



# Political connection of financial intermediaries: Evidence from China's IPO market<sup>☆</sup>



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## ABSTRACT

Using a sample of Chinese Initial Public Offerings (IPOs) from 2006 to 2011, we document that politically connected (PC) underwriters increase the likelihood of clients' IPO applications being approved by the Chinese Securities Regulatory Commission (CSRC). We further show that PC underwriters charge premium underwriting fees. Consistent with the rent-seeking argument, we find that minority shareholders' interests may be impaired as indicated by post-IPO underperformance. We do not detect significant differences in the underpricing of IPO deals underwritten by PC versus non-PC investment banks.

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## 1. Introduction

Reputation and relationships are two important factors for investment banks to be successful in fulfilling their role of financial intermediaries (Morrison and Wilhelm, 2007). Reputational effects have been extensively researched in the literature (Beatty et al., 1998; Rau, 2000; Fang, 2005; and McKenzie and Takaoka, 2008, among others). Prior studies have documented that reputable underwriters experience faster expansion and enjoy price premium. In contrast, studies examining the effect of relationships on investment banks are scarcer, with few exceptions (Allen and Babus, 2009). Yasuda (2005, 2007), for example, show that the underwriter's relationships with commercial banks are effective in at-

tracting new clients and retaining the incumbent clients for corporate bond underwriting businesses.

Political connections, a specific form of relationships, play an important role in economic activities, especially in emerging markets with less developed legal systems, more government interventions, and weaker investor protection (e.g., Faccio, 2006; Fan et al., 2007; Claessens et al., 2008). Previous studies, however, have mainly focused on individual firms' political connections with regard to access to bank loans, borrowing terms, bailout events, long-term performance, and market values, etc. (e.g., Fisman, 2001; Khwaja and Mian, 2005; Faccio et al., 2006; and Ferguson and Voth, 2008). These studies show that firms benefit from such political connections at significant social costs.<sup>3</sup> If financial intermediaries can similarly employ political connections for private benefits, their professionalism may be compromised, resulting in a misallocation of scarce economic resources. However, research on the implications of financial intermediaries' political connections has been very limited. To the best of our knowledge, Butler et al. (2009) is the only study that considers the possible effect of underwriters' political connections in bond markets.

In this study, we extend the analysis to the effect of underwriters' political connections in the initial public offering (IPO) mar-

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<sup>3</sup> For example, Khwaja and Mian (2005) estimate that the rent-seeking costs related to political connections in the bank lending process range from 0.2% to 1.95% of GDP each year in Pakistan.

ket. China's emerging stock market provides an ideal setting for us to delve deeply into these questions. Since its inception, the Chinese stock market has been tightly regulated and controlled by the government. Regulation generates rent-seeking opportunities that can be exclusively appreciated by those with ample political capital (Shleifer and Vishny, 1993).<sup>4</sup> The investment banks in China vary with regard to their political connections. Specifically, the executives of some investment banks once worked as senior bureaucrats in government agencies or even in regulatory agencies for the capital market. The political capital accumulated from such experience is expected to solicit preferential treatment for their clients when the underwriter interacts with government agencies. We define an underwriter as politically connected (PC) if its chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the China Securities Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination Committee or M&A Committee of the CSRC. Since the company must obtain CSRC approval to access the stock market via an IPO, we expect such political capital to strengthen the competitive advantage of these investment banks in their underwriting businesses, rendering professional reputation less of a concern.

Given the unique regulatory features of the Chinese IPO market, an exploration of the role of underwriters' political connections and their economic consequences enhances our understanding of how China's capital markets operate. We thus address the following research questions in this study: 1) Do political connections influence dealings with regulators; that is, do underwriters' political connections increase the probability of their clients' IPO application being approved by the regulators? 2) Do political connections generate premium underwriting fees for the investment banks? 3) Are underwriters' political connections beneficial/valuable to minority shareholders; that is, what effect do political connections have on the quality of IPOs measured by post-IPO performance? 4) Do minority shareholders account for the effect of the underwriters' political connections; that is, to what extent do underwriters' political connections influence the underpricing of IPOs?

Using a sample of Chinese IPO applicants from 2006 to 2011, we document that the probability of obtaining IPO approval from the CSRC is much higher for deals underwritten by PC investment banks. This result is robust after we control for a number of clients' characteristics, such as firm size, leverage, return on assets (ROA), and earning quality. We also control for the characteristics of the underwriter, such as foreign ownership, central government ownership, and ranking status in the market, as well as the success rate of prior underwriting deals, and obtain robust results.

We also find that the PC underwriters recoup economic rents for their political capital by charging premium underwriting fees. Thus, both the underwriters and their clients benefit from the former's political capital. In contrast, we find that the IPO firms underwritten by PC investment banks underperform those underwritten by non-politically connected (non-PC) investment banks in the post-IPO period. The post-IPO (up to two years after the IPO) stock performance is significantly lower, and the change in accounting performance is considerably worse for the client firms of PC underwriters. Overall, these findings indicate that PC underwriters help inferior companies gain access to the equity capital markets by mobilizing their political resources to handle bureaucratic reg-

ulation and supervision, which compromises the professionalism and expertise of financial intermediaries. Further analyses show that the IPO underpricing does not exhibit significant differences between the clients of PC and those of non-PC underwriters, implying that minority investors cannot price protect themselves.

This study contributes to the literature in the following ways. First, it expands the limited literature on the value of relationship (political connections in particular) to financial intermediaries with evidence obtained from the Chinese IPO market, which can also be generalized to other relationship-based economies. Second, our study extends the literature on political connections by shedding light on the role that financial intermediaries' political connections play in capital markets. We offer additional evidence to the literature on political rent seeking by documenting how the underwriters and their clients can enjoy the benefits of political capital at the expense of minority shareholders' interests. Third, our findings add to the rich literature on IPO underpricing, effect of underwriters' professionalism and reputation, post-IPO performance, and the role of underwriters in general. Finally, our study generates important insights into the IPO process of Chinese firms and expands our knowledge of the unique features of China's security markets.

The remainder of this paper is organized as follows. Section 2 describes the institutional background of China's IPO market. Section 3 develops our research hypotheses. Section 4 presents the research sample and methodologies. Section 5 discusses our empirical findings, and Section 6 concludes the paper.

## 2. Institutional background

### 2.1. China's IPO market

The Chinese stock market has been characterized by heavy government regulation since its inception in the early 1990s. The regulation governing the Chinese IPO market has experienced several stages. The initial "quota" system with tight government control was followed by the relatively more market-based "channel" system with confined competition among underwriters. In 2004, the CSRC switched from the "channel" system to the "sponsorship" system, which is an even more market-based mechanism and allows the underwriter to play a much more important role than ever before. In the IPO process, the sponsor recommends its client firm for IPO application to the CSRC. Only those who pass the CSRC evaluation and gain approval can seek an IPO. Accordingly, underwriters take on more responsibility under the "sponsorship" system. For example, in addition to the services provided during the IPO process, the underwriter would also be held responsible for its clients' information disclosure in the two years following the IPO. This requirement strengthens underwriters' incentive to deliver diligent service in the IPO market and intensively monitor their clients. This system is intended to introduce market mechanisms into the Chinese IPO market and is expected to improve the protection for minority shareholders, mitigate the government intervention in the IPO market, and enhance market institutions.

As a common feature in the above mentioned IPO systems, the regulator plays an essential role in deciding which firms can finally go to the IPO market. Firms pursuing IPOs in China must satisfy with a set of bright line regulations. For example, it requires that the cumulative net profits of the firm in the three years prior to the IPO must exceed 30 million renminbi (RMB); the company cannot report a net loss in any of the three years prior to its listing on the main board. Additionally, the firm needs to meet a number of qualitative and ambiguous criteria, which allows for significant discretions in the IPO approval process. For instance, the firm is required to set up functioning corporate governance before going for the IPO.

<sup>4</sup> Yang (2013) investigates the impact of the political connections of audit firms, defined as having partner serving on the Issuance Examination Committee of the China Securities Regulatory Commission (CSRC), on the decision of IPO application of its clients. Given the specific form of connection as he focuses on, unsurprisingly he finds that the connected auditors increase the likelihood of its clients obtaining IPO approval and they charge a premium in audit fees. We focus on the political connections of underwriters since underwriters play a more crucial role in handling the regulators than auditors in the IPO application process.

The firm typically submits an application package with the documents prepared according to the specified rules to the CSRC. According to the CSRC (2012), it consists of three key steps in examining the IPO applications: 1) pre-screening, 2) preliminary examination, and 3) formal examination. In each step, the regulator can raise questions related to the application, to which the applying firm needs to provide a response. In the Issuance Examination Committee meeting, the IPO application needs to receive at least five votes from seven members in order to obtain IPO approval. Given the discretions allowed in the decision making during the examining process, it helps to obtain a positive outcome by knowing someone on the committee or seeking information about who will be sitting on the committee. Thus, the political connection of market intermediaries involved in the IPO, such as the underwriter and auditor, can play an important role in the IPO process. Firms pursuing IPOs are willing to pay a premium for the political capital that may facilitate the IPO approval. According to an article published in Caixin Media, the market price for the name list of key persons in the examining process is around one million RMB, and the price for one vote from the committee members is around half million RMB. Compared with the auditor, the underwriter is expected to play a more significant role because the underwriter needs to accompany the client in meeting the committee members and addressing the raised questions. Consistent with the institutional process as described, 16% of the IPO applications underwritten by the PC underwriter are rejected, while 23% of the application underwritten by the non-PC underwriter are rejected, indicating the importance of the political connection of the underwriter.

## 2.2. Development of investment banks in China

China's securities market has undergone explosive development since the early 1990s, which has driven the progress of investment banking businesses. As of 2011, there are 107 investment banks in China, 72 of which are permitted to assume the role of underwriters. As the key players in the securities market, most of the Chinese investment banks were initially established under the old planning economy system. Basically, they can be categorized into the following groups: 1) nationwide investment banks founded by entities such as state-owned national commercial banks and insurance companies, such as Guotai Securities and China Securities; 2) regional investment banks founded by regional financial institutions, such as Shengyin Securities and Beijing Securities; 3) investment banks founded by local finance bureaus, such as Shanghai Finance Securities; and 4) those founded by national or regional trust and investment firms, such as CITIC Securities and Everbright Securities. While many investment banking firms have become independent legal entities over time, a majority of them are still state-owned enterprises and retain the corresponding "political hierarchy." In many cases, the chairman or CEO of an investment bank was once a government officer with strong political ties at various levels.

