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Reward meritocracy or nepotism: The case of independent financial advisors appointed by Chinese listed companies

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ABSTRACT

As independent financial advisors, securities firms are the core intermediaries in major asset reorganization (MAR) of listed companies. Furthermore, they play the dual roles of transaction and authentication. Based on this institutional background, this paper studies how listed companies choose between industry experience (“meritocracy”) and relationships (“nepotism”). Using the MAR of A-share listed companies from 2008 to 2013 as the sample, this paper shows that higher transaction costs (i.e., greater demand for the transaction function of advisors) are related to the higher possibility of advisors with weaker relationships and more industry experience being hired. It also shows that higher suspicion of tunneling (i.e., greater demand for the signal of fairness associated with advisors’ authentication function) is related to the higher possibility of advisors with weaker relationships being hired, but it is not significantly related to whether advisors have more or less industry experience. This paper also shows that reputation has a certain governance effect on the negative consequences of relationship. For the most part, listed companies reward meritocracy but not nepotism when appointing independent financial advisors.

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1. Introduction

The mergers and acquisitions (M&A) of listed companies are important in building corporate strength and promoting industrial upgrading. In addition, the role of major asset reorganization (MAR), with a larger transaction scale and more far-reaching impacts on the fundamentals of the companies involved, is especially prominent when listed companies seek overall business transformation. Although the majority of listed companies do not lack M&A experience, they resort to M&A as a means of strategic deployment or as an investment tactic far less than other business activities. Furthermore, the expertise of specialists remains indispensable, even for those most experienced in M&A (Sleptsov et al., 2013). Information disclosure, transaction terms, implementation processes, and many other aspects of MAR fall under the scrutiny of the China Securities Regulatory Commission (CSRC), which continues to roll out new laws and regulations to regulate relevant activities. Therefore, it is very difficult for enterprises to implement innovation in business practices while trying to meet regulation requirements on their own. Additionally, negative impacts from the failure of restructuring may be amplified due to the larger transaction scale. The above facts highlight the necessity of hiring independent financial advisors or other agencies with expertise and knowledge in this field to help reduce transaction costs.

Securities companies serve as the independent financial advisors and core agencies in MAR. According to the Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies and the Measures for the Administration of Major Asset Reorganization of Listed Companies, independent financial advisors play dual roles. Their first role concerns transaction,¹ which refers to the entire process of their participation in MAR, from planning and preparation to integration. They identify and determine the target, provide advice on the terms of transaction, including pricing, and assist listed companies in avoiding risks (e.g., transaction risks and regulatory risks), disclosing information, and responding to CSRC inquiries. Their second role concerns authentication, which means that from an impartial and independent perspective, they examine the fairness of the objectives, schemes, and pricing of the restructuring and evaluate the clarity of the asset ownership, the asset integrity, the ability of the listed companies to sustain their operation and profitability, whether the profit forecast can be realized, whether the company has maintained its business independence, and whether the interests of minority shareholders are infringed upon. All of these elements are shown in independent financial advisors' reports. Once a listed company hires a securities company as its independent financial advisor, it must simultaneously undertake both the transaction role and authentication role. In this paper, these roles are identified as the dual roles of an independent financial advisor. The dual roles of independent financial advisors are similar to the two services offered by investment banks in the U.S. market—the financial advisory service and the service of fairness opinions. The financial advisory service resembles the transaction role in that they both try to ensure that the transaction is successfully completed and provide their assistance in the process. The service of fairness opinions resembles the authentication role in that they both offer unbiased opinions, with the exception that investment banks focus more on the fairness of consideration (Kisgen et al., 2009), whereas independent financial advisors must assess whether any possibility of unfairness exists throughout the restructuring process from the perspectives of the motives, terms, and implementation of the restructuring. Moreover, in terms of the connotations of a fair transaction, the U.S. market focuses on the possibility of establishing a business empire, which falls into the scope of the first type of agency problem. However, the Chinese market mainly focuses on the second type of agency problem of whether restructuring will become a tool for major shareholders to encroach upon the resources of listed companies.

The influence of independent financial advisors on MAR starts with their employment by the listed companies. Therefore, how listed companies make their hiring decisions is the first step toward “unlocking” the “black box” that contains the functioning mechanisms and effects of independent financial advisors. Generally, two important factors must be considered when a company decides to hire a third-party agency: connections and experience. Establishing connections begins with the business cooperation between the company and

¹ This paper summarizes the transaction and authentication roles. However, they are not explicitly listed in the *Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies* or the *Measures for the Administration of Major Asset Reorganization of Listed Companies*.

the agency, and the mutual trust that results from such connections helps information be communicated efficiently and at a low cost (Chen et al., 2016; Liu and Tang, 2009). Experience is accumulated as the agency builds up its business in a certain field within a given period, such that rich experience signifies the expertise of the third-party agency and, thus, predictable valuable advice and assistance services (Liu et al., 2010; Song et al., 2016). The foreign literature suggests that companies engaging in M&A consider the traits of investment banks in terms of connections and experience when making hiring decisions (Francis et al., 2014; Wang et al., 2014). What makes the study of independent financial advisors distinct is that unlike the agencies offering specialty services, such as auditors, asset appraisers, and lawyers, independent financial advisors undertake dual roles and listed companies may prefer independent financial advisors with better connections with them or, in other circumstances, those with more experience in the trade. The key determinant is which of the company's needs prevails. The competence of independent financial advisors to fulfill their dual roles is naturally doubted. In addition, the validity of their authentication is compromised, as they are self-evaluated, which may negatively affect the hiring decisions of listed companies. For these reasons, this paper's research question requires separate examination of the dual roles of transaction and authentication played by independent financial advisors and consideration of how listed companies choose between connections and experience.²

This paper is significant for three reasons. First, it supplements the empirical literature on the study of independent financial advisors and the hiring decisions of listed companies, including the hiring of general financial advisors. Currently, in the Chinese literature, only Li et al. (2017) discuss, based on a sample of M&A events from 2009 to 2014, the mechanisms of financial advisors in different relationships with listed companies and the relevant influences on the economic consequences of M&A. Chen et al. (2015) also talk about the impacts of the reputation of financial advisors on the market reaction on listed companies' M&A announcement days. However, neither of them discusses the hiring decisions of listed companies, and both focus on general financial advisors that do not share the dual role trait of independent financial advisors. This paper, nevertheless, draws conclusions about the motives of listed companies in their hiring of independent financial advisors. Accordingly, it provides policymaking guidance on how to optimize the policy constraints related to independent financial advisors, regulate the M&A activities of listed companies, and curb the opportunistic behavior of independent financial advisors.

