Executive Reduction and Employee Stock Ownership Plan

Empirical Evidence from Chinese A-share Listed Companies

Danxun Yan(✉)

Department of Finance, Zhongnan University of Economics and Law, Wuhan, China
201921030243@stu.zuel.edu.cn

Abstract. Since 2014, employee stock ownership plans have received extensive attention and support from the capital market, and the number of companies implementing the plan has gradually increased. At the same time, the changes to the company's value that may be caused by the reduction of executives' holdings have also become issues that need to be paid attention to. This paper uses a sample of A-share listed companies from 2014 to 2020 to sort out both the short-term and the long-term research contexts, the basic status quo of the reduction of executives' holdings and the launch of the employee stock ownership plans in the A-share Main Board Market. Then it employed the logit regression model to examine the impact of executives' shareholding reduction behavior on the employee stock ownership plan, and uses the event analysis method and the OLS regression model to explore the impact of the two activities on the company's long-term and short-term value. The study concluded with three findings: First, companies whose executives have reduced their holdings have a significantly greater probability of implementing employee stock ownership plans. Second, companies that have implemented employee stock ownership plans have significantly increased their market prices in the short term. Third, long-term value is believed to be neither effected by executive reductions nor employee stock ownership plans. Finally, the idea of improving the performance of the company in the short term is put forward.

Keywords: executive reduction · employee stock ownership plan · company value

1 Introduction

Since China's actual economy the active capital market have grown, the phenomenon of executives' reduction of holdings in China's A-share main board market has gradually emerged. In 2014, about 1,100 A-share listed companies reduced their holdings, amounting to RMB 230 billion. In the first half of 2015, there was a climax of the departure of executives of listed companies: the cumulative reduction of holdings reached about 500 billion yuan, which more than doubled compared with the same period of the previous year. A large number of shareholding reductions actually have adverse effects on all parties: in terms of resource allocation, the occurrence of a large number of shareholding reductions will trigger panic among market investors, which in turn affects the

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performance of the market's resource allocation function; at the macroeconomic level, the inefficient capital market supervision and market imbalance caused by the reduction of holdings will lead to the loss of the basic economic adjustment ability of the market.

Because of western capital market's relatively secure and experienced development and the reality that shares of listed businesses can only be exchanged and circulated inside the secondary market only when outstanding amount and volume meet the desired proportion, the phenomena of CEOs reducing their holdings is prevalent inside this western capital market. Timely disclosure of information to the outside world is sufficient.

In China, under the share-trading model, according to relevant laws, the shares of executives of listed companies cannot be traded in the secondary market. Since the split share structure reform, the shares held by executives have gradually been allowed to trade in the secondary market. The reform of the system triggered a strong motive for company executives to increase or decrease their holdings of the company's stocks, and also triggered strong stock market turmoil and market reactions. Both the theoretical and practical circles have paid extensive attention to this phenomenon. This paper conducts a detailed study on the basis of the existing relevant theoretical basis and existing research results.

As for employee stock ownership plan, a generalized profit-sharing mechanism, has the dual attributes of economic incentives and social governance [1]. In order to create a community of interests for business owners and laborers, it was suggested in 2013's "Decision of the Central Committee of the Communist Party of China on Several Major Issues Concerning Comprehensively Deepening the Reform" to "permit employees to hold shares in a mixed-ownership economy." The Company's Guiding Opinions on Implementing the Pilot Employee Stock Ownership Plan, which has garnered considerable interests. From 2014 to 2018, there were 963 employee stock ownership plans announced by listed companies, which were implemented by companies in almost every industry [2]. However, existing research mainly focuses on the market announcement effect of employee stock ownership plans [3, 4] and the influence of controlling shareholder behavior [5], but little focus has been placed on executive ownership Changes in stock behavior.

Following is how the remainder of this essay is organized: Section 2 review the literature; Section 3 introduces the empirical method adopted and puts forward the research hypothesis; Section 4 presents the empirical results; Section 5 analyzes the empirical results; Section 6 gives a summary of the full text, points out the conclusions and the prospect of further study in the subject.

2 Literature Review and Hypothesis

2.1 Research on Insider Trading

One of the advantages of insiders is that they can obtain relevant information that affects the future stock price of the company in advance, then choose to buy and sell the company's stock accordingly. Piotroski and Roulstone (2005) believe that insiders have advantages of both valuation judgment and performance forecasting [6]. Zhu et al. (2011) found that the reduction of insiders took advantage of the valuation judgment, and cashed out when the market value was overvalued [7]. Zeng and Zhang (2012) found that insiders tend to sell stocks before bad news is disclosed in regular reports [8].