## 3. Literature review and hypothesis development

### 3.1. Related literature

Beginning with the pioneering work of Tullock (1965), a body of literature on the importance of political connections and their value implications has steadily been accumulated. Fisman (2001) documents significantly lower abnormal stock returns for a number of Indonesian firms connected to the country's former president Suharto when a decline in Suharto's health was announced. A recent study by Goldman et al. (2009) also shows a positive abnormal stock return following the announcement of the

nomination of a PC individual to the board with U.S. data. Meanwhile, several studies attempt to explore the mechanisms through which political connections can create value for firms. For example, Sapienza (2004) examines the effect of government ownership on bank lending behavior and finds that state-owned companies enjoy lower interest rates when borrowing from state-owned banks. Claessens et al. (2008) document that the bank leverage of PC firms increases substantially after an election in which political connection is measured by campaign contribution. In cases of financial distress, PC firms are more likely to be bailed out by the government (Faccio et al., 2006). In addition, Leuz and Oberholzer-Gee (2006) find that firms with strong political connections are less likely to go outside the country to raise funds. They further show that firms closely connected to prior governments tend to underperform in the new regime and subsequently increase their foreign financing. Using data from Thailand, Pramuan and Wiwat-tanakantang (2009) note that PC firms can enjoy preferential government policies, hindering their competitors and enhancing their own market share. Overall, the evidence implies that political connections are valuable and that the value is well explored by the possessor of such connections.

A few studies analyze the role of political connections in China, among which Fan et al. (2007) focus on the relationship between political connection and issuing firms' initial returns and post-IPO firm performance. They find that PC firms underperform their non-connected counterparts and are more likely to appoint other bureaucrats to the board of directors. Li et al. (2008) show that the party membership of private entrepreneurs helps them obtain loans from banks or other state institutions and has a positive effect on firm performance. Chen et al. (2011) document that firms are more likely to establish political connections in regions with less market-oriented local economies, while the controlling owners of PC firms tend to concentrate their shareholdings and dominate the board. In addition, Berkman et al. (2010) find that firms with strong ties to the government have not benefitted from the regulations designed to improve minority shareholder protection in the Chinese stock market. These studies collectively support the importance of political connection in China and the prevalence of the rent-seeking activities engaged in by PC corporations. The firm's own political connection also plays an important role in the listing decision. Hung et al. (2012) find that political connection helps the state-owned enterprises seek overseas listing.

Previous studies mainly focus on the political connections of individual firms. The implications of financial intermediaries' political connections for capital markets have been largely ignored in the Chinese emerging market. Given the significant role of financial intermediaries in allocating capital resources, their political connections could have far-reaching effects on the financial market. Butler et al. (2009) is one of the few studies that consider the possible effect of underwriters' political connections in the issuance of municipal bonds using U.S. data. They show that investment bankers received quid pro quo by charging higher fees during the pay-to-play era when underwriting firms routinely made political campaign contributions to win underwriting business from the state. Yang (2013) investigates the role of the political connections of audit firms, another important market intermediary, and finds that the clients of those audit firms with partners serving on the Stock Issuance Examination and Verification Committee of the CSRC are more likely to push their clients through the IPO screening process. The politically connected auditors charge premium for their audit service. However, the firms audited by non-top-tier auditors with such political connections underperform in the post-IPO period. According to prior literature, other political forces may also shape the listing outcome of the firm. For example, Piotroski and Zhang (2014) show that the impending political promotion of local government officers is associated with more IPOs from the re-

gion. Specifically, the to-be-promoted politicians have incentives to push more SOEs in the region for IPOs to strengthen the local economic performance. Meanwhile, the private firms have a greater tendency to seek IPOs in the promotion period of local officers due to their worry about the dissipation of political connections. Our study extends the prior literature and analyzes the impact of underwriters' political connections on their clients' IPO process.

### 3.2. Hypothesis development

In the IPO process, investment banks get involved in the early stages of security issuance, such as the restructuring of the company, preparing documents required by regulators, and communicating with regulators and the market. In a transitional economy such as China, security issuance is highly subject to government intervention, and regulatory approval is required for a firm to access the capital market.<sup>5</sup> Underwriting investment banks normally work closely with firms throughout the IPO process. For example, the underwriter helps to provide responses to questions raised in the meeting by the Issuance Examination Committee. Thus, the political capital possessed by the underwriter is expected to facilitate effective communication with regulators and, accordingly, lead them to make favorable regulatory decisions. The Chinese economy is typically relation-based rather than rule-based. Bountiful anecdotal evidence suggests that underwriters' political connections have a significant impact on the IPO approval process in China. For example, leading Chinese business news magazine *Caijing* reported that the former CEO of Galaxy Securities, Mr. Shiqing Xiao, who previously served in several CSRC departments, had successfully used his special political ties to help client firms obtain IPO approval (Tan and Zhang, 2011). Political connections are expected to help underwriters gain competitive advantage in successfully pushing client firms' IPO applications through the approval process. We thus state our first hypothesis as follows:

*Hypothesis 1: Underwriters' political connections increase the likelihood that their clients' IPO applications will be approved by the CSRC.*

Going public would grant issuing firms the opportunity to obtain external financing and improve their market reputation. In a developed economy, such as that of the U.S., the underwriter's reputation plays a key role in capital markets. For example, reputable underwriters can charge a fee premium on their clients and expand their business operations more rapidly (Fang, 2005; Rau, 2000). In China, where the stock market is highly regulated and controlled by the government, going public is a precious opportunity for which firms compete. Client firms must bear substantial costs if they fail to obtain IPO approval from the CSRC. As a consequence of failing to go IPO and raising external financing as needed, the client firm may miss investment opportunities, which would significantly influence its future prospects. According to the CSRC regulation, a firm must wait for six months after the initial rejection before it can resubmit its IPO application. Substantial resources are consumed in the reapplication process, especially if the firm switches to a new underwriter. Therefore, client firms that are eager to go public may need the support from PC underwriters to keep a smooth communication channel with regulator/issuance committee members or even to secure favorable decisions in the IPO process. Therefore, we expect political connections to play a significant role by facilitating the rent-seeking behavior of investment banks. If an underwriter's political connections can increase the likelihood of its client firms' IPO applications being approved, the client firms may be willing to pay a fee premium for hiring

a PC underwriter. Thus, we formally state our second testable hypothesis as follows:

*Hypothesis 2: Politically connected underwriters charge a fee premium for their underwriting services.*

As explained above, both the PC underwriters and their clients may be better off due to the potential benefits derived from the underwriters' political capital. However, these benefits may be at the expense of undermined professionalism in underwriting services. Taking the premium charge in underwriting service, the underwriter will utilize its political connections to lobby/bribe officers at the CSRC to obtain IPO approval. If the PC underwriters can increase the likelihood of IPO approval, we conjecture that the CSRC may loosen the criteria for scrutinizing client firms underwritten by investment banks with political connections. The political connection can also reduce the litigation risk, and the PC underwriters thus may not exercise sufficient diligence in monitoring their clients, which could potentially undermine IPO quality. Thus, the benefits of the underwriters' political capital, as enjoyed by the underwriters and their clients, could be at the expense of minority shareholders' interests. Carter et al. (1998) show that the underperformance of IPO stocks over a three-year holding period is less severe for IPOs handled by more prestigious underwriters. If client firms obtain favorably biased consideration in their IPO application due to the political connections of their underwriters, we expect their post-IPO performance to be poorer than that of firms using underwriters without such connections. We thus state our third hypothesis as follows:

*Hypothesis 3: The client firms of politically connected underwriters tend to underperform those of non-politically connected underwriters in the post-IPO period.*

IPOs have been documented to generally exhibit positive first-day returns on average and so can seem to be "underpriced" (Ritter and Welch, 2002). IPO underpricing is a phenomenon that is prevalently documented in the finance literature, with the extent of underpricing varying from country to country. IPO underpricing is typically explained by the information asymmetry existing between the issuing firm and investors (Rock, 1986). Previous studies show that reputable underwriters can reduce the information asymmetry by certifying the quality of the issue and thus mitigating the IPO underpricing (Booth and Smith, 1986; Carter and Manaster, 1990; Michaely and Shaw, 1994). If both PC underwriters and their client firms may recoup benefits from the former's political capital, it is interesting to consider whether the minority shareholders would account for such an effect. In particular, would shareholders demand greater IPO underpricing when the firms go public? If the minority shareholders anticipate the long-term underperformance of firms underwritten by PC investment banks, we expect them to price-protect themselves by discounting the IPO offering price. Nevertheless, given that the investment channels are limited in China and IPO shares are mostly oversubscribed, it is possible that the minority shareholders may have little influence over the offer price of IPOs. Therefore, it is unclear whether the anticipation of the long-term negative effect of IPOs underwritten by PC investment banks would be reflected in higher initial returns on the first day of trading—that is, higher IPO underpricing. Thus, we state our fourth hypothesis as follows:

*Hypothesis 4: The IPO underpricing for the client firms of politically connected underwriters tends to be greater.*

## 4. Research design

### 4.1. Measurement of underwriters' political connection

The key variable in our study is underwriters' political connection. To measure this, we first follow Fan et al. (2007) to identify whether the underwriter's chairman or CEO has served as a cur-

<sup>5</sup> The SEC must also approve IPOs in the U.S., and the decision is largely made by following the specified criteria without much subjective judgment.



rent or former officer of the central or local governments or the military.<sup>6</sup> During our sample period, the regulatory enforcement of the Chinese securities market, including IPO scrutiny and approval, is centralized at the CSRC, which reports directly to the State Council. Therefore, the underwriters' political connections mainly function by dealing with the CSRC to help client firms with their stock issuances.<sup>7</sup> In China, officers at the deputy bureau head level and above are considered to compose a high-ranking cadre with more connections to the central ministries and State Council.<sup>8</sup> We thus consider underwriters with chairmen or CEOs who are currently or were formerly governmental officers at the deputy bureau head level or above as being politically connected. In addition, we also consider an underwriter as PC if its chairman or CEO currently sits on the Issuance Examination Committee or the Mergers and Acquisitions (M&A) Committee of the CSRC or if he or she was previously employed by the CSRC. We first measure *Political Connection* as a dummy variable, defined as 1 if the underwriter is politically connected and 0 otherwise. We also use an alternative measure of political connection, *Political Rank*, which is defined by ordering the political connection status according to the chairman/CEO's highest political rank. In particular, we assign a value of 0 to those without connections, 1 to those with a chairman/CEO at the deputy bureau head level, 2 to those with a chairman/CEO at the bureau head level, and 3 to those with a chairman/CEO at the deputy governor or minister level, or with CSRC experience and/or a chairman/CEO currently sitting on the CSRC's Issuance Examination or M&A Committees. This variable is supposed to capture the strength of political connection.