Second, this paper analyzes the motives of listed companies in their hiring of independent financial advisors from the perspectives of the dual roles of transaction and authentication and connections versus experience simultaneously. Contrarily, the foreign literature is limited to the discussion of the influence of connections or experience on the decision making of listed companies from the perspective of investment banks serving as financial advisors (Chang et al., 2016; Francis et al., 2014; Wang et al., 2014). Furthermore, such studies on the fairness-opinion service provided by investment banks only involve the characteristics of acquirers or the reputations of investment banks (Cain and Denis, 2013; Chen, 2010; Kisgen et al., 2009; Makhija and Narayanan, 2007). However, this paper, based on the traits of listed companies and the characteristics of MAR, distinguishes the scenarios between those in which listed companies need the transaction role of independent financial advisors more and those in which they need the authentication role more before examining how listed companies' choose between "nepotism" and "meritocracy" in their hiring of independent financial advisors. In this sense, this paper expands the research scope of the foreign literature by fully exposing the motives of listed companies in hiring independent financial advisors.

Third, distinct from the U.S. market, the mandatory Chinese regulation on the dual roles of independent financial advisors also provides an exogenous setting for the hiring motives of listed companies. Thus far, no foreign studies have examined the situation in which one investment bank is hired to offer both the financial advisory service and fairness opinion service, how the board of directors makes the decision, or whether any difference in preference exists if they separately hire financial advisors. The board of directors may have absolute discretion in the hiring of investment banks and may have doubts in hiring one investment bank to provide two services (e.g., doubts about information sharing between the two services or that someone in the

² It must be stressed that because this paper discusses the hiring decisions of listed companies, its theoretical construction and hypothetical derivation are based on the realistic needs of listed companies for independent financial advisors and the signals that said advisors send to the outside. This paper does not discuss the economic impacts of independent financial advisors with certain types of characteristics on MAR or on the fundamentals of listed companies.

company may easily reach agreement with the investment bank offering both services). Therefore, in the U.S. context, whether the board of directors hires the same investment bank and what kind of investment banks it hires are actually two interconnected research questions. However, it is difficult to define clear boundaries between them. In the Chinese context, the exogenous setting of the dual roles of independent financial advisors can help focus our research on how listed companies choose between nepotism and meritocracy and thus help address the motives behind their choices.

The remainder of this paper is organized as follows. Section 2 introduces the regulatory background. Section 3 establishes the theoretical framework and proposes a hypothesis. Furthermore, it separates the transaction and authentication roles of independent financial advisors and analyzes the influences of connections and experience independently. Section 4 introduces the research design. Section 5 lists the empirical results and provides the analysis. Section 6 summarizes the entire paper.

2. Institutional background

In China, listed companies can decide whether they want to hire financial advisors if the M&A or restructuring is only of general significance. However, an independent financial advisor is required if they are planning an MAR. The *Measures for the Administration of Major Asset Reorganization of Listed Companies* specifies the duties of independent financial advisors, indicating that they shall “prudently check whether the MAR constitutes a related-party transaction and express a clear opinion on the basis of the facts confirmed through inspection. Where a MAR involves a related-party transaction, the independent financial advisor shall express a clear opinion on the impact of the restructuring on the non-related shareholders of the listed company.” Additionally, after the CSRC approves the MAR, they shall “inspect and verify the compliance and risks during the implementation process of MAR, asset transfer and related follow-up matters, and deliver clear concluding observations.” Similar regulations can also be found in the *Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies*: “For matters concerning the MAR of a listed company, the financial advisor shall pay attention to: the purpose of restructuring, the restructuring plan, the fairness of the transaction pricing, the clarity of asset ownership, the integrity of the assets, whether the business operation and profitability of the listed company are sustainable after the restructuring, the achievability of the profit forecast, the independence of the company’s operation, and whether there is the possibility that the party engaging in the restructuring is using the restructuring to infringe the interests of the listed company.” Moreover, “As per the regulations on the M&A and restructuring by CSRC, the financial advisor is responsible to offer continuous authentication within the prescribed time limit after... the completion of MAR... and other matters.” To summarize the services of independent financial advisors mentioned above, they must verify the fairness of the entire MAR process, ranging from planning to implementation, which is referred to as the authentication role of independent financial advisors in this paper. Due to this role, independent financial advisors differ from other financial advisors in general M&A and restructuring cases in that they must maintain an independent identity and a neutral standing with no interest in the listed company in the forms including but not limited to holding shares of, acting as guarantor for, or taking a part-time job at the listed company, and they should not provide financial advisory services for the counterparty in the transaction according to the *Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies*. These measures also assert that the general business scope of financial advisors (not limited to independent financial advisors) includes but is not limited to due diligence and valuation, helping listed companies avoid risks (including trading risks and regulatory risks), designing the transaction structure, sending the report materials to the CSRC, and assisting the listed company in information disclosure. This covers almost all aspects of the M&A transaction and is collectively referred to as the transaction role of independent financial advisors in this paper. Therefore, according to the regulations from the policy level, independent financial advisors hired by listed companies for MAR must play the dual roles of transaction and authentication simultaneously.

In the institutional background of China, the distinctiveness of independent financial advisors lies in their mandatory dual roles, between which there exists an endogenous conflict. The supervisory role requires independent financial advisors to evaluate the fairness of the transaction in which they are deeply involved. However, in reality, they are not motivated to truly discover and disclose their own dereliction of duty. Moreover,

the motivation to pursue the completion of the transaction (to obtain commissions³) also makes them unwilling to spend extra time and money on identifying the terms of the transaction that may harm the interests of the minority shareholders and require the listed company to make modifications. Foreign research has reached a consistent conclusion. For example, [Kisgen et al. \(2009\)](#) find that the purchase of fair opinions by the board of directors of the acquirer results in a negative market reaction and that hiring an investment bank that does not act as a financial advisor helps reduce the loss of shareholder value. [Chen \(2010\)](#) finds the market response to be even worse when the investment bank that is hired to provide a fairer opinion also serves as a financial advisor than when it does not provide financial advice, whether it is on the announcement day or 6 months after. It must be acknowledged that in the Chinese context, where the market does not attach importance to the true value of a company, the authentication mechanism is not perfect and is not sufficiently strict and listed companies do not have the motivation to actively require “being regulated.” They are most likely to reach a consensus with independent financial advisors that will do the “surface work” of their authentication role, the objective of which may very likely be to beautify the restructuring to pass the resolution of the shareholders’ meeting and the review of the CSRC and to obtain good market feedback.