In addition, Dai and Lin (2018) proposed that executives with profit-seeking tendencies would have reasons to use the employee stock ownership plan as a profit-making channel, whether for the purpose of seeking control or obtaining capital appreciation [9]. According to the theory of signaling and the assumption of rational economic man, executives increase or decrease their holdings for the sake of maximizing their own interests: Generally speaking, when the value of the company is underestimated by the market, the senior management will take advantage of their own information and will increase the number of company shares; And when the company's value is overvalued by the market, the senior management uses the advantage of internal information to reduce the number of company shares. Investors can reassess the company's value in light of the signs that executives are buying or selling more or less stock. It can be expected that the market will respond positively to the increase in the company's holdings by executives, and will react negatively to the company's reduction of executives' holdings. However, many related literatures are more theoretical and lack actual data. Therefore, we propose the first part of the third research hypothesis: The market will respond negatively to the decrease in executive ownership of the company in the short term, and also the loss in executive ownership is a sign that the market value and future profitability of the company are declining.

2.2 Employee Stock Ownership Research

Most of the existing literature discusses employee stock ownership plan incentives from the perspective of enterprises themselves, and the most in-depth discussions include incentive incentives, talent incentives, and capital constraint incentives.

Incentive motives believe that allocating stocks to employees can align the interests of employees and shareholders, thereby reducing employees' moral hazard and mitigating agency problems [10]. Especially when the cost of direct supervision is too high, the mutual supervision provided by equity can more motivate employees to work hard [11]. Talent motivation starts from the theory of human capital [12], which believes that the key factor that capital affects the company is the key factor in the decision-making of the ownership of the highest-level employees. On the one hand, companies can use idle funds to retain talents [11], stabilize the team [10], and constitute a unique advantage of human capital [13]. Employee stock ownership schemes, on the other hand, can be a tool to balance company and industry wage levels, thereby avoiding employee turnover [14]. Furthermore, for risk-oriented employees, equity compensation is more attractive than traditional fixed compensation [13]. However, it is generally believed that employees are only willing to forgo monetary compensation if they are optimistic about the company's future share price, so the pull effect is very limited. The employee stock ownership plan scheme is based on the real need of the business for capital. To a certain extent, allocating stocks to employees can replace cash compensation [11] or reduce employees' need for cash compensation, thereby saving cash expenditures. However, some studies indicate that employee stock ownership plans are often used by well-funded companies [13, 15]. These variables could be indicative of the company's response to the employee stock scheme. This leads to the rest of Hypothesis 2. The strengths of this paper are: in order to show how the implementation of employee stock ownership plans and the decline in managerial stock ownership and to reveal the actual impact of the two expectations on market reaction and firm value.

Most of the establishment and implementation of employee stock ownership plans have been actively participated or led by executives. In theory, will executives as rational persons launch employee stock ownership plans under the condition of changing their own shareholding ratios? Will the two events of employee stock ownership plan and executive reduction have an impact on market expectations and company value? This paper attempts to conduct research from these two aspects.

2.3 Research Hypothesis

Compared with the general manager incentive plan, the employee shareholder plan has the following characteristics: (1) The incentive coverage is larger, has an incentive effect on ordinary employees from the management; (2) The controlling shareholder borrows or provides guarantees, the depth of participation and the support of the source of funds; (3) Most of the necessary shares are purchased from the secondary market or privately issued; (4) The lock-up period is short; (5) The unlocking conditions are low, and there is no performance threshold, and participants are more concerned about the stock price than the performance; (6) Information disclosure and regulatory requirements are modest.

Due to the above characteristics, the employee stock ownership plan helps to straighten out the interests of controlling shareholders, management and key employees, and realize the "interest synergy" of insiders [14, 16, 17]; Kim and Ouimet (2014) suggests that, in the long run, it will help the company to reduce production costs and improve the company's operating efficiency and development speed [17].

Rational personal economic assumptions for managers, under certain circumstances, have a strong need for market cap management and fixed interest rates, which in turn motivates them to reduce their holdings and disrupt the company's employee stock ownership plan implement.

This leads to the following hypotheses.

H1: Under other conditions being the same, the shareholding reduction rate of executives is positively correlated with the probability of establishing a plan for employee stock ownership. The higher the shareholding reduction rate, the higher the probability of implementing an employee stock ownership plan.

When the total number of shares in the company is the same, there are several ways for the shares to be reduced by executives: either conduct normal transactions on the secondary market or sell them internally to the company's shareholders. There is also a possibility that equity will be spread among the rest of the executives or even ordinary employees through employee stock ownership plans. So, will the reduction of executives' holdings indeed affect the launch of the employee stock ownership plan?