We acknowledge that in a relationship-based economy such as China's, political connections may be multidimensional. Thus, our measures of political connection may not fully capture all the political resources that the investment banks are capable of deploying to help their clients. Investment banks classified as non-PC may have alternative channels through which to establish political connections with officers at the CSRC. We believe that the noise in our political connection measures can only bias against us finding results consistent with our predictions.

#### 4.2. Data sources and sample

Our sample consists of all the IPO application cases in China between 2006 and 2011. We chose 2006 as the starting year because the identities of IPO applicants and their prospectuses have been disclosed by the CSRC regardless of the applications' outcomes since 2006. The sample stops by 2011 because we require two years data after the IPO to investigate the impact of the political connection of the underwriter imposed on the post-IPO performance. There is an advantage in using this sample period. According to our discussion in Section 2.1, the development of the Chinese IPO market has gone through several stages since the 1990s, with the trend shifting from strict government control toward partially market-oriented mechanisms. Specifically, in early 2004, the CSRC issued a regulation introducing a sponsor system for firms seeking public listings as part of an effort to build up a market-

driven system for stock issuances.<sup>9</sup> Under the sponsor system, the role of underwriting investment banks becomes more significant in the IPO process, which allows us to investigate the implications of the underwriters' political capital. In addition, the ownership reform of the state-owned enterprises concluded in 2005, and a new set of IPO regulations became effective beginning in 2006. Therefore, focusing our sample on the same regulatory regime enables us to more precisely capture the effects of the political connections of underwriters.<sup>10</sup>

We collect the information on the underwriters for the IPO deals from WIND, including company name, IPO issuing and listing dates, underwriters' names, company industry, initial offering price, and total offer proceeds.<sup>11</sup> The regulatory decision on IPO application is also compiled from WIND and confirmed by the announcements publicly available from the CSRC website. There were 1314 firms applying for IPOs during our sample period. We delete firms who obtained IPO approval while not listed during our sample period (24 firms). We also eliminate firms lacking the required financial data (26 firms). In addition, we remove firms with total IPO proceeds exceeding RMB 5 billion (64 firms). These giant companies are strategically selected by the central government to go IPO, and we believe that the underwriters' political capital can have little impact on these firms' IPO process.<sup>12</sup> After dropping one firm that initially obtained IPO approval and was subsequently invalidated, we end up with 1200 firms applying for IPOs in our sample. We manually collect the pre-IPO financial data of client firms from the application documents submitted to the CSRC and extract the other financial and stock return data from the China Stock Market and Accounting Research Database (CSMAR).

## 5. Empirical results

### 5.1. Descriptive statistics

Table 1 provides the distribution of our sample underwriters by year. As shown in Panel A, the number of investment banks providing underwriting services ranges from 34 in 2006 to 42, 36, 42, 61, and 60 in 2007, 2008, 2009, 2010, and 2011, respectively. This distribution involves 72 unique investment banks. During the sample period, political connections are prevalent among the underwriters, about 44% of which are politically connected, according to our definition. Accordingly, the PC underwriters represent more than half (52%) of the IPO market (measured by the number of client firms), as reported in Panel B of Table 1. As shown, the market share of PC underwriters is not evenly distributed across different industries. The top three industries with regard to the market share taken by political underwriters are construction (67%), transportation (59%), and finance and insurance (59%), which are subject to stringent regulation by state policies, implying that firms from these regulated industries may have a higher demand for political capital from their underwriter when applying for IPO.

Table 2 provides the descriptive statistics for our main variables of interests, as well as control variables used in our empir-

<sup>6</sup> Ideally, we should consider the political connectedness of other senior managers. Nevertheless, given that a majority of these securities firms are not public firms, it is difficult to obtain such information.

<sup>7</sup> In contrast, firms' political connections can play a role in dealing with governments at different levels to seek valuable resources.

<sup>8</sup> In ascending order, the bureaucratic ranks in China are section head, deputy division or department head, division or department head, deputy bureau head, bureau head, deputy governor or minister, and governor or minister. Officers at the deputy bureau head level and above are appointed and led by the Organization Department of the central or provincial Communist Party of China (CPC) committee (Li and Zhou, 2005).

<sup>9</sup> It requires that IPO candidate firms obtain qualified sponsors as part of an effort to improve governance in its rapidly growing stock markets. According to the Securities Law, the qualifications of sponsors and the regulatory measures governing sponsors shall be formulated by the securities regulatory authority under the State Council.

<sup>10</sup> The regulatory environment of China's stock market has experienced many changes since 1990. Between 1990 and 2000, the central government imposed a strict IPO quota on the provinces and the municipalities under the traditional central planning system. From March 2001 to the present, China has moved to the standard registration system, which allows firms to make the decision to go public by themselves, although the scrutiny and approval of the CSRC is still required.

<sup>11</sup> WIND is the leading capital market information provider in China, occupying about 90% of the institutional market share.

<sup>12</sup> Our results are robust if we include these firms in our sample.

**Table 1**  
Sample.

<i>Panel A Sample of underwriters</i> This table presents the distribution of underwriters by year according to political connection status. The underwriters are defined as politically connected if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC.			
Year	All Underwriters	Politically Connected Underwriters	
		N	Percentage
2006	34	17	50.00%
2007	42	18	42.86%
2008	36	15	41.67%
2009	42	19	45.24%
2010	61	25	40.98%
2011	60	27	45.00%
Total	275	121	44.00%
<i>Panel B Distribution of clients by year</i> This panel presents the distribution of the IPO clients of underwriters by year.			
Year	Full Sample	Clients of PC Underwriters	
		N	Percentage
2006	65	33	50.77%
2007	137	53	38.69%
2008	103	43	41.75%
2009	186	107	57.53%
2010	388	211	54.38%
2011	321	176	54.83%
Total	1200	623	51.92%
<i>Panel C Distribution of clients by industry</i> This panel presents the distribution of IPO clients by industry.			
Industry	Full Sample	Clients of PC Underwriters	
		N	Percentage
Agriculture, forestry, livestock farming, fishery	23	13	56.52%
Mining	23	10	43.48%
Manufacturing	854	443	51.87%
Utilities	9	5	55.56%
Construction	21	14	66.67%
Transportation	17	10	58.82%
IT	141	75	53.19%
Wholesale and retail trade	26	15	57.69%
Finance and insurance	17	10	58.82%
Real estate	10	4	40.00%
Social services	32	14	43.75%
Communication and cultural industry	24	10	41.67%
Comprehensive	3	0	0.00%
Total	1200	623	51.92%

ical tests. The definitions of all variables are provided in the appendix. As Table 2 shows, *Top10*, an indicator variable of whether the underwriter is ranked among the top 10 based on the market share in the two-year period prior to the current IPO year, has a mean of 0.376, indicating that 37.6% of the IPOs are underwritten by the top 10 investment banks. The *Top10* is significantly different between clients of PC and non-PC underwriters, which implies that the investment banks with political connections have a competitive advantage in expanding market share, which is consistent with our prediction based on the rent-seeking argument. We use the *Top10* variable as a measure for reputation because the underwriter with a good reputation typically captures a greater market share. In turn, the underwriter with a larger client pool is expected to care more about its reputation given the greater potential costs associated with the reputational damage caused by a particular underwriting engagement. Thus, we control *Top10* in the regression models. The variable *CenGov*, which equals one if the investment bank is ultimately controlled by the central government and zero

otherwise, has a mean of 0.204 for our full sample, which is significantly higher for clients of PC underwriters. This implies that political connections are more prevalent in underwriters controlled by central financial institutions. Thus, we include this variable to control for the potential impact of political capital that is beyond our definition of political connection. *ForJoin*, which captures the foreign venture partner in the investment bank, has a mean of 0.03 for our full sample, which is higher for the clients of non-PC underwriters compared to those of PC underwriters. The foreign owners tend to bring in their underwriting expertise in the more developed stock market, which may help their clients to gain the approval from the CSRC. Notably, earnings management (*EarnMgmt*) for the clients of PC underwriters has a mean of 0.014 compared to 0.013 for those of non-PC underwriters. However, the difference is not statistically significant. Chaney et al. (2011) find that the politically connected firms engage in more earnings management to hide proprietary information. We thus include *EarnMgmt* as a

**Table 2**  
Descriptive statistics.

Variable	Pooled sample			Political connection = 0			Political connection = 1		
	N	Mean	Median	N	Mean	Median	N	Mean	Median
Top10	1200	0.376	0.000	577	0.276	0.000	623	0.469***	0.000***
CenGov	1200	0.204	0.000	577	0.139	0.000	623	0.265***	0.000***
ForJoin	1200	0.026	0.000	577	0.038	0.000	623	0.014***	0.000***
Prior Pass Rate	1200	0.682	0.818	577	0.624	0.733	623	0.735***	0.85***
EarnMgmt	1200	0.013	0.006	577	0.013	0.006	623	0.014	0.006
Assets	1200	19.724	19.609	577	19.648	19.579	623	19.795***	19.686**
Leverage	1200	0.202	0.152	577	0.201	0.148	623	0.204	0.153
ROA	1200	0.132	0.118	577	0.132	0.119	623	0.132	0.117
Current Ratio	1200	1.683	1.422	577	1.687	1.468	623	1.679	1.368
SOE	1200	0.188	0.000	577	0.191	0.000	623	0.185	0.000
FirmPC	1200	0.019	0.000	577	0.021	0.000	623	0.018	0.000
AuditPC	1200	0.138	0.000	577	0.144	0.000	623	0.132	0.000
FirmAge	1200	8.305	8.000	577	8.378	8.000	623	8.238	8.000
IndPolicy	1200	0.625	1.000	577	0.631	1.000	623	0.620	1.000
Marketization	1200	9.593	10.550	577	9.551	9.550	623	9.631	10.550***
Proceeds	955	20.205	20.189	442	20.141	20.148	513	20.261***	20.245***
Days	955	2.420	2.398	442	2.447	2.398	513	2.396***	2.398***
Ownership	955	0.381	0.375	442	0.383	0.375	513	0.379	0.378
Exchange	955	0.063	0.000	442	0.048	0.000	513	0.076*	0.000*
Assets_IPO	955	20.925	20.824	442	20.849	20.741	513	20.990***	20.895***
Leverage_IPO	955	0.233	0.198	442	0.227	0.195	513	0.238	0.203
Pre-IPO Growth	955	0.266	0.235	442	0.264	0.236	513	0.267	0.235

This table provides the descriptive statistics for all the control variables used in the analysis. The definition for each variable is reported in the Appendix.