In summary, the institutional background in China serves as a special setting for the close inspection of the hiring decisions of listed companies. That is, cases in which the two roles of independent financial advisors have endogenous conflicts and their authentication role is likely to be ineffective, different preferences may exist for the different roles of independent financial advisors in the hiring of listed companies.

3. Theoretical analysis and hypotheses

This paper uses the following method of analysis. Based on the characteristics of listed companies and MAR, it first distinguishes between the situations in which listed companies need the transaction role of independent financial advisors more and those in which they need the authentication role more. It then discusses how listed companies choose between the connections and experience of independent financial advisors in these situations.

3.1. Transaction role of independent financial advisors and hiring decisions of listed companies

The higher the transaction costs of restructuring, the more listed companies need the transaction role of independent financial advisors. Transaction costs in restructuring include information search, contract making, and bargaining. Transaction costs are mainly shown in two aspects. First, information asymmetry between the M&A company and the target company causes risks during the processes of target selection, valuation, and integration ([Servaes and Zenner, 1996](#)). Second, both parties must pay for the expenses and time needed to communicate and negotiate during the transaction ([Boeh, 2011](#)). However, independent financial advisors can reduce the cost of information search in the process of locating the target ([Wang et al., 2014](#)), accurately analyze and judge the detailed information of the target ([Hayward, 2003](#); [Reuer and Koza, 2000](#); [Singh and Montgomery, 1987](#)), and reduce the costs of consultation and negotiation in the transaction process ([Kesner et al., 1994](#); [Thomas, 1995](#)). That is, independent financial advisors reduce the transaction costs in restructuring mainly through their transaction role. The following subsection separately analyzes how listed companies choose between nepotism and meritocracy in considering their needs for the transaction role of independent financial advisors.

3.1.1. Nepotism: Influences of connections

From the perspective of the transaction role, connections that already exist between independent financial advisors and listed companies are conducive to enhancing the former’s services. With connections established,

³ The literature shows that a large part of the commissions for financial advisors in the U.S. M&A market is calculated as a percentage of the total transaction price and that most commissions are paid after a transaction is completed ([Kesner et al., 1994](#)). No study has investigated the form of commission received by financial advisors or independent financial advisors in China. However, considering that China has drawn on the experience of the U.S. for almost all aspects of its M&A and investment banking systems, it can be speculated that the commissions of independent financial advisors are calculated similarly in China.

financial advisors can better understand the resources, strategy, culture, and goals of listed companies, thus making their information services more pertinent and increasing the efficiency of their screening targets (Sleptsov et al., 2013). The transaction role of independent financial advisors also covers the following services: valuation, negotiation, consultation of the terms of the transaction, and assistance to listed companies in preparing report materials and information disclosure. In addition, connections also enhance the ability of independent financial advisors by promoting the flow of specific and professional information (Mesquita et al., 2008; Vasudeva et al., 2013), which reduces the costs of information collecting and filtering.

However, turning the analytical perspective from the function of their relationship to the behavioral motives of independent financial advisors, the securities companies of the independent financial advisors always seek to maximize the profit rather than the value of listed companies. Lack of motivation or conflict of interest can limit the role of financial advisors, which is referred to as the “agency conflict” between financial advisors and companies engaging in M&A (Hayward, 2003; Kesner et al., 1994; Rau, 2000).

Agency conflict is demonstrated in two ways. First, in China, the financial advisory business accounts for only a small portion of the income of securities companies. It is not realistic to obtain large commissions from a single customer. Therefore, with the motive of maximizing profits, it is reasonable for them to follow the enthusiasm of the market in M&A and restructuring and to attract new customers by providing high-quality services. This is the only way that the future development of independent financial advisors can be guaranteed. As connections between old customers and independent financial advisors have already been established, a certain reduction in the energy and resources allocated to old customers would not lead to a loss in this group of customers. As Hayward (2003) argues, establishing relationships strengthens companies’ dependence on financial advisors and reduces the possibility of them changing financial advisors. Therefore, establishing connections actually substantially weakens the incentive of financial advisors to provide high-quality services and to create value for old customers. In addition, as such connections augment the influence of financial advisors on listed companies, financial advisors deem successive business cooperation as a reward for the past services they have delivered (Eccles and Crane, 1988). Therefore, beyond the necessary work they must do, they do not exert extra effort to secure the opportunity for further business cooperation. All of these motives result in them providing nonoptimal services to old customers (Sleptsov et al., 2013).

Second, establishing connections may itself stem from the purpose of independent financial advisors to guide the behavior of listed companies to maximize their own interests. Relationships can cause companies to become dependent on agencies. Specifically, agencies may lead companies into complex transactions that require specialized knowledge, as complex services means higher agency fees (Abrahamson and Fairchild, 1999; Hayward, 2003). It is not difficult for securities companies specializing in underwriting and M&A to guide the behavior of listed companies, as the latter usually only focus on their own businesses and are less likely to be familiar with the trading methods of capital markets,⁴ which means that they need advice from professional institutions. Independent financial advisors must invest in building relationships, which increases their costs but also allows them to secure subsequent business orders and benefit from a stronger position in negotiating commissions (Berger et al., 1972; Levinthal and Fichman, 1988).

In summary, the higher the transaction costs of MAR, the higher the need of listed companies for independent financial advisors to assist in completing the restructuring. They may hire independent financial advisors out of trust or change to a different independent financial advisor to obtain better services. In cases where both possibilities exist, this paper proposes the following hypotheses:

H1a. When other conditions remain unchanged, the higher the transaction costs of MAR, the more likely a listed company is to hire an independent financial advisor with which it has connections.

⁴ Of course, with increased awareness of market value management, listed companies may also increase their knowledge and skills concerning capital markets by hiring the former employees of securities companies. Pan and Dai (2013) note that such direct and indirect relationships, including interpersonal and monetary relationships, may be expressed as stable cooperation between listed companies and specific investment banks. Therefore, the connections mentioned in this paper are actually a synthesized indicator of both direct and indirect relationships.

H1b. When other conditions remain unchanged, the higher the transaction costs of MAR, the more likely a listed company is to hire an independent financial advisor with which it does not have connections.

