$p < 0.05$, *$p < 0.1$

3.2. CCP's governance role

To gain a deeper insight into the governance role of the CCP committee, we explore the potential heterogeneity across firms with different ownership structures. Specifically, we perform our analysis on two groups of firms—state-owned entities and those that are not under the direct control of the government. We conjecture that the impact of establishing a Party branch in reducing insider trading will be particularly pronounced for non-state-owned entities. This is because state-owned companies are already subject to government oversight, acting as a buffer against the influence of establishing a CCP. Table 2 reports our estimates. We observe that having a CCP branch significantly discourages firms from participating in insider sales for those not owned by the state government (columns 1, 3, and 5). However, such an association is absent for the state-owned firms (columns 2, 4, and 6).

Table 2. Heterogeneity across firms with or without state ownership

	Indicator for opportunistic sale	Opportunistic sale frequency	Opportunistic sale amount

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	(1) Non-state-owned	(2) State-owned	(3) Non-state-owned	(4) State-owned	(5) Non-state-owned	(6) State-owned
*Treat*Post*	-0.0498***	0.0048	-0.3858***	0.4509	-0.8604***	0.3071
	(0.0165)	(0.0428)	(0.1156)	(0.3979)	(0.2490)	(0.6961)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
FE	Year/Firm	Year/Firm	Year/Firm	Year/Firm	Year/Firm	Year/Firm
Observations	22,734	14,811	22,734	14,811	22,734	14,811
R-squared	0.3279	0.2731	0.3026	0.2770	0.3505	0.3028

Standard errors are in parentheses. ***p < 0.01, **p < 0.05, *p < 0.1

Finally, we reiterate the corporate governance role of CCP and focus on whether firms audited by the major auditing firms can be a distinguishable factor. Prior research demonstrates that the Big Four is associated with enhanced audit quality and increased auditing pressure (Dowling and Leech, 2014; Eshleman and Guo, 2014), which in turn can lead to a decrease in insider trading (Xiao et al., 2023). In light of this, we examine firms based on whether they have undergone auditing by the Big Four or not and present our results in Table 3. To our anticipation, the findings are significantly more pronounced for firms not audited by the Big Four, while the effect is less marked for the remaining firms.

Table 3. Heterogenous impact of the Big Four auditing firms

	Indicator for opportunistic sale		Opportunistic sale frequency		Opportunistic sale amount	
	(1) Non-Big Four	(2) Big Four	(3) Non-Big Four	(4) Big Four	(5) Non-Big Four	(6) Big Four
*Treat*Post*	-0.0413***	0.0040	-0.3357***	-0.7261	-0.7299***	-0.1913
	(0.0146)	(0.0593)	(0.1026)	(0.5808)	(0.2205)	(0.9107)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
FE	Year/Firm	Year/Firm	Year/Firm	Year/Firm	Year/Firm	Year/Firm
Observations	35,421	2,164	35,421	2,164	35,421	2,164
R-squared	0.3202	0.4079	0.3042	0.4141	0.3517	0.4528

Standard errors are in parentheses. ***p < 0.01, **p < 0.05, *p < 0.1

4. Conclusion

We offer novel evidence that the establishment of CCP significantly reduces firms' opportunistic selling. This aligns with Chang and Wong (2004), suggesting that CCP control can

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aid in mitigating a firm's agency problem, despite their documentation of a negative impact on the firm's profitability. Our findings, collectively, indicate that the CCP branch substantially strengthens the monitoring role of the Communist Party and can be as effective as the other governance mechanism. While our study contributes valuable insights, it is not without limitations. Future endeavors can explore how this policy impacts opportunistic purchasing to attain a more comprehensive understanding of its implications.

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Appendix A

A reform implemented by the China Securities Regulatory Commission (CSRC) in 2018 has captured our attention. For the first time in history, the CSRC has mandated that public-listed firms establish a CCP organization/committee within the company, irrespective state-owned or not.[6] Notably, the initial objective is for the Party to act as an internal control mechanism, with the ability to significantly enhance corporate governance, as the Communist Party can directly intervene through a Party branch within a firm given its pivotal role in China's political landscape. Previous scholars have demonstrated the CCP's active formalization of its role by integrating itself into the corporate governance structure of state-owned enterprises (SOEs), solidifying its dominance in enterprise decision-making processes (Beck and Brødsgaard, 2022).[7] Therefore, the implementation of the new policy provides an excellent exogenous shock for us to investigate the associations between CCP establishment and insider sales.