\* statistical significance at the 10% levels.

\*\* statistical significance at the 5%.

\*\*\* statistical significance at the 1%.

control variable in our regressions.<sup>13</sup> We also control for *Prior Pass Rate*, which is defined as the passing rate of all deals underwritten by the investment bank in two years prior to the current IPO. This variable can be a combined proxy for both the professionalism and political capital of underwriters in helping their clients obtain IPO approval from the regulator. The mean of *Prior Pass Rate* is 0.735 and 0.624 among PC and non-PC underwriters, and the difference is statistically significant, suggesting that the political connection of underwriters contributes significantly to the difference. A set of financial variables of the firms is also controlled in our analysis. We define *Assets* as the logarithm value of the average total assets in the three years before the IPO. The mean of the *Assets* (19.80) for the client firms of PC underwriters differs significantly from that (19.65) for those of non-PC underwriters. Our sample client firms have a mean leverage of 0.202 and a median of 0.152 overall, and there is no statistical difference in leverage between the client firms of the two types of underwriters. *ROA*, defined as the average return on assets in the three years before the IPO, has a mean and median of 13.2% and 11.8%, indicating that these firms are relatively good performers as a result of the bright line regulation on the IPO requirement. Our sample firms are also liquid, with a mean and median of the current ratio greater than 1. *FirmPC* measures the firms' own political connection, which may also have an impact on the regulatory decision or even the choice of underwriter. Thus, we control this variable in our analysis. *FirmPC* has a mean of 0.018 and 0.021 among the clients of PC underwriter and non-PC underwriter, respectively. Yang (2013) finds that the auditor political connection can help its clients to obtain the approval for the IPO application. Therefore, we control for *AuditPC* in our analysis. It equals one if the partner of the audit firm serves on the Issuance Examination Committee of the CSRC and zero otherwise. The mean of *AuditPC* is 13.8% for the full sample, indicating that some of our sample IPO firms are audited by firms connected to

the CSRC. There are no statistically significant differences between the mean and median of the *AuditPC* variable for our two subsamples. *FirmAge*, which is the number of years since the foundation of the firm to the year of the IPO application, does not exhibit any difference between the clients of PC and non-PC underwriters. *IndPolicy*, the indicator for the industry supporting policy, is statistically similar for clients of PC and non-PC underwriters. We control these variables because they potentially influence the regulatory decision. The descriptive statistics for *marketization*—that is, the marketization index (Fan and Wang, 2009)—reveals that more clients of PC underwriters are from regions with greater marketization as the medians of two subsamples exhibit a significant difference.

The total proceeds (the logarithm of the amount of proceeds raised in the IPO) for our sample IPOs have a mean and median of 20.205 and 20.189, respectively. In addition, the total proceeds raised by the clients of PC underwriters are significantly greater than those raised by the clients of non-PC underwriters. Consistent with the difference in IPO size, it also takes less time for the clients of PC underwriters to be listed after IPOs. The mean and median of *Ownership*, which is the percentage of shares owned by the largest shareholder after the IPO, is 38.1% and 37.5%, respectively, indicating that the ownership of Chinese firms is relatively concentrated. There is no difference in *Ownership* between the clients of PC versus non-PC underwriters. The *Exchange* variable takes a mean of 0.063, implying that 6.3% of the firms in our sample are listed on the Shanghai Stock Exchange. This is mainly due to the changes in the stock market structure during our sample period—that is, the opening of the Growth Enterprises Market (GEM) and Small and Medium Enterprises (SME) markets in the Shenzhen Stock Exchange. It appears that the clients of PC underwriters are more likely to be listed in the Shanghai Stock Exchange compared with those of non-PC underwriters (7.6% vs. 4.8%). The assets after IPO (*Assets\_IPO*) are still larger for clients of PC underwriters. However, there is no significant difference in the leverage (*Leverage\_IPO*) of clients underwritten by PC versus non-PC under-

<sup>13</sup> Chen and Yuan (2004) show that earnings quality is the concern of regulators in approving applications for rights offerings.

**Table 3**  
Correlation of variables in main regression.

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
1.Pass	1.000																
2.Political Connection	0.069	1.000															
3.Top10	0.017		1.000														
4.CenGov	0.067	0.199		1.000													
5.ForJoin	0.020	0.000			1.000												
6.Pre Pass Rate	0.009	0.156	−0.056			1.000											
7.EarnMgmt	0.747	0.000	0.053				1.000										
8.Assets	−0.022	−0.075	−0.040	−0.004				1.000									
9.Leverage	0.443	0.010	0.170	0.882					1.000								
10.ROA	0.042	0.192	0.375	0.074	−0.063					1.000							
11.Current Ratio	0.149	0.000	0.000	0.010	0.028						1.000						
12.SOE	−0.014	0.008	0.019	−0.008	0.005	0.052						1.000					
13.FirmPC	0.625	0.786	0.502	0.795	0.863	0.074							1.000				
14.AuditPC	0.058	0.083	0.113	0.111	0.008	0.089	−0.340							1.000			
15.FirmAge	0.043	0.004	0.000	0.000	0.795	0.002	0.000								1.000		
16.IndPolicy	−0.023	0.006	0.037	0.004	−0.018	0.067	−0.100	−0.010								1.000	
17.Marketization	0.437	0.829	0.204	0.886	0.529	0.020	0.001	0.727									1.000
	0.052	−0.003	0.058	−0.024	0.000	0.111	0.411	−0.508	−0.058								
	0.074	0.932	0.046	0.411	0.989	0.000	0.000	0.000	0.044								
	−0.036	−0.005	0.035	−0.052	0.033	0.054	0.392	−0.498	−0.131	0.641							
	0.219	0.873	0.231	0.073	0.251	0.063	0.000	0.000	0.000	0.000							
	0.025	−0.008	−0.029	0.101	0.056	−0.043	−0.062	0.260	−0.069	−0.149	−0.111						
	0.383	0.789	0.317	0.001	0.051	0.137	0.033	0.000	0.017	0.000	0.000						
	0.056	−0.011	0.042	0.110	0.092	0.029	−0.063	0.132	0.003	−0.076	−0.034	0.213					
	0.055	0.692	0.145	0.000	0.001	0.314	0.028	0.000	0.916	0.008	0.245	0.000					
	0.039	−0.018	−0.020	−0.010	0.027	−0.004	0.079	−0.052	−0.033	0.065	0.080	0.013	0.015				
	0.173	0.539	0.488	0.726	0.359	0.881	0.006	0.070	0.254	0.024	0.006	0.658	0.609				
	−0.290	−0.013	0.007	−0.015	−0.003	0.062	0.013	0.060	−0.037	−0.073	−0.010	−0.003	−0.049	−0.010			
	0.000	0.643	0.799	0.606	0.932	0.033	0.653	0.038	0.203	0.012	0.736	0.926	0.091	0.733			
	0.071	−0.012	−0.046	−0.026	0.007	0.012	0.115	−0.160	−0.102	0.119	0.166	−0.016	−0.030	0.044	−0.007		
	0.015	0.687	0.113	0.365	0.815	0.685	0.000	0.000	0.000	0.000	0.000	0.580	0.302	0.125	0.805		
	0.043	0.022	0.049	0.033	−0.019	0.041	0.051	−0.060	0.098	0.104	0.056	−0.208	−0.083	−0.005	−0.001	−0.102	
	0.138	0.440	0.092	0.254	0.520	0.161	0.078	0.037	0.001	0.000	0.052	0.000	0.004	0.867	0.962	0.000	

This table presents the *Pearson* correlation coefficient among all the variables used in the analysis.

writers. We measure growth as the average growth in sales, which does not show a significant difference for the clients of the two types of underwriters.

Table 3 reports the correlation matrix. Our main variable of interest, *Political Connection*, and several control variables—*Top10*, *Assets*, *ROA*, *Firm PC*, and *IndPolicy*—are positively correlated with *Pass* and are statistically significant at the conventional level. *Firm Age* is negatively correlated with *Pass*, which is significant at the 1% level. In addition, *CenGov*, *Top10*, *Prior Pass Rate*, and *Assets* are positively correlated with *Political Connection*, and *ForJoin* is negatively correlated with *Political Connection*, which confirms the importance of controlling for these variables in all subsequent analyses. Regarding the correlation among the other variables, we do not find any irregularities.

## 5.2. Effect of political connections on regulatory decisions

Given the fierce competition for issuing equity in capital markets and the regulatory barriers to these markets in China, underwriters' political connections may potentially help client firms to conquer these barriers. Table 4 provides the results for the univariate test and logistic regressions examining the impact of the underwriters' political connections on the regulatory decisions regarding IPO applications.