As we all know, there are several possible reasons for a company's executives to reduce their holdings: First, the company is not well managed, and the market has overpriced the company. Second, due to information asymmetry, insider executives reduce the company's stock holdings in advance to reduce losses. Third, the company's major shareholders plan to delist their company and withdraw their shares. Overall, these actions have negative impacts on the value of the company and the pricing of it in the secondary market.

Reasons for the launch of employee stock ownership plan: whether to solve the principal-agent problem or to deal with the stocks in the market. The launch of it is equivalent to sending a signal to the market that the company's principal-agent problem is about to be resolved, excellent employees can be retained who will work hard, and the company's efficiency will be significantly improved. Thus, the market may give a positive result in the short term.

In addition, employee equity ownership programs' main objective is to increase the company's long-term worth.

According to the information above, lead to the hypothesis 2 and hypothesis 3, exploring whether these two activities will affect the company's short-term market response:

H2 focuses on the impact on the immediate market response.

H2a: The reduction of executives' holdings has a negative impact on the immediate market response;

H2b: The introduction of the employee share scheme has a favorable effect on the reaction of the market right away.

H3 studies the impact of these two actions on the long-term worth of a corporation.

H3a: The reduction of executives' holdings will hinder the company's long-term value growth;

H3b: The implementation of the employee share scheme will support the company's long-term value growth.

3 Data, Variables and Model

3.1 Data

As the research sample, we will use the A-share listed businesses which introduced employee stock plans in Shanghai and Shenzhen stock exchanges between 2014 and 2020, excluding the financial industry, ST companies and samples with missing data, a total of 2602 listed companies were obtained. The announcement information of major shareholders' shareholding increase in this article comes from the CSMAR database. The researcher also compared it with the announcement information of the company's shareholding increase on the websites of cninfo.com, Shanghai Stock Exchange and Shenzhen Stock Exchange and the announcement of the increase in shareholding of the major shareholders of the listed company shall prevail. Transactional data, including stock returns, market returns, and financial information about businesses, are sourced from the CSMAR database (Table 1.).

Table 1. Variables definition.

variable name	Variable symbol	Variable definition
Selling by senior executives	draw	Senior executives' reduced holdings will be recorded as 1 and senior executives' unreduced holdings will be recorded as 0
Employee stock ownership scheme introduced	Esop_i	When an employee ownership plan is implemented, the value is1, and when it is not implemented, it is 0
Scale of company	Size	Total Assets
Return on total asset	Roa	Net profit / total assets mean
Ratio of liabilities to assets	Debt	Year-end net asset liability ratio
The event date	Year	The year of the company researched
The joining together of two values	Dual	If the chairman and general manager hold concurrent posts, it will be marked as 1; otherwise, it will be marked as 0
Price book value	Bm	Total assets divided by market value at the end of the year
Increase rate of business revenue	Grow	The growth rate of revenue relative to the previous year
Outstanding shares	L_stock	Percentage of shares still outstanding at the end of the year

3.2 Variables

3.3 Model

In order to verify H1, considering whether Since the launch of the ESOP is a binary variable, the study will apply the Logit model as follows:

$$\begin{aligned} \mathrm{prob}\big(\mathrm{esop_i} = 1\big)_{i,t+1} &= \alpha + \beta_1 \times draw_{i,t} + \beta_2 \times size_{i,t} + \beta_3 \times roa_{i,t} \\ &+ \beta_4 \times debt_{i,t} + \beta_5 \times dual_{i,t} + \beta_6 \times year + \varepsilon_{i,t} \end{aligned} \tag{1}$$

Among them, the explained variable esop_i indicates whether the business will introduce its employee equity ownership plan in the next year, and the launch of the plan is recorded as "1", otherwise it is recorded as "0". The explanatory variables refer to the research of Liao and Wang et al. (2016) [4]. Draw represents whether the company's executives reduced their holdings of the company's stock at the end of the year. The reduction is recorded as "1", and the non-reduction is recorded as "0". For the selection of control variables, refer to the literature of previous incentive research [2, 10] to select corporate characteristic variables, corporate governance variables and corporate financial variables.

Among them, the explained variable esop_i indicates whether the company will launch the board plan of the employee stock ownership plan in the next year, and the launch of the plan is recorded as "1", otherwise it is recorded as "0". The explanatory variables refer to the research of Liao Wang et al. (2016) [4]. Draw represents whether the company's executives reduced their holdings of the company's stock at the end of the year. The reduction is recorded as "1", and the non-reduction is recorded as "0". For the selection of control variables, refer to the literature of previous incentive research [2, 10] to select corporate characteristic variables, corporate governance variables and corporate financial variables.