[6] Details please find **Article 5** in the **Code of Corporate Governance for Listed Companies** (http://www.csrc.gov.cn/csrc_en/c102034/c1372459/1372459/files/P020190415336431477120.pdf)

[7] Beck, K.I., Brødsgaard, K.E., 2022. Corporate governance with Chinese characteristics: Party organization in state-owned enterprises. The China Quarterly 250, 486-508.

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Appendix B

Table B1. Variable definitions and sources.

Variable	Definition	Sources
Big Four	An indicator equals 1 if the firm's auditor belongs to the Big Four, and 0 otherwise.	CSMAR
Board size	Number of directors on the board	CSMAR
Firm age	Log form of firm age	CSMAR
Independent%	Percentage of the independent directors on the board	CSMAR
Indicator for state-owned	An indicator equals 1 if the firm is owned by the state government, and 0 otherwise.	CSMAR
Leverage	Total debt divided by total assets	CSMAR
Operating cash flow	Operating cash flow scaled by total assets	CSMAR
Opportunistic sale amount	Size of firm's total insider opportunistic sales in the year in nature logarithm form	Liu et al. (2023)
Indicator for opportunistic sale	Equals to 1 the company's insider is identified as engaging in opportunistic sales, and 0 otherwise.	Liu et al. (2023)
Opportunistic sale frequency	Frequency of firm's insider opportunistic sales in the year.	Liu et al. (2023)
Post	An indicator equals 1 if the year is after 2018, and 0 otherwise.	
Return on assets	Net income scaled by total assets	CSMAR
Size	Total assets	CSMAR
State-owned shares	The percentage of the shares are owned by the state government	CSMAR
Treat	Equals to 1 if the firm has the Communist Party Organization within the firm, 0 otherwise.	Manually collected from the firm's annual report.

Note: This table shows detailed descriptions and sources of all key variables.

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Table B2. Summary statistics

	N	Mean	SD	P25	P75
Treat	37643	0.695	0.4604	0	1
Operating cash flow	37643	0.0461	0.0735	0.0068	0.0883
Return on assets	37643	0.0364	0.0706	0.014	0.0686
Indicator for opportunistic sale	37643	0.2228	0.4161	0	0
Opportunistic sale frequency	37643	0.9278	2.65	0	0
Opportunistic sale amount	37643	3.1076	5.9924	0	0
Total assets	37643	3.6294	1.3154	2.6932	4.3806
Leverage	37643	0.434	0.2161	0.263	0.5895
Firm age	37643	2.0471	0.9117	1.3863	2.7726
State-owned shares	37643	0.056	0.1457	0	0
Independent%	37643	0.3743	0.0533	0.3333	0.4286
Board size	37643	8.611	1.7055	7	9

Note: This table reports the summary statistics of related variables.

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Appendix C

To ensure that our baseline findings are not confounded by unobservable factors, we perform a placebo (year 2017) analysis.[8] If the primary driver were indeed the mandate, we would anticipate observing non-significant coefficients for the interaction term. We notice from Table C1 that our results no longer hold for placebo years. It is noteworthy that in the unreported analysis, the same phenomenon pertains to any other years as "*placebos*". To rule out selection bias possibilities, Table C2 represents baseline estimation results for the propensity-score-matched (PSM) sample. We again find that our baseline results remain hold.

Table C1. Placebo tests

	(1) Indicator for opportunistic sale	(2) Opportunistic sale frequency	(3) Opportunistic sale amount
*Treat*Placebo*	0.0065	0.0625	0.0324
	(0.0144)	(0.0977)	(0.2162)
Controls	Yes	Yes	Yes
FE	Year/Firm	Year/Firm	Year/Firm
Observations	37,643	37,643	37,643
R-squared	0.3222	0.3050	0.3540

Standard errors are in parentheses. ***p < 0.01, **p < 0.05, *p < 0.1

Table C2. PSM analysis

	(1) Indicator for opportunistic sale	(2) Opportunistic sale frequency	(3) Opportunistic sale amount
*Treat*Post*	-0.0667***	-0.4656***	-1.0381***
	(0.0199)	(0.1425)	(0.3021)
Controls	Yes	Yes	Yes
FE	Year/Firm	Year/Firm	Year/Firm
Observations	11,360	11,360	11,360
R-squared	0.0494	0.0461	0.0554

Standard errors are in parentheses. ***p < 0.01, **p < 0.05, *p < 0.1

[8] We utilize 2017 as our placebo year, operating under the assumption that the policy was implemented in 2017 instead of 2018. If this hypothetical date were accurate, we would expect to observe statistically significant results.

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