Panel A of Table 4 illustrates a univariate analysis of the approval rate of IPO applications. The approval rate for the clients of PC underwriters is 82.30%, whereas it is only 76.77% for the clients of non-PC underwriters. The difference in the approval rate for clients of PC versus non-PC underwriters is statistically significant at 5% with a chi-square of 5.731. Panel B of Table 4 presents the results of the logistic regressions used to analyze the effects of political connections on the likelihood of obtaining IPO approval.

Column (1) presents the baseline model without including the political connections of underwriters. All the variables in the baseline model are loaded with coefficients that are generally consistent with theoretical predictions. For example, the coefficient on *Top10* is positive and significant at 1%, suggesting that clients of large underwriters are more likely to obtain IPO approval. Consistent with Yang (2013), we obtain a significant and positive coefficient on *AuditPC*. As expected, a number of firm characteristics affect the likelihood of IPO approval. Specifically, larger firms, better performing firms, lower-leveraged firms, younger firms, and firms from industries with more government support according to the industrial policy are more likely to obtain IPO approval. As revealed in columns (2) and (3), the estimated coefficients on both measures of the political connection variables (*Political Connection* and *Political Rank*) are 0.283 and 0.238, and both are statistically significant at the 5% level. To determine the economic significance of our finding, we predict the probability of gaining approval by the CSRC for IPO application underwritten by the PC and non-PC underwriter, respectively, by holding all the control variable constant at their mean. It shows that the client of the PC underwriter has a probability of 82.74% to get the approval, while the client of the non-PC underwriter has a probability of only 78.31%. The difference of 4.43% in the probability is of economic significance given the tight regulation in the IPO market of China. However, the indicator variables for the ownership of underwriter, *CenGov* (central government-owned underwriter) and *ForJoin* (foreign-owned underwriters), are not loaded significantly although the signs of coefficients are consistent with our predictions.

Columns (4) and (5) show the regression results when we use an alternative measure of political connection—that is, *Political Rank*—a refined measure that captures the strength of the political connection. It is measured based on the highest political hierar-



**Table 4**

Effects of political connections on regulatory decisions.

Panel A Univariate test

This panel provides the univariate test for the difference in approval rate for clients of underwriters with and without political connections. The underwriters are defined as politically connected if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC.

	Clients of politically connected underwriters	Clients of non-politically connected underwriters
Number of clients rejected	110	134
Number of clients approved	513	443
Approval rate	82.30%	76.77%
Test for difference in approval rate	Chi <sup>2</sup> = 5.731 (p-value = 0.017)	

Panel B Multivariate test

This panel presents the regression results for the effects of underwriters' political connections on regulatory decisions. The dependent variable is Pass, which is equal to 1 if the IPO application is approved by CSRC, and zero otherwise. *Political Connection* equals one if the chairman or CEO of the investment bank has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC, and zero otherwise. *Political Rank* takes value according to the CEO or chairman's political hierarchy as: 0 for no political connection or below deputy bureau level; 1 at the deputy bureau level; 2 at the bureau level; 3 at or above the deputy provincial level or in the CSRC and/or currently sitting on the Issuance Examination Committee or M&A Committee of the CSRC. All other variables are defined as in the appendix. The logistic model is applied with standard error clustered by industry. T statistics are reported in parentheses.

Variables	(1)	(2)	(3)	(4)	(5)
Political Connection		0.283** (2.244)	0.238** (2.413)		
Political Rank				0.130** (2.284)	0.133** (2.419)
Top10	0.334*** (3.732)	0.374*** (5.284)	0.289*** (3.578)	0.399*** (5.735)	0.298*** (3.655)
CenGov	−0.015 (−0.131)	0.047 (0.566)	−0.079 (−0.631)	−0.021 (−0.224)	−0.149 (−0.990)
ForJoin	−0.411 (−1.087)	−0.335 (−0.842)	−0.366 (−0.942)	−0.350 (−0.971)	−0.433 (−1.193)
Prior Pass Rate	0.162 (0.825)		0.120 (0.612)		0.266** (2.338)
EarnMgmt	−2.180 (−1.006)		−2.414 (−1.104)		0.779 (0.256)
Assets	0.413*** (3.818)		0.403*** (3.650)		0.383*** (2.825)
ROA	3.575** (2.368)		3.704** (2.513)		3.932** (2.561)
Leverage	−2.174*** (−2.644)		−2.127*** (−2.605)		−1.297** (−2.319)
Current Ratio	−0.436** (−2.452)		−0.436** (−2.441)		−0.211 (−1.212)
SOE	−0.005 (−0.020)		0.002 (0.010)		0.164 (1.038)
FirmPC	1.322 (1.297)		1.362 (1.326)		2.461 (0.870)
AuditPC	0.283** (2.122)		0.280** (2.073)		0.429*** (3.178)
FirmAge	−0.140*** (−18.113)		−0.140*** (−17.155)		−0.142*** (−20.646)
IndPolicy	0.547*** (2.909)		0.546*** (2.900)		0.633*** (4.078)
Marketization	0.084** (2.040)		0.084** (2.042)		0.099** (2.216)
Constant	−5.550*** (−2.749)	1.037*** (9.481)	−5.441*** (−2.686)	1.251*** (16.895)	−6.057*** (−2.846)
Year Dummies	Yes	Yes	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes	Yes	Yes
Observations	1200	1200	1200	1200	1200
Pseudo R-squared	0.136	0.062	0.138	0.066	0.176

\*statistical significance at the 10% levels.

\*\* statistical significance at the 5%.

\*\*\* statistical significance at the 1%.

chy ever taken by the chairman or CEO of the underwriter. Consistent with prior results, we obtain a positive coefficient on *Political Rank* (at  $p < 0.05$ ), suggesting that the higher the political rank of the underwriters' CEO/chairman, the more likely that their client firms may obtain IPO approval. In summary, the above results support our hypothesis that underwriters' political capital is important in circumventing the regulatory barriers to IPO financing, which is consistent with the rent-seeking argument. We also find that the historical performance underwriter, the *Prior Pass Rate*, is loaded with a significant and positive coefficient in Column (5), implying the persistence of the underwriter's ability to push his clients through CSRC's examination.

However, we need to apply caution in interpreting our empirical evidence from Table 4 because the matched pairs of client and underwriter are not randomly determined. We expect firms without their own political capital to be more likely to hire a PC underwriter given the important role of the political connection in the examination process. Nevertheless, this selection concern may bias us against documenting a positive association between the political connection of the underwriter and the likelihood of obtaining approval if firms' own political connection can be a substitute for that of underwriters. Indeed, we already control for both the clients' political connection (*FirmPC*) and auditors' political connection (*AuditPC*), potentially another substituting factor, in the regression model. Furthermore, the PC underwriters may be willing to serve clients who can pay higher underwriting fees to maximize the value of their political capital. On the one hand, it is possible that only clients with better economic fundamentals can afford premium underwriting fees and hire a PC underwriter. On the other hand, it may be the case that clients with poor fundamentals need to rely more heavily on the political capital of underwriters and hire PC underwriters. In order to account for the potential impact of such selection bias, although not obvious in which direction, we have tried to control as many fundamental factors as possible in our model. Nevertheless, we acknowledge that we cannot completely rule out the selection issues in our analyses, which may be a caveat of our study.

### 5.3. Effects of political connections on underwriting fees

Our findings suggest that the clients of PC underwriters potentially benefit from hiring a PC underwriter by increasing the likelihood of obtaining approval for their IPO applications. The underwriters, thus, have an opportunity to enjoy the economic rents of their political capital by charging premium underwriting fees. Table 5 presents the results of our analysis of the impact of underwriters' political connections on underwriting fees.

Panel A of Table 5 shows the results of the univariate test on the underwriting fees. *Fee* is defined as the underwriting fee scaled by proceeds raised in the IPO. The univariate test does not show a significant difference in the underwriting fees charged by PC and non-PC underwriters, both of which are on average around 5.3% of the total proceeds raised by their clients. We report the results of the multivariate regressions in Panel B of Table 5. Column (1) presents the estimation result for the baseline model. As reported, the underwriting fee is associated with the firm fundamentals. For example, both *Proceeds* and *Assets* are loaded with negative and significant coefficients due to the scale of economy. *ROA* and *Firm PC* are also loaded with negative and significant coefficients because the firms with better performance pose a lower litigation risk in the IPO process, and firms may utilize their own political connections to push through an IPO approval. We obtain a positive and significant coefficient on *FirmAge*, consistent with firms with a longer history demand for more effort in the underwriting process, such as the need for firm restructurings before the IPO. We report the results for the tests of the impact of underwriters' po-

litical connection on underwriting fees in Columns (2) and (3). As shown, we obtain positive coefficients of 0.002 and 0.001 on *Political Connection* and *Political Rank*, respectively, which are statistically significant at the 5% and 10% level. This evidence supports that political connection generates significant economic rents for investment banks in the IPO underwriting businesses. The effect of the control variables exhibits similar patterns as we show in the results for the baseline model. Collectively, the empirical results support our H2, implying that political capital generates economic rents for underwriters by allowing them to charge premium underwriting fees.

### 5.4. Effect of political connection on post-IPO performance

The above evidence indicates that both underwriters and their clients can realize their own economic rents from the political capital of underwriters. Therefore, the professional role of the underwriter may be undermined accordingly. A possible economic consequence of the lack of professionalism in the IPO process could be the inferior performance of IPO firms in the post-IPO period. To explore whether such an effect exists, we plot Fig. 1, which demonstrates the differences in the long-term post-IPO returns, as measured by *CAR* (cumulative abnormal returns adjusted by market returns), for client firms underwritten by PC vs. non-PC underwriters. Consistent with our expectation, the clients of PC underwriters underperform the market significantly in two years after their IPOs, while the clients of non-PC underwriters outperform the market in the same period. Panel A of Table 6 presents the univariate analysis of the *CAR* in one year and two years after IPOs. As shown, the mean and median of *CAR* for the client firms underwritten by PC investment banks are relatively more negative than those for the clients of non-PC investment banks, and the differences are statistically significant. The mean *CAR* of the client firms of PC underwriters is approximately -6.5% over the two years after the IPOs, compared to 0.08% for the clients of non-PC underwriters. Additional analysis (untabulated) shows that about 60.3% of the client firms of PC underwriters experience negative *CAR* over the two years after the IPOs, whereas only 51.4% of the non-PC underwriters' client firms experience negative *CAR*. Such evidence suggests that unqualified client firms may have chosen PC underwriters to utilize their political capital to facilitate regulatory approval of their IPO applications.