In addition, the book value ratio (bm), which represents the valuation, the growth rate of operating income (grow), which represents the growth, and the ratio of shares outstanding (l_stock) are also added.

In order to verify the hypothesis H2a and H2b, referring to Qiu (2015), this paper constructs the OLS model as follows [5]:

$$\mathrm{caar}(-\mathrm{t},\mathrm{t}) = \alpha + \beta_1 \times draw + \varepsilon_{i,t} \tag{2}$$

$$\mathrm{caar}(-\mathrm{t},\mathrm{t}) = \alpha + \beta_2 \times esop\_i + \varepsilon_{i,t} \tag{3}$$

Set the event window to (−20, 20) and the estimation window to (−140, −21).

Among them, the explained variable caar (−t, t) represents the market model's average cumulative excess return on the day the employee stock ownership plan was originally announced, or the t days before and after the date the executive's shareholding was reduced. Setting different t values can speculate whether the impact of the event day on the cumulative excess return is significant, so as to judge the impact of the event on the short-term market reaction.

To test hypotheses H3a and H3b, the OLS regression test was used. Among them, the definitions of draw and esop_i are consistent with the model (1), and the explained variable outcome is the company's long-term worth in the current year and the next year, including the return on total assets (roa) and the rate of increase in operating income for the business (grow).

$$\begin{aligned} outcome_{i,t(t+1)} &= \alpha + \beta_1 \times draw_{i,t} + \beta_2 \times year_{i,t} + \beta_3 \times debt_{i,t} \\ &\quad + \beta_4 \times esop_{i,t} + \beta_5 \times bm_{i,t} + \beta_6 \times l\_stock + \varepsilon_{i,t} \end{aligned} \tag{4}$$

4 Empirical Results

4.1 The Relationship Between Shareholding Reduction Rate and the Probability of Implementing the Plan for Employee Stock Ownership

Table 1 reports the regression results of executives' shareholding reduction action and employee stock ownership plan roll-out using the Logit model, in which columns (3) and (4) are the results of univariate regression, columns (1) and (2) is the regression result with the addition of control variables. The regression coefficient shows that whether executives reduce their holdings is significantly positively correlated with the launch probability of the employee stock ownership plan at the 1% level.

Table 2. Executives' shareholding reduction and employee stock ownership plan launch

	(1)	(2)	(3)	(4)
draw	0.562***	0.631***		
Esop_i			0.568***	0.631***
control	Yes	No	Yes	No
Pseudo R2	0.021	0.013	0.045	0.006

Note: ***, *** and * indicate significant at the 1%, 5% and 10% levels, respectively

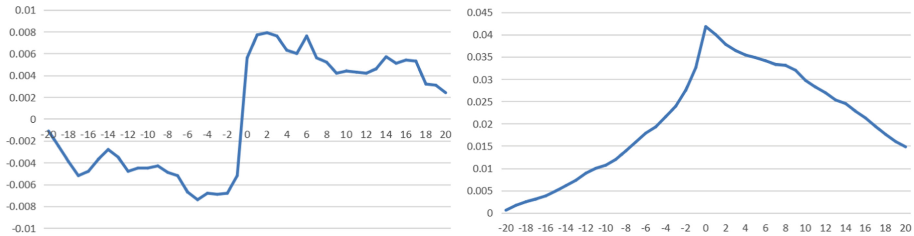

Fig. 1. Curve of cumulative excess return on the first announcement date of the employee ownership plan and the actual change date of executives' shareholding reduction

4.2 Short-Term Market Reactions Caused by Two Actions

In order to measure the announcement effect of employee stock ownership plan, this paper focuses on testing the announcement effect on the first announcement day. It can be seen from the left chart of Fig. 1 that during the (-20, 20) window period, there were obvious cumulative excess returns on both the plan date and the establishment date, and the cumulative excess returns after the announcement date were generally maintained between 0.4% and 0.8%. Within the range, it shows that the employee stock ownership plan has a significant positive multiple announcement effect, and the effect of market value management on short-term stock prices is obvious.

Looking at the chart below, the accumulated excess returns from the actual changes in executives' reductions have increased significantly within a large range around the event day, which is different from the initial expectation.