3.1.2. Meritocracy: Influences of experience

Apart from established connections, the industry experience of independent financial advisors can also influence the hiring decisions of listed companies. The more experience an independent financial advisor has, the stronger its expertise is in acting as a go-between and assisting in the completion of transactions and the greater its ability is to master innovative transaction models. However, if the majority of its customers come from a specific industry, the independent financial advisor can better identify the needs of its customer with its well-established personal and information network resources and the industrial knowledge it has mastered (e.g., policy and regulation, the development direction of the industry, the position of the customer in the industry, and value chain). In this case, it has a greater advantage in screening targets and predicting synergies for listed companies (Chang et al., 2016). In their analysis of individual investment banks, Ertugrul and Krishnan (2014) find that industry experience is associated with better M&A performance, shorter transaction time, and higher probability of M&A success. Wang et al. (2014) find financial advisors' experience in the target industry to be positively associated with market responses, especially in cases of diversified M&A, a lack of M&A experience by the companies engaging in M&A, and the low information transparency of the target industry. Financial advisors can also obtain access to information from industry analysts at a low cost and deepen their understanding of industrial information (Kadan et al., 2012). In foreign countries, boutique investment banks specializing in one or several industries have occupied a stable market share. Song et al. (2013) find that in complex M&A transactions, companies are more likely to hire boutique investment banks as financial advisors because they have more specialized industry experience.

Therefore, the higher the transaction costs of MAR, the more listed companies need independent financial advisors with rich industry experience to leverage their expertise and network resources to achieve the smooth completion and maximum value of the restructuring. Chang et al. (2016) find that the rich industry experience of financial advisors increases their probability of being hired, especially when the M&A case is complex and the information asymmetry between the two parties is high. However, they also found that although industry experience is associated with higher M&A success rates, companies may reject hiring financial advisors that have worked for their peers for fear of information leakage. It is clear that the relationship between industry experience and the probability of independent financial advisors' being hired remains an empirical issue. Considering all of the above reasons, the following hypothesis is proposed:

H2. When other conditions remain unchanged, the higher the transaction costs of MAR, the more likely a listed company is to hire an independent financial advisor with industry experience.

3.2. Authentication role of independent financial advisors and hiring decisions of listed companies

In the case of the transaction role, listed companies may be motivated to hire independent financial advisors to reduce their transaction costs. However, in the case of the authentication role, they do not have the motivation to actively seek authentication in the current context, where the mechanism of information disclosure is imperfect and other regulatory mechanisms remain underdeveloped. However, their need for independent financial advisors' authentication role still exists, as investors may have negative feedback on possible agency problems within listed companies (Lin et al., 2011; Nain and Yao, 2013). Minority shareholders may also reject M&A proposals that may harm their own interests by voting against them in the general shareholders' meeting.⁵ Furthermore, the image of "being authenticated" can convey a signal to the outside world, including

⁵ For example, in 2012, the shareholders' meeting of Greatwall Computer (000066) rejected the proposal to acquire the shares of TPV Technology Co., Ltd., because the minority shareholders believed that the actual acquisition motive of the major shareholder was to pass the investment loss on to the minority shareholders. In 2011, the proposal of asset injection by the major shareholders of Guangdong Provincial Expressway Development Company Limited (000429) was also rejected by the shareholders' meeting, mainly because the acquisition premium was as high as 767% and the interests of the minority shareholders were infringed upon.

investors and the CSRC, that the MAR is under no influence of agency problems and that the trading is fair. In this sense, it would help the MAR pass the reviews of the shareholders' meeting and the CSRC and obtain good feedback from investors. The following section analyzes how listed companies, with the motive of signaling the fairness of restructuring to the outside world, choose between independent financial advisors with close ties and those with competence.

3.2.1. *Nepotism: Influences of connections*

If MAR is essentially a channel for major shareholders to siphon resources from a listed company, then their most vital concern (as the leaders of the restructuring) would be that the transaction successfully passes the resolution of the company's board of directors and the review of the CSRC. To obtain their commissions, independent financial advisors would also hope for the transaction to be completed smoothly. In this case, established connections between the two parties provide convenience for the listed companies (or rather the major shareholders leading the restructuring) and independent financial advisors to privately reach consensus to pursue their personal interests. Independent financial advisors do not restrict the behavior of major shareholders when it infringes upon the interests of listed companies through the MAR. In contrast, they are more likely to use their expertise in the "packaging and beautification" of information to ensure that the proposal is approved.

If a listed company has already been plagued by the second type of agency problem before the restructuring, MAR may arouse strong suspicion of their tunneling assets from the company, which would then give rise to distrust among the investors and a high probability of being rejected by the CSRC. In this case, the listed company would be motivated to ensure the successful completion of the restructuring through the expertise of the independent financial advisor in packaging and beautification. Therefore, it is possible for the company to hire an independent financial advisor that has established a good relationship with itself, but it is also possible for it to hire someone without connections or with weak connections to "avoid suspicion" by indicating the fairness of the transaction to minority shareholders and the CSRC. The foreign literature has yet to analyze the impact of connections on the fair opinion business of investment banks. For the independence of investment banks, [Chen \(2010\)](#) finds that if an investment bank is hired to provide both the financial advisory service and fair opinion service, the market reaction is even worse than in the case of an independent investment bank. [Kisgen et al. \(2009\)](#) also find that the purchase of fair opinions by the board of directors of the merger worsens market reaction, but hiring multiple investment banks or one that does not act as a financial advisor helps reduce the loss of shareholder value. These findings suggest that the market shows concern over whether investment banks that provide fair opinions can maintain their independence, at least in form.

To conclude, a listed company may hire an independent financial advisor with good connections and use its expertise in packaging and beautification to ensure that the restructuring passes the resolution of the shareholders' meeting and the review by the CSRC. However, it may also take the initiative to avoid suspicion by engaging independent financial advisors without connections to communicate the signal that the restructuring is fair to the outside world. In cases where both possibilities exist, this paper proposes the following hypotheses:

H3a. When other conditions remain unchanged, the greater the suspicion of major shareholders' tunneling is, the more likely a listed company is to hire an independent financial advisor with connections.

H3b. When other conditions remain unchanged, the greater the suspicion of major shareholders' tunneling is, the more likely a listed company is to hire an independent financial advisor without connections.

3.2.2. *Meritocracy: Influences of experience*

When listed companies have strong incentives to signal the fairness of the restructuring to the outside world, they may prefer to hire independent financial advisors with more industry experience. Veteran independent financial advisors are better at providing high-quality authentication service, as they are supposed to have more experience to tell whether the listed company has intentionally hidden or twisted any information, whether there is any inconsistency in the statement, and which parts of the transaction may best expose injus-

tice. As a result, the industry experience of independent financial advisors can convey to the outside world a favorable signal that the restructuring is subject to strict authentication.