We formally test the effects of underwriters' political connections on their client firms' post-IPO stock performance and present the results in Panel B of Table 6. In the baseline model, we observe a significantly positive coefficient on the *Top10* variable in the model with the *CAR* measured over two after the IPO, implying that underwriters' professionalism plays a role in protecting the interests of minority shareholders. We document negative coefficients on *ForJoin* and significantly positive coefficients for *CenGov*. This does not necessarily mean that the foreign-owned investment banks are less professional than the state-owned ones. It may be due to the difference in their client pools, which deserves a follow-up study. Unlike Fan et al. (2007), we document a positive coefficient on firms' political connections even though it is not statistically significant. We believe the difference is mainly due to the different sample compositions of the two studies. We have more than 70% family firms in our sample, while Fan et al. (2007) have 90% state-owned enterprises in their sample. The political connection serves as an intervention channel by government in state-owned enterprises in Fan et al. (2007), while it is expected to facilitate rent seeking in family firms (Fisman, 2001). The firm's own political connection is expected to continue to facilitate the rent-seeking activities of the firm in the post-IPO period. Thus, the prediction on the impact of firm political connection on its post-IPO performance

**Table 5**

Effects of political connections on underwriting fees.

<i>Panel A Univariate test</i>			
This table provides the univariate test for the underwriting fee, which is defined as the underwriting fee scaled by the proceeds from IPO. The underwriters are defined as politically connected if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC.			
	All sample		
	N	Mean	Median
Clients of politically connected underwriters	513	0.053	0.051
Clients of non-politically connected underwriters	442	0.053	0.050
Difference		0.000	0.001
T/Z-statistics for test of difference		0.177	0.268
<i>Panel B Multivariate test</i>			
This table presents the results for the effects of underwriters' political connections on the underwriting fees, which is the underwriting fee scaled by the proceeds of the IPO. <i>Political Connection</i> equals one if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC, and zero otherwise. <i>Political Rank</i> takes value according to CEO or chairman's political hierarchy as 0 for no political connection or below deputy bureau level; 1 at the deputy bureau level; 2 at the bureau level; 3 at or above the deputy provincial level or in the CSRC and/or currently sitting on the Issuance Examination Committee or M&A Committee of the CSRC. All other variables are defined as in the appendix. The OLS model is applied with standard error clustered by industry.			
VARIABLES	(1)	(2)	(3)
Political Connection		0.002*	
		(1.783)	
Political Rank			0.001**
			(2.957)
Top10	−0.001	−0.001	−0.001*
	(−0.854)	(−1.376)	(−1.837)
CenGov	−0.003***	−0.004***	−0.004***
	(−5.432)	(−5.349)	(−5.454)
ForJoin	0.003	0.004	0.003
	(1.025)	(1.300)	(1.129)
Prior Pass Rate	0.015***	0.015***	0.015***
	(19.165)	(27.161)	(20.410)
Proceeds	−0.009***	−0.009***	−0.009***
	(−9.625)	(−9.894)	(−10.134)
Assets	−0.006***	−0.006***	−0.006***
	(−8.469)	(−8.604)	(−8.571)
ROA	−0.030***	−0.029***	−0.030***
	(−3.610)	(−3.411)	(−3.740)
Leverage	−0.001	−0.001	−0.001
	(−0.714)	(−0.461)	(−0.517)
SOE	−0.000	−0.000	0.000
	(−0.079)	(−0.034)	(0.025)
FirmPC	−0.006***	−0.006***	−0.006***
	(−3.801)	(−3.798)	(−3.641)
AuditPC	−0.000	−0.000	−0.000
	(−0.208)	(−0.202)	(−0.149)
FirmAge	0.001***	0.001***	0.001***
	(11.547)	(12.939)	(11.971)
IndPolicy	0.000	0.000	0.000
	(0.442)	(0.449)	(1.013)
Marketization	−0.000	−0.000	−0.000
	(−0.642)	(−0.776)	(−0.568)
Constant	0.353***	0.356***	0.351***
	(38.470)	(31.660)	(38.801)
Year Dummies	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes
Observations	955	955	955
Adjusted R-squared	0.334	0.333	0.339

\* statistical significance at the 10% levels.

\*\* statistical significance at the 5%.

\*\*\* statistical significance at the 1%.

**Table 6**

Effect of PC underwriter on post-IPO stock performance.

*Panel A Univariate test*

This table provides the univariate for the cumulative abnormal returns in one and two years after the IPO for the politically connected and non-politically connected underwriter. Abnormal return is market-adjusted return. The underwriters are defined as politically connected if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of the CSRC.

	Cumulative Abnormal Return in one year after IPO			Cumulative Abnormal Return in two years after IPO		
	N	Mean	Median	N	Mean	Median
Clients of PC underwriters	513	−0.064	−0.111	471	−0.065	−0.138
Clients of non-PC underwriters	442	−0.02	−0.05	405	0.008	−0.012
Difference		−0.044**	−0.061**		−0.073**	−0.126**
T/Z-statistics		2.056	2.207		−2.509	−2.579

*Panel B Multivariate test*

This table presents the results for the effects of underwriters' political connections on their clients' post-IPO stock performance. *Political Connection* equals one if the chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC, and zero otherwise. *Political Rank* takes value according to the CEO or chairman's political hierarchy as 0 for no political connection or below deputy bureau level; 1 at the deputy bureau level; 2 at the bureau level; 3 at or above the deputy provincial level or in the CSRC and/or currently sitting on the Issuance Examination Committee or M&A Committee of the CSRC. All other variables are defined as in the appendix. All the variables are defined as in the appendix. The OLS model is applied with standard error clustered by industry, and T statistics are reported in parentheses.

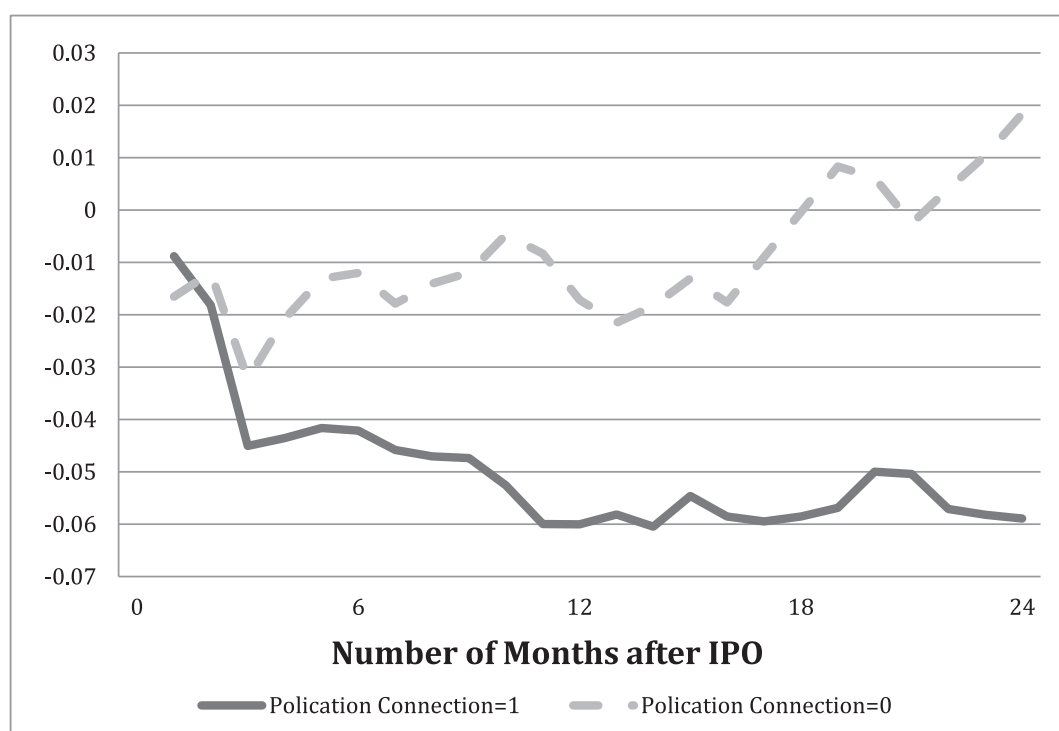
Variables	(1)	(2)	(3)	(4)	(5)	(6)
	CAR in one year after IPO			CAR in two year after IPO		
Political Connection		−0.047*** (−3.090)			−0.080*** (−3.154)	
Political Rank			−0.016** (−2.249)			−0.025* (−1.805)
Top10	−0.007 (−0.493)	0.001 (0.089)	−0.000 (−0.011)	0.051** (2.910)	0.063*** (3.248)	0.060*** (3.343)
CenGov	0.043** (2.843)	0.051*** (3.104)	0.056*** (3.095)	0.055* (1.854)	0.069** (2.446)	0.077** (2.881)
ForJoin	−0.164*** (−4.691)	−0.172*** (−4.679)	−0.165*** (−4.522)	−0.190*** (−4.755)	−0.203*** (−5.582)	−0.215*** (−6.129)
Prior Pass Rate	0.001 (0.063)	0.009 (0.419)	0.000 (0.016)	−0.002 (−0.043)	0.013 (0.335)	−0.002 (−0.059)
Assets_IPO	−0.030** (−2.455)	−0.029** (−2.378)	−0.031** (−2.562)	−0.134*** (−6.166)	−0.133*** (−6.284)	−0.138*** (−7.988)
Leverage_IPO	0.066 (1.539)	0.078 (1.732)	0.074 (1.687)	0.113 (1.738)	0.135* (1.986)	0.110 (1.350)
Pre-IPO Growth	0.090 (1.346)	0.091 (1.378)	0.089 (1.320)	0.162 (1.228)	0.161 (1.231)	0.124 (0.842)
Ownership	−0.037 (−0.638)	−0.040 (−0.696)	−0.042 (−0.718)	0.005 (0.080)	0.001 (0.019)	0.005 (0.085)
SOE	−0.029 (−1.109)	−0.030 (−1.085)	−0.030 (−1.103)	0.008 (0.348)	0.008 (0.317)	−0.004 (−0.126)
FirmPC	0.011 (0.242)	0.005 (0.114)	0.007 (0.154)	0.097 (1.649)	0.088 (1.567)	0.025 (0.340)
AuditPC	−0.007 (−0.415)	−0.009 (−0.494)	−0.008 (−0.467)	−0.061* (−2.088)	−0.062* (−2.170)	−0.068** (−2.603)
FirmAge	0.002 (0.642)	0.002 (0.590)	0.002 (0.654)	0.006 (1.599)	0.006 (1.495)	0.006 (1.746)
IndPolicy	0.037** (2.262)	0.038** (2.291)	0.037** (2.203)	0.043 (1.402)	0.044 (1.431)	0.021 (0.911)
Marketization	−0.011** (−2.766)	−0.011** (−2.824)	−0.011** (−2.874)	0.002 (0.472)	0.002 (0.486)	0.001 (0.100)
Constant	0.652** (2.542)	0.662** (2.545)	0.696** (2.716)	2.636*** (6.325)	2.643*** (6.536)	2.914*** (10.123)
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Observations	955	955	955	876	876	876
Adjusted R-squared	0.026	0.030	0.028	0.054	0.061	0.077