Table 2. reveals the outcome of the H2b hypothesis mean test. Overall, the employee stock ownership plan has an obvious positive announcement effect, and the mean difference test between groups shows that in most of the window periods, the difference between executives' shareholding reduction group and the executives' non-reducing shareholding group is not significant. To conclude, the above results preliminarily prove that the market holds a relatively positive attitude towards putting into practice the employee ownership plan. It may be that in the short term, investors cannot distinguish the motives of executives to implement employee ownership plans, so that CEOs might increase stock prices by establishing employee stock ownership schemes in order to accomplish short-term market value management.

Table 3. The difference of the first announcement effect between the holding reduction group and the non-holding reduction group

	full sample 1025	non-reduction group 505	Underweight group 520	mean difference
Window period income on the date of the initial announcement				
caar(-1, 1)	0.0129*	0.0134**	0.0119***	−0.002
caar(-2, 2)	0.0147*	0.0156***	0.0131***	0.003
caar(-5, 5)	0.0134**	0.0139***	0.0127*	−0.001

Note: ***, *** and * indicate significant at the 1%, 5% and 10% levels, respectively

Table 4. The impact of executives' reduction of holdings and the implementation of employee ownership plans on the company's long-term value

	(1) roa_{t}	(2) roa_{t+1}	(3) $grow_{t}$	(4) $grow_{t+1}$
Esop_i	0.0272	-0.0061	-2.5825	0.0042
draw	0.0082	0.0042	-4.8428	−5.3322
control	Yes	Yes	Yes	Yes
Adj-R2 N	0.001 17271	0.003 17271	0.000 15029	0.000 15029

Note: ***, *** and * indicate significant at the 1%, 5% and 10% levels, respectively

4.3 Long-Term Value Changes Caused by Two Actions

According to Hypothesis H3, it is necessary to determine whether the employee stock ownership plan and executives' shareholding reduction behavior have changed the company's long-term worth. The interaction term results in Table 4 show that neither the introduction of the employee stock ownership plan nor the reduction of executive holdings has a significant impact on the company's long-term value. While it does not rule out that the time interval between the selection of measurement indicators is not long enough to make the long-term impact manifest. Besides, because the selection of indicators to measure long-term value is not sufficient, the actual company operating efficiency should also be considered.

The above results support the hypotheses H3a and H3b of this paper: executives' shareholding reduction behavior and employee stock ownership plan have no effect on long-term market value and performance.

5 Discussion

Whether executives' reduction of their holdings is closely associated in a positive manner with the launch probability of the employee stock ownership plan at the 1% level. It exhibits that the reduction of executives' holdings indeed affects the launch of the employee stock ownership plan. One of the possible reasons is that the executives take compensation measures to implement the employee stock ownership plan in order to prevent the reduction of the company's market value due to the reduction of stock holdings.

The market has a more positive attitude towards putting into practice the employee ownership plan. It may be that in the short term, investors cannot distinguish the motives of executives to implement employee stock ownership plans, so that executives can achieve short-term market value management by putting employee ownership programs in place to increase stock prices.

However, neither the introduction of the employee ownership plan nor the reduction of executive holdings has a significant impact on the real value of the company. It is concluded that executives' shareholding reduction behavior and employee stock ownership plan have no effect on long-term market value and performance. Of course, it does not rule out that the effect is not significant because the time interval between the selection of measurement indicators is not long enough to make the long-term impact manifest.

6 Conclusion

This study investigates the effect of CEOs' shareholding reduction behavior on the introduction of the employee ownership incentive plan, as well as the changes of the two behaviors on the company's long-term and short-term value using a dataset of A-share listed firms from 2014 to 2020. There are 3 findings in this study. Firstly, as the result shown that companies whose executives reduced their holdings have a significantly greater probability of implementing employee stock ownership plans. Secondly, companies that implemented employee stock ownership plans have significantly increased their market prices in the short term, which is in line with expectations. Thirdly, the short-term value fluctuations in the employee stock ownership plan shown are inconsistent with expectations, and reasons behind this are worth further exploration; In terms of long-term value, it is currently believed that neither executives' shareholding reduction nor employee ownership plan can significantly affect the company's long-term value.

It implies that although there is a view that the launch of the employee share scheme will have a good influence on the company, but the reduction in executive shares will have a negative effect on the company's value, the data analysis does not prove this point of view. Before the abnormal fluctuation of the stock price before and after the holdings and its impact on the company's long-term value, operating ability, financing ability, etc., it cannot be ruled out that the introduction of the employee ownership plan of executives of the business to reduce their holdings will produce the market reaction in the short term. The reaction is conducive to the increase of short-term cumulative excess returns and the promotion of short-term company value, besides, the impact on the company's long-term value is not significant.

Meanwhile, it is also important to notice that the screening of samples in this study was not precise enough as PSM matching and other methods were not applied to solve the problem of internal differences between those samples.

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