However, when an independent financial advisor must perform both the transaction and authentication roles, one's "self-regulation" is bound to trigger endogenous conflict. The authentication role requires the independent financial advisor to evaluate the fairness of the transaction in which it is deeply involved. Thus, it is reasonable that it would not have the motivation to truly discover and disclose its own dereliction of duty. The motivation for completing the transaction to obtain the commissions also objectively exists, making the independent financial advisor reluctant to spend extra time and money to identify the unfair terms of the transaction that may harm the interests of the minority shareholders or to require modification from the listed company. Moreover, different from the transaction role, the direct consequences of which can be reflected by the success of the transaction and the transaction speed, the effect of the authentication role is not as easy to observe directly. The listed company or other regulators do not have clear standards for evaluating this role. Therefore, the work of authentication from the independent financial advisor is likely to be in vain. Good industry experience can be measured by the performance of independent financial advisors in their transaction role, but may not necessarily be shown in their authentication role. If the outside world, including investors and the CSRC, also reach consensus regarding the endogenous conflict between the two roles, listed companies may not hire an independent financial advisor with greater industry experience to signal that the restructuring is fair.

In summary, due to the endogenous conflict between the two businesses, whether a listed company hires an independent financial advisor with industry experience to signal that the restructuring is fair is an empirical problem. This paper proposes the following hypothesis⁶:

H4. When other conditions remain unchanged, the greater the suspicion of major shareholders' tunneling is, the more likely a listed company is to hire an independent financial advisor with industry experience.

4. Research design

4.1. Samples

This paper uses MAR events in the nonfinancial industry in the Chinese A-share market as a sample, excluding general M&A events. The reasons are listed as follows. First, financial advisors in general M&A are not subject to the *Measures for the Administration of Major Asset Reorganization of Listed Companies*, nor do all M&A have to provide authentication opinions as required by the *Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies*.⁷ Therefore, it is uncertain whether the financial advisors play the authentication role in general M&A cases. Second, MAR indicates a substantial change in the structure of a company, the impact of which is more significant on listed companies than that of general M&A, thus highlighting the role of independent financial advisors. In addition, it can help avoid the subjectivity of the general M&A samples in which the scale of target companies is restricted.⁸ Third, the information disclosure of listed companies is more standardized and comprehensive in cases of MAR, as the CSRC has more stringent requirements for the information disclosure of MAR. This is conducive to the data collection in this paper. For other general M&A events, due to incomplete information disclosure, it is difficult to identify whether it is possible for a listed company to hire a financial advisor or an independent financial advisor but not disclose information. This paper also avoids the problem of missing samples by choosing the samples of MAR.

⁶ A set of opposing hypotheses is not presented here. According to the analysis above, another possibility is not that listed companies tend to hire independent financial advisors without industry experience but that the preference of listed companies for industry experience cannot be observed.

⁷ This is according to Article 24 of the *Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies*, including the acquisition of listed companies, tender offers, MAR, and the issuance of shares to purchase assets.

⁸ For example, as too small-scale M&A would not have a material impact on listed companies, the general literature excludes samples with consideration paid in the amount of 1 million yuan or less.

The time interval for the samples of MAR is 2008 to 2013. The starting year is 2008, as the important document regulating the behavior of independent financial advisors, *Measures for the Administration of Financial Advisory Business of M&A and Restructuring of Listed Companies*, was implemented in 2008. The ending year is 2013 due to the implementation of channel reform for M&A review in 2013. The Securities Association of China issued the *Guidelines for the Professional Evaluation of Practice Ability of Securities Companies in Financial Advisory Business in Mergers and Acquisitions of Listed Companies* and the *2013 Professional Evaluation Results of Practice Ability of Securities Companies in Financial Advisory Business in Mergers and Acquisitions of Listed Companies*, which may subsequently exert influence over the hiring preferences of listed companies.⁹

4.2. Model setting and variable definition

The following probit models (1) and (2) test H1 and H2, respectively. When a listed company makes a hiring decision, it is also making a choice between nepotism and meritocracy. That is, hiring an independent financial advisor with connections does not rule out the possibility that the independent financial advisor also has industry experience and vice versa. Therefore, the residuals of models (1) and (2) are likely to be relevant. To reduce the deviation of the model, this paper learns from the method of Reid and Carcello (2017). Furthermore, it uses seemingly unrelated regression (SUR) to simultaneously estimate models (1) and (2) and test the difference in β_1 in models (1) and (2) to examine the different preferences for nepotism and meritocracy when listed companies are more in need of independent financial advisors' transaction role.

$$Same = \beta_0 + \beta_1 Transaction + ControlVariables + \varepsilon \quad (1)$$

$$Exper = \beta_0 + \beta_1 Transaction + ControlVariables + \varepsilon \quad (2)$$

H3 and H4 are examined using the following probit models (3) and (4), respectively. SUR is also used to estimate models (3) and (4) simultaneously and to test the different preferences for nepotism and meritocracy when listed companies are more in need of independent financial advisors' authentication role.

$$Same = \beta_0 + \beta_1 Tunneling + ControlVariables + \varepsilon \quad (3)$$

$$Exper = \beta_0 + \beta_1 Tunneling + ControlVariables + \varepsilon \quad (4)$$

Among the dependent variables of the above models, *Same* represents the connections between listed companies and independent financial advisors: before the M&A in the sample, some listed companies hired the same financial advisors from securities companies for businesses that may be M&A, restructuring, IPO underwriting, related party transactions, and equity incentives. In addition to setting up the virtual variable *Same* to examine the existence of connections, this paper also subdivides the characteristics of the connections: the number of connections (*Same_number*) to measure the strength of the connections and the ratio of connections (*Same_ratio*) to measure the exclusiveness of the services offered by the independent financial advisor from the securities company to the listed company. *Exper* represents the industry experience of independent financial advisors: if the securities companies have participated in the M&A of listed companies in the same industry (or possibly the sample listed companies themselves) as the financial advisors, they are considered to have industry experience.¹⁰ In addition to setting up the virtual variable *Exper* to examine the existence of industry experience, this paper subdivides the characteristics of industry experience: the number of experiences (*Exper_number*) to measure the strength of experience and the ratio of experiences (*Exper_ratio*) to measure the concentration of independent financial advisors' experience in the industry.

⁹ The professional evaluation results of the practice ability in the financial advisory business may replace connections or industry experience as a major factor affecting the decision making of listed companies. For example, in Article 8 of the newly revised *Measures for Administration of Major Asset Restructuring of Listed Companies* in 2014, in the CSRC review, the content and procedures may be reduced based on the ability and quality of financial advisors. Therefore, when other conditions remain unchanged, listed companies tend to hire independent financial advisors with better professional evaluation results to ensure the smooth and rapid CSRC approval of restructuring.

¹⁰ Among all of the samples in this paper, only a couple of listed companies hire independent financial advisors from two agencies for their MAR. This paper treats the situation as follows: as long as one of the two agencies has the feature of connections, it is deemed that the given listed company hires an independent financial advisor with connections for MAR. The same is true in the case of industry experience.

Table 1
Variable definitions.

Type	Name	Variable	Definition and description
Dependent variables	Existence of connections	<i>Same</i>	If the securities company of the independent financial advisor has provided services (e.g., M&A, IPO underwriting, related party transactions, and equity incentives) to the listed company within the 5 years before the current period, this variable equals 1. Otherwise, it equals 0
	Number of connections	<i>Same_number</i>	This variable equals the number of services (e.g., M&A, IPO underwriting, related party transactions, and equity incentives) offered by the securities company of the independent financial advisor to the listed company within the 5 years before the current period. If no service has been provided within these 5 years, it equals 0
	Ratio of connections	<i>Same_ratio</i>	This variable equals <i>Same_number</i> divided by the sum of the number of businesses for which the listed company requires financial advisory services. This variable measures the exclusiveness of the services offered by the securities company of the independent advisor to the listed company
	Existence of industry experience	<i>Exper</i>	If the independent financial advisor has served as the financial advisor for the M&A business of other companies in the same industry as the listed company within the 5 years before the current period, this variable equals 1. Otherwise, it equals 0
	Number of experiences	<i>Exper_number</i>	This variable equals the number of times the independent financial advisor has served as the financial advisor for the M&A business of companies in the same industry as the listed company within the 5 years before the current period. If it has not served within these 5 years, it equals 0
	Ratio of experience	<i>Exper_ratio</i>	This variable equals <i>Exper_number</i> divided by the sum of the number of times the financial advisor has offered financial advisory services for the M&A of all listed companies within the 5 years before the current period. This variable measures the independent financial advisor's experience in the industry
Explanatory Variables	Restructuring scale (measuring transaction costs)	<i>Pay</i>	This variable equals the natural logarithm of the consideration. The larger the value is, the larger the scale of the restructuring is and the greater the transaction costs are (Servaes and Zenner, 1996; Song et al., 2013; Wang et al., 2014)
	Unrelated restructuring (measuring transaction costs)	<i>Ifunrelate</i>	If the target is in an industry not related to that of the listed company (i.e., unrelated restructuring), this variable equals 1. Otherwise, it equals 0. The less related the two industries, the greater the transaction costs are (Servaes and Zenner, 1996; Sleptsov et al., 2013; Song et al., 2013)
	Related-party restructuring (measuring the suspicion of major shareholders' tunneling)	<i>Relate</i>	If the MAR is a related party restructuring, this variable equals 1. Otherwise, it equals 0. According to Chen and Xu (2012) and Deng (2011), the related party M&A are likely to be a means for major shareholders to expropriate the listed companies
	Separation of ownership and control (measuring the suspicion of major shareholders' tunneling)	<i>Divert</i>	The annual-industrial median of the past year is used as the standard. If the listed company's separation of ownership and control in the previous period is not less than this median, this variable equals 1. Otherwise, it equals 0. According to Tang et al. (2012), the separation of ownership and control equals control rights divided by cash-flow rights

(continued on next page)

Table 1 (continued)

Type	Name	Variable	Definition and description
Control variables	Target type	<i>Target_type</i>	If stock shares are included in the target, this variable equals 1; otherwise, it equals 0 (Servaes and Zenner, 1996)
	Return on assets	<i>ROA</i>	The net profit of the previous period/the average balance of the total assets of the previous period, the average balance of total assets = (total assets at the end of the period + total assets at the end of the previous year)/2
	Company age	<i>Age</i>	The current year minus the year in which the listed company was established plus 1
	Share-based payment	<i>Payment</i>	If the payment methods include share-based payment, this variable equals 1; otherwise, it equals 0 (Servaes and Zenner, 1996)
	Asset size	<i>Size</i>	The natural logarithm of the operating income in the previous period (Zhang and Yuan, 2013)
	Asset-to-liability ratio	<i>Lev</i>	The asset-liability ratio in the previous period (Golubov et al., 2012)
	Experience in MAR	<i>First</i>	If the listed company's first MAR occurs during the sample period, this variable equals 1; otherwise, it equals 0 (Servaes and Zenner, 1996)
	Nature of property	<i>Soe</i>	If the actual controller of the company in the previous period is a state-owned enterprise, this variable equals 1. Otherwise, it equals 0
	Management shareholding	<i>Ma_stock</i>	The shareholding ratio of the management in the previous period
	Growth	<i>Growth</i>	The operating profit growth rate
	Year	<i>Year</i>	If the observed value is in the year, this variable equals 1
	Industry	<i>Industry</i>	If the observed value is in the industry, this variable equals 1
Province	<i>Province</i>	If the observed value is in the province, this variable equals 1	

Among the explanatory variables of the above models, *Transaction* represents the transaction costs of the restructuring, measured by the scale and unrelatedness of the restructuring. When the scale of restructuring is relatively large, both the transaction parties would be extremely cautious in determining the true value of the target to avoid negative impacts from unreasonable consideration. However, large scale also means great difficulty in integration. The job to integrate the target with a complete business model and management structure into itself to form synergies requires the acquirer to have a strong ability of integration. The less related the acquirer and the target, the less likely the M&A is to create synergies (Anand and Singh, 1997) and the less familiar the acquirer may be with the strategic steps of integrating the target to create synergies (Hoskisson and Hitt, 1994). Tunneling indicates that major shareholders are suspected of emptying out the company through MAR and is measured by separation of ownership and control in the related restructuring and the listed company. According to Chen and Xu (2012) and Deng et al. (2011), related-party M&A are likely to become a means for major shareholders to expropriate listed companies. Moreover, the high separation of ownership and control gives major shareholders more capability (great controlling rights) and motivation (small cash-flow rights) to encroach on the interests of listed companies (Yu et al., 2014).

In the regression model, this paper also controls the characteristic variables of other listed companies and the restructuring and the year-, industry-, and region-fixed effects.

The MAR samples come from the CSMAR M&A database. The data on the connections and industry experience of independent financial advisors come from the announcements at <http://www.cninfo.com.cn> and are collated manually by the author. The data relevant to the restructuring, such as the names of independent advisors, the industry of the target company, and the payment of consideration, are collected and sorted by the author based on the announcements published at <http://www.cninfo.com.cn>. Furthermore, the other data about the characteristics of listed companies come from the M&A/structuring database of the CSMAR. In particular, as connections and industry experience involve independent financial advisors'

business in previous years, this paper also considers such events as the name change, acquisition, and business takeover of the securities company of the independent financial advisor.

Table 1 presents the definitions and descriptions of the variables discussed in this paper.

5. Empirical results

5.1. Descriptive statistics

Table 2 shows the descriptive statistical results of the variables listed in this paper. The average value of *Same* is 0.122, indicating that the listed companies hire independent financial advisors with connections in only 12% of the MAR events. The maximum value of *Same_number* is only 2, which also indicates that the listed companies frequently change the securities companies they hire. The average value of *Exper* is 0.564, the average value of *Exper_ratio* is 2.728, and the maximum value of *Exper_number* is 21, indicating the universality of industry experience. The average value of *Ifunrelate* is 0.330, indicating that many MAR targets are from industries that are not related to the listed companies, which increases the difficulty of identifying the value of the targets and necessitates the transaction role of independent financial advisors. The average value of *Relate* is 0.856, indicating that the vast majority of MAR events occur between related parties, which increases the possibility of major shareholders' tunneling and highlights the importance of the authentication role of independent financial advisors.

5.2. Multivariate analysis

The test results of H1 to H4 are listed in Table 3. The second to fifth columns are the test results of H1 and H2. The second and third columns test H1 and H2 with the restructuring scale (*Expense*) as the explanatory variable. The coefficient of *Expense* in the second column is significantly negative, the coefficient of *Expense* in the third column is significantly positive, and the coefficient between the two groups is significant at the 1% level. The fourth and fifth columns test H1 and H2 with unrelated restructuring (*Ifunrelate*) as the explanatory variable. The results are similar to those in the second and third columns. The coefficient of *Ifunrelate* in the fourth column is significantly negative, the coefficient of *Ifunrelate* in the fifth column is significantly positive,

Table 2
Descriptive statistics.

Variables	N	Mean	SD	Median	Min	Max
<i>Same</i>	312	0.122	0.328	0.000	0.000	1.000
<i>Same_ratio</i>	312	0.108	0.301	0.000	0.000	1.000
<i>Same_number</i>	312	0.128	0.354	0.000	0.000	2.000
<i>Exper</i>	312	0.564	0.497	1.000	0.000	1.000
<i>Exper_ratio</i>	312	0.158	0.192	0.100	0.000	1.000
<i>Exper_number</i>	312	2.728	4.222	1.000	0.000	21.000
<i>Expense</i>	312	21.091	1.127	21.193	17.701	24.095
<i>Ifunrelate</i>	312	0.330	0.471	0.000	0.000	1.000
<i>Relate</i>	312	0.856	0.352	1.000	0.000	1.000
<i>Divert</i>	312	0.369	0.483	0.000	0.000	1.000
<i>Target_type</i>	312	0.894	0.308	1.000	0.000	1.000
<i>ROA</i>	312	0.021	0.102	0.026	-0.313	0.255
<i>Age</i>	312	15.279	4.578	15.000	5.000	25.000
<i>Payment</i>	312	0.837	0.370	1.000	0.000	1.000
<i>Size</i>	312	21.078	1.311	20.922	18.751	25.800
<i>Lev</i>	312	0.566	0.353	0.521	0.048	1.677 ¹
<i>First</i>	312	0.936	0.245	1.000	0.000	1.000
<i>Soe</i>	312	0.574	0.495	1.000	0.000	1.000
<i>Ma_stock</i>	312	0.026	0.087	0.000	0.000	0.533
<i>Growth</i>	312	-0.437	4.526	-0.058	-22.709	19.964

¹ Observations with leverage higher than 1 are not excluded, as financial crisis is a key reason why listed firms make M&A.

Table 3
Test results for H1 to H4.

	Same	Exper	Same	Exper	Same	Exper	Same	Exper
<i>Expense</i>	-0.536 ^{***} (-3.89)	0.184 ^{**} (2.21)						
Test of differences Chi ² <i>Ifunrelate</i>		20.71^{***}	-0.588 ^{**} (-2.02)	0.453 ^{**} (2.14)				
Test of differences Chi ² <i>Relate</i>				8.58^{***}	-0.745 ^{***} (-2.61)	0.430 (1.55)		
Test of differences Chi ² <i>Divert</i>						8.92^{***}	-0.504 ^{**} (-1.98)	0.214 (1.32)
Test of differences Chi ² <i>Target_type</i>								5.57^{**}
	0.074 (0.17)	0.195 (0.67)	-0.102 (-0.27)	0.447 (1.55)	-0.021 (-0.05)	0.235 (0.80)	-0.023 (-0.06)	0.055 (0.22)
<i>ROA</i>	1.095 (0.71)	0.974 (1.15)	-0.877 (-0.62)	0.788 (0.94)	1.291 (0.95)	0.840 (1.00)	1.986 (1.43)	0.550 (0.71)
<i>Age</i>	-0.031 (-1.12)	-0.027 (-1.29)	-0.025 (-1.00)	-0.011 (-0.58)	-0.029 (-1.09)	-0.029 (-1.39)	-0.040 (-1.50)	-0.031 [*] (-1.70)
<i>Payment</i>	-0.225 (-0.67)	0.187 (0.79)	-0.247 (-0.83)	0.223 (0.96)	-0.152 (-0.48)	0.153 (0.65)	-0.133 (-0.43)	-0.001 (-0.00)
<i>Size</i>	0.123 (1.01)	-0.049 (-0.61)	-0.123 (-1.20)	0.123 (1.51)	-0.022 (-0.21)	-0.007 (-0.09)	-0.003 (-0.03)	-0.090 (-1.36)
<i>Lev</i>	-0.464 (-1.03)	0.181 (0.68)	-0.537 (-1.21)	-0.006 (-0.02)	-0.488 (-1.21)	0.225 (0.85)	-0.793 [*] (-1.87)	0.320 (1.36)
<i>First</i>	-1.800 ^{***} (-4.08)	-0.517 (-1.36)	0.263 (1.15)	-0.540 (-1.48)	-1.319 ^{***} (-3.26)	-0.561 (-1.53)	-1.285 ^{***} (-2.94)	-0.361 (-1.10)
<i>Soe</i>	-0.416 (-1.46)	0.219 (1.09)	-0.246 (-0.94)	0.147 (0.78)	-0.295 (-1.05)	0.149 (0.73)	-0.814 ^{***} (-2.74)	0.373 ^{**} (1.96)
<i>Ma_stock</i>	3.112 ^{**} (2.51)	0.970 (0.82)	3.087 ^{***} (2.70)	1.196 (1.09)	3.253 ^{***} (2.66)	1.068 (0.87)	1.764 [*] (1.90)	2.312 ^{**} (2.07)
<i>Growth</i>	0.047 (1.22)	0.024 (1.36)	0.732 ^{***} (3.17)	0.029 (1.63)	0.032 (0.91)	0.025 (1.44)	0.020 (0.54)	0.022 (1.33)
<i>Constant</i>	8.520 ^{**} (2.55)	-3.075 (-1.33)	2.089 (0.89)	-3.437 [*] (-1.81)	0.799 (0.32)	-0.275 (-0.15)	0.360 (0.14)	2.600 [*] (1.65)
<i>Year</i>	yes	yes	yes	yes	yes	yes	yes	yes
<i>Industry</i>	yes	yes	yes	yes	yes	yes	yes	yes
<i>Province</i>	yes	yes	yes	yes	yes	yes	yes	yes
LR chi ²		182.112		149.643		167.600		81.675
N		312		312		312		312

Note: This table reports the regression results for H1 to H4. All of the variables are defined in Table 1. The figures in parentheses are robust z-statistics adjusted for heteroskedasticity.

* Significance at the 10% level (two-tailed test).

** Significance at the 5% level (two-tailed test).

*** Significance at the 1% level (two-tailed test).

and the coefficient between the two groups is significant at the 1% level. The above results show that with respect to the transaction role of independent financial advisors, listed companies tend to hire those without connections but with industry experience when making hiring decisions. That is, meritocracy outweighs nepotism. Thus, H1b and H2 are supported.

The sixth to ninth columns of Table 3 are the test results of H3 and H4. In the sixth and seventh columns, the related party restructuring (*Relate*) is used as the explanatory variable to test H3 and H4. In the sixth column, the coefficient of *Relate* is significantly negative. In the seventh column it is positive, but not significant.

The coefficient between the two groups is significant at the 1% level. The eighth and ninth columns test H3 and H4 with the separation of ownership and control (*Divert*) as the explanatory variable, the results of which are similar to those of the sixth and seventh columns. The *Divert* coefficient in the eighth column is significantly negative. In the ninth column, the coefficient of *Divert* is positive, but not significant. The coefficient between the two groups is significant at the 5% level. The above results indicate that for the authentication role of independent financial advisors, listed companies tend to hire independent financial advisors without connections when making hiring decisions, but there is no evidence to support that listed companies tend to hire independent financial advisors with industry experience. They avoid nepotism but do not necessarily choose meritocracy. Thus, H3b is supported, whereas H4 is not.

The two following reasons may explain why H4 is not supported. First, from the perspective of the motives of independent financial advisors, as mentioned above, there is an endogenous conflict between their dual roles. To successfully and smoothly complete the restructuring, they have the motivation to issue a fair evaluation opinion even for unfair restructuring. Although better industry experience means a higher number of transactions completed in the past, the transaction completion can only directly manifest the fulfillment of the transaction role. The authentication role is more similar to an obligation imposed on the independent financial advisors that they have to perform and it is understandable that this role becomes reduced to a kind of formalism. Thus, abundant industry experience does not necessarily mean that the authentication role of the independent financial advisors' is of high quality. Second, from the perspective of the motives of listed companies, different from the U.S., where the board of directors hires investment banks to provide fair opinions as a manifestation of duty of care, in China, it is mandatorily required by the CSRC that independent financial advisors provide the authentication, rather than out of the needs of listed companies or other relevant stakeholders. For Chinese listed companies still with an imperfect corporate governance mechanism, it is common for major shareholders to control and tunnel companies. In the current context, where the information disclosure mechanism is not perfect and other regulatory mechanisms remain underdeveloped, listed companies do not have the motivation to actively seek authentication from the authorities and authentication is only an obligation imposed on them. Therefore, they only have the motivation to "superficially" transmit the signal that the restructuring is fair. Thus, they may avoid hiring an independent financial advisor with connections to avoid suspicion, but would not actively ask for authentication and restriction from independent financial advisors. As a result, even if industry experience can measure the quality of the independent financial advisors' authentication role to a certain extent, listed companies lack the motivation to actively seek substantive authentication from independent financial advisors.

5.3. Further study

5.3.1. Effect of reputation

The test results for H1 and H3 all show that listed companies tend to hire independent financial advisors without connections, which means that connections have negative impacts on both the transaction and authentication role of independent financial advisors. Independent financial advisors can establish connections as a means to pursue self-interest in both their transaction role and authentication role. In this sense, maximizing their own interests rather than maximizing the interests of listed companies becomes their primary goal, which is the root cause for the adverse impacts of connections. A series of studies notes that reputation mechanisms can alleviate conflicts of interest between principals and agents (Kesner et al., 1994; McLaughlin, 1996; Sharma, 1997). Specifically, when the present value of future earnings after the execution of the contract is higher than the gains from breaching the current contract, the parties in the transaction trade in good faith and commit to establishing and maintaining their reputation (Klein et al., 1978; Williamson, 1979). This is the value of reputation. Another series of studies finds that financial advisors with a strong reputation can create greater value for M&A shareholders (Golubov et al., 2012; Kale et al., 2003). Thus, it can be inferred that the higher the reputation of independent financial advisors is, the more importance they would attach to constraining opportunistic behavior to present a good image that they are representing the interests of principals (Thomas, 1995). This can then reduce the adverse effects of connections and increase the possibility of listed companies hiring independent financial advisors with connections.

Table 4
Effect of reputation.

	Same High reputation group	Same Low reputation group	Same High reputation group	Same Low reputation group	Same High reputation group	Same Low reputation group	Same High reputation group	Same Low reputation group
<i>Expense</i>	−0.473 (−1.56)	−0.525*** (−3.09)						
<i>Ifunrelate</i>			−0.545 (−0.83)	−0.788** (−2.00)				
<i>Relate</i