\* statistical significance at the 10% levels.

\*\* statistical significance at the 5%.

\*\*\* statistical significance at the 1%.





**Fig. 1.** This figure plots the distribution of Cumulative Abnormal Return up to 24 months after IPO for firms underwritten by politically connected and non-politically connected investment banks. The abnormal return is the monthly market-adjusted return.

indeed depends on the composition of the research sample.<sup>14</sup> Consistent with Yang (2013), the coefficient on *AuditPC* is significantly negative. The estimated coefficient on *Political Connection* is significantly negative (at the 1% level) in both models with CAR measured over one and two years after the IPO as the dependent variables, respectively. The results remain similar when we replace *Political Connection* with *Political Rank*. This implies that the interests of minority shareholders may be harmed when investing in an IPO underwritten by PC underwriters. The political capital of the underwriter, similar to that of other market intermediaries, such as audit firms (Yang, 2013), may facilitate the low-quality IPO applicants in obtaining approval from the regulators.

In addition, we test the effects of underwriters' political connections on their client firms' accounting performance in the post-IPO period, measured alternatively by change in ROS, growth in sales, and growth in EBIT. We report the results in Table 7. The descriptive statistics, as presented in Panel A of Table 7, show that the post-IPO accounting performance of the clients of PC underwriters are generally worse than that of the clients of non-PC underwriters. The results of the regression analyses are provided in Panel B of Table 7. Both *Political Connection* and *Political Rank* load with a significantly negative coefficient in all regressions. Thus, we document some evidence consistent with the clients of PC underwriters underperform those of non-PC underwriters in the post-IPO period. The underperformance in the post-IPO period also helps exclude the potential alternative explanation

for the evidence documented in the IPO approval and underwriting fee model. Rather than rent seeking, the political connection can be a proxy for expertise in handling the bureaucratic regulation. Specifically, underwriters with political connections, such as having executives sitting on the examination committee, may understand the rules and approval process much better than other underwriters without such experience. Consequently, clients of PC underwriters are more likely to pass the IPO screening process of the regulator, and, in turn, they may be willing to pay premium underwriting fees. However, if that is the case, we should not observe the post-IPO underperformance among the clients of PC underwriters as shown in the paper.

### 5.5. Effect of political connection on underpricing

Due to the potential detriment of shareholders' interests arising from the rent-seeking behavior of PC underwriters and their clients, minority shareholders may choose to price-protect themselves. If so, we expect to observe greater underpricing of IPOs underwritten by PC investment banks. Table 8 presents the results of the effect of the political connections of the underwriter on the IPO underpricing. The univariate analysis in Panel A of Table 8 shows that the means and medians of the IPO underpricing variable differ significantly between the client firms of the two types of underwriters. However, our multivariate regression analysis shows a negative coefficient of  $-0.002$  on *Political Connection* while it is statistically insignificant, as presented in column (1) of Panel B. Such results can be explained as minority shareholders failing to account for the rent-seeking incentives of the PC underwriters in the IPO process. Alternatively, this can also be attributed to the limited investment channels and inferior bargaining power of investors in the Chinese IPO market, who are prohibited from the rational pricing of IPO deals. Consistent with underpricing to compensate investors for information asymmetry, the negative coefficient on *Proceeds* suggests that large firms demand a

<sup>14</sup> We perform an analysis of the impact of political connection on post-IPO performance in the subsamples of family firms versus SOEs respectively. The untabulated results show that political connection has a negative impact on the post-IPO performance with regard to both stock returns and accounting measures for the sample of SOEs, while political connection loads with a positive coefficient in the same estimation for the non-SOEs subsample. This confirms our conjecture that the seemingly inconsistent evidence of the impact of a firm's political connection on its post-IPO performance documented in our study is mainly attributable to the difference in the sample composition.

**Table 7**  
Effect of PC underwriters on post-IPO accounting performance.

*Panel A Univariate test*

This table provides the univariate test for the difference in the post-IPO accounting performance for firms underwritten by politically connected and non-politically connected investment banks. The underwriters are defined as politically connected if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of the CSRC.

	N	Change in ROS		Growth in Sales		Growth in EBIT	
		Mean	Median	Mean	Median	Mean	Median
Clients of PC underwriters	513	−0.061	−0.049	0.871	0.74	0.34	0.197
Clients of non-PC underwriters	442	−0.051	−0.036	0.913	0.758	0.49	0.387
Difference		−0.010**	−0.013**	−0.042	−0.018	−0.15***	−0.190***
T/Z-statistics		−2.102	−2.415	−0.910	−0.248	−2.573	−2.853

*Panel B Multivariate test*

This table presents the results for the effect of underwriters' political connections on their clients' post-IPO accounting performance. The dependent variables are *Change in ROS*, which is the change in the average ROS over the three years before the IPO to that over two years after the IPO; *Growth in Sales*, which is percentage growth in average sales over the three years before the IPO to that over two years post-IPO; and *Growth in EBIT*, which is percentage growth in average EBIT over the three years before the IPO to that over two years post-IPO, alternatively. *Political Connection* equals one if the chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of CSRC, and zero otherwise. *Political Rank* takes value according to the CEO or chairman's political hierarchy as 0 for no political connection or below deputy bureau level; 1 at the deputy bureau level; 2 at the bureau level; 3 at or above the deputy provincial level or in the CSRC and/or currently sitting on the Issuance Examination Committee or M&A Committee of the CSRC. All other variables are defined as in the appendix. All the variables are defined as in the appendix. The OLS model is applied with standard error clustered by industry, and T statistics are reported in parentheses.

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
		Change in ROS			Growth in Sales			Growth in EBIT	
Political Connection		−0.014*			−0.072*			−0.207**	
		(−2.042)			(−1.948)			(−3.004)	
Political Rank			−0.005*			−0.036**			−0.089***
			(−1.848)			(−2.402)			(−3.695)
Top10	0.002	0.005	0.005	−0.055	−0.042	−0.039	0.007	0.045	0.046
	(1.052)	(1.452)	(1.415)	(−1.049)	(−0.809)	(−0.719)	(0.250)	(1.470)	(1.570)
CenGov	0.006*	0.008***	0.010***	0.026	0.038	0.055	0.132**	0.167***	0.206***
	(2.166)	(3.325)	(3.547)	(0.663)	(0.987)	(1.371)	(2.646)	(3.328)	(3.636)
ForJoin	0.010	0.007	0.009	−0.091	−0.105	−0.095	0.154	0.114	0.145
	(0.963)	(0.699)	(0.943)	(−0.920)	(−1.124)	(−0.969)	(1.322)	(1.113)	(1.300)
Prior Pass Rate	−0.006	−0.003	−0.006	0.003	0.016	0.003	−0.043	−0.008	−0.044
	(−0.784)	(−0.396)	(−0.788)	(0.073)	(0.375)	(0.066)	(−0.942)	(−0.147)	(−0.920)
Assets_IPO	0.001	0.002	0.001	0.009	0.010	0.008	0.029	0.033	0.027
	(0.456)	(0.548)	(0.428)	(0.289)	(0.331)	(0.257)	(0.714)	(0.824)	(0.683)
Leverage_IPO	0.107***	0.109***	0.108***	0.414**	0.428**	0.420**	0.451*	0.491*	0.468*
	(4.814)	(4.781)	(4.769)	(2.321)	(2.408)	(2.382)	(1.859)	(1.988)	(1.905)
Pre-IPO Growth	−0.053**	−0.053**	−0.054**	1.055***	1.054***	1.049***	0.570*	0.569*	0.557
	(−2.788)	(−2.817)	(−2.778)	(3.723)	(3.727)	(3.685)	(1.840)	(1.847)	(1.757)
Ownership	0.016	0.015	0.014	−0.089	−0.095	−0.103	−0.018	−0.036	−0.053
	(0.780)	(0.713)	(0.652)	(−0.702)	(−0.739)	(−0.798)	(−0.083)	(−0.164)	(−0.234)
SOE	0.000	0.000	−0.000	−0.094	−0.095	−0.099	−0.061	−0.064	−0.073
	(0.137)	(0.073)	(−0.092)	(−1.244)	(−1.215)	(−1.239)	(−1.461)	(−1.355)	(−1.385)
FirmPC	−0.010	−0.012	−0.012	−0.103	−0.111	−0.114	−0.178	−0.199	−0.204
	(−0.517)	(−0.585)	(−0.589)	(−0.511)	(−0.549)	(−0.565)	(−0.802)	(−0.913)	(−0.925)
AuditPC	−0.010	−0.010	−0.010	−0.093**	−0.095**	−0.094**	−0.110	−0.115*	−0.113*
	(−1.525)	(−1.681)	(−1.637)	(−2.740)	(−2.859)	(−2.885)	(−1.667)	(−1.895)	(−1.881)
FirmAge	0.000	0.000	0.001	−0.013***	−0.013***	−0.013***	−0.004	−0.004	−0.003
	(0.962)	(0.842)	(0.961)	(−3.322)	(−3.422)	(−3.218)	(−0.808)	(−0.893)	(−0.643)
IndPolicy	0.004**	0.004**	0.003*	0.069***	0.071***	0.067***	0.097***	0.101***	0.091***
	(2.184)	(2.703)	(1.953)	(5.175)	(4.915)	(4.613)	(13.734)	(14.629)	(13.163)
Marketization	−0.001	−0.001	−0.001	0.012	0.012	0.012	−0.011	−0.010	−0.012
	(−0.538)	(−0.561)	(−0.608)	(1.359)	(1.371)	(1.321)	(−0.875)	(−0.946)	(−1.122)
Constant	−0.098	−0.099	−0.089	0.417	0.415	0.484	−0.418	−0.426	−0.252
	(−1.431)	(−1.472)	(−1.347)	(0.690)	(0.689)	(0.816)	(−0.461)	(−0.482)	(−0.293)
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	955	955	955	955	955	955	955	955	955
Adjusted R-squared	0.099	0.106	0.105	0.144	0.145	0.146	0.066	0.078	0.079

\* Statistical significance at the 10% levels.

\*\* Statistical significance at the 5%.

\*\*\* Statistical significance at the 1%.

lower level of underpricing. The positive coefficient on *Ownership* indicates that investors demand a higher level of underpricing for firms with concentrated ownership. When we replace *Political Connection* with *Political Rank* in the regression, we also document an

insignificant coefficient on *Political Rank* (column [2]), supporting that investors may fail to rationally price the IPO deals underwritten by PC investment banks.

**Table 8**  
Effects of underwriters' political connections on underpricing.

<i>Panel A Univariate test</i>			
This table provides the univariate test for the difference in the underpricing of firms underwritten by politically connected underwriters and non-politically connected underwriters. The underwriters are defined as politically connected if their chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of the CSRC.			
	N	Mean	Median
Clients of PC underwriters	513	0.558	0.35
Clients of non-PC underwriters	443	0.66	0.438
Difference		−0.102**	−0.088***
T/Z-statistics		−2.458	−2.77
<i>Panel B Multivariate test</i>			
This table presents the results for the effects of underwriters' political connections on the underpricing of their clients. The dependent variable is Underpricing, which is the initial day of return after listing. <i>Political Connection</i> equals one if the chairman or CEO has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), or currently sits on the Stock Issuance Examination and Verification Committee or M&A Committee of the CSRC, and zero otherwise. <i>Political Rank</i> takes value according to the CEO or chairman's political hierarchy as 0 for no political connection or below deputy bureau level; 1 at the deputy bureau level; 2 at the bureau level; 3 at or above the deputy provincial level or in the CSRC and/or currently sitting on the Issuance Examination Committee or M&A Committee of the CSRC. All other variables are defined as in the appendix. All the variables are defined as in the appendix, and T statistics are reported in parentheses.			
Variables	(1)	(2)	(3)
Political Connection		−0.002 (−0.138)	
Political Rank			−0.008 (−0.998)
Top10	0.012 (0.747)	0.012 (0.726)	0.021 (1.321)
CenGov	0.089*** (3.110)	0.090*** (3.105)	0.098*** (3.413)
ForJoin	−0.028 (−0.568)	−0.029 (−0.566)	−0.031 (−0.640)
Prior Pass Rate	−0.133*** (−6.609)	−0.133*** (−6.761)	−0.139*** (−6.661)
Proceeds	−0.338*** (−31.967)	−0.338*** (−32.214)	−0.358*** (−31.767)
Days	0.231*** (7.996)	0.231*** (7.852)	0.211*** (8.454)
Ownership	0.202** (2.428)	0.202** (2.430)	0.196** (2.383)
SOE	0.117*** (3.624)	0.117*** (3.614)	0.116*** (3.588)
FirmPC	0.123 (1.427)	0.123 (1.429)	0.113 (1.325)
AuditPC	−0.044 (−1.409)	−0.044 (−1.429)	−0.044 (−1.455)
FirmAge	−0.011*** (−6.904)	−0.011*** (−7.018)	−0.010*** (−6.326)
IndPolicy	0.030** (2.441)	0.030** (2.480)	0.030** (2.400)
Marketization	−0.015*** (−3.440)	−0.015*** (−3.437)	−0.015*** (−3.542)
Exchange	0.151** (2.352)	0.151** (2.348)	0.178*** (3.163)
Constant	6.990*** (32.661)	6.993*** (32.868)	7.391*** (35.264)
Year Dummies	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes
Observations	955	955	955
Adjusted R-squared	0.610	0.609	0.610

\*statistical significance at the 10% levels.

\*\*\* statistical significance at the 1%.

\*\* statistical significance at the 5%.

## 6. Conclusion

In this study, we investigate the impact of underwriters' political connections on the Chinese IPO market. We show that underwriters' political capital significantly increases the probability that

their client firms obtain an IPO approval from the CSRC, which is a key step in accessing the equity market in China. Accordingly, we show that PC underwriters charge a fee premium for their underwriting services. Further analyses show that firms underwritten by PC firms underperform their counterparts in the post-IPO pe-

riod in terms of stock returns and earnings growth. In addition, we do not find a significant difference in the IPO underpricing for deals underwritten by PC versus non-PC investment banks. Such evidence suggests that the minority shareholders' interests would be impaired when the IPO market relies heavily on underwriters' political capital rather than their professionalism. In summary, our findings emphasize the important role of underwriting investment banks' political connections in China's IPO market, an emerging market with government intervention in the IPO screening process. This could be attributed to a lack of the supporting market institutions needed to value professional reputations, which exist in more developed economies such as the U.S. Relationship-based business models potentially undermine the development of market-oriented institutions. We expect our study to provide useful policy implications for developing economies to improve their regulatory environment for the sustainable and healthy development of the capital market.

### Appendix variable definitions

Variable	Variable Definitions
Political Connection	Equals 1 if the chairman or CEO of the underwriter has working experience in the government/military at or above the deputy bureau level, or in the Chinese Security Regulatory Commission (CSRC), and/or currently sits on the Issuance Examination Committee or M&A Committee of the CSRC, and 0 otherwise.
Political Rank	The highest political hierarchy ever taken by the chairman or CEO of the underwriter, which is coded as 0 for no political connection or below deputy bureau level; 1 for the deputy bureau level; 2 for the bureau level; 3 at or above the deputy provincial level or in the CSRC and/or currently sitting on the Issuance Examination Committee or M&A Committee of the CSRC.
Pass	Equals 1 if the IPO application is approved by the CSRC and 0 otherwise.
Top10	Equals 1 if the total proceeds of the deals underwritten by the investment bank is ranked among the top 10 in the two years prior to the current IPO and 0 otherwise.
CenGov	Equals 1 if the underwriter is ultimately controlled by central government and 0 otherwise.
ForJoin	Equals 1 if the underwriter is partially held by foreign joint venture partners and 0 otherwise.
Prior Pass Rate	The average pass rate of all the IPO deals underwritten by the investment bank in two years prior to the current IPO.
EarnMgmt	The average non-operating incomes (or losses) divided by assets in the three years before the IPO.
Assets	The logarithm value of average total assets in the three years before the IPO.
ROA	The average return on assets in the three years before the IPO.
Leverage	The average ratio of long-term liabilities to total assets in the three years before the IPO.
Current Ratio	The average ratio of current assets to current liabilities in the three years before the IPO.
SOE	Equals 1 if the firm is ultimately controlled by the government and 0 otherwise.
FirmPC	Equals 1 if the firm's chairman or CEO has work experience in the government at or above the deputy bureau level and 0 otherwise.
AuditPC	Equals 1 if the partner of the audit firm for the IPO company serves on the Issuance Examination Committee or M&A Committee of the CSRC during the IPO application and 0 otherwise.
FirmAge	The number of years since the founding year to the IPO application year.

(continued)

Variable	Variable Definitions
IndPolicy	Equals 1 if the firm belongs to the industry, which is supported by government policy according to the 11th Five-Year Plan (Supported industries include A-Agriculture, forestry, livestock farming, fishery; B-Mining; C01-Food processing; C43-Chemical material and products manufacturing; C51-Electronic parts and components manufacturing; C67-Non-ferrous metal foundries and presses; C73-Special equipment manufacturing; C75-Traffic equipment manufacturing; C76-Electric equipment and parts manufacturing; C81-Medicine manufacturing; C85-Biological products; D01-Electric power, steam, and hot water production and supply; D03-Gas production and supply; F-Transportation; G-IT; J-Real estate; K-Social Services), and zero otherwise
Marketization	The marketization index, available in <a href="#">Fan and Wang (2009)</a> , for the province in which the company is registered.
Fee	The underwriting fee scaled by the proceeds raised in the IPO
Proceeds	The logarithm value of the total proceeds raised in the IPO.
Underpricing	The initial day return after listing, which is the difference between the closing price of first trading and the offering price, scaled by offering price.
Ownership	The percentage of shares owned by the largest shareholder at the end of the IPO year.
Days	The logarithm of the number of days between the IPO and listing dates.
Exchange	Equal to 1 if the company is listed on the Shanghai Stock Exchange, and 0 if the company is listed on the Shenzhen Stock Exchange.
CAR	The cumulative monthly abnormal return measured by market-adjusted return in the period of one or two years post-IPO.
Change in ROS	Change in the average ROS over the three years before the IPO to that over two years after the IPO.
Growth in Sales	Percentage growth in average sales over the three years before the IPO to that over two years post-IPO.
Growth in EBIT	Percentage growth in average EBIT over the three years before the IPO to that over two years post-IPO.
Assets_IPO	The logarithm value of total assets at the end of the IPO year.
Leverage_IPO	The ratio of total liabilities to total assets at the end of the IPO year.
Pre-IPO Growth	The average growth in sales two years prior to the IPO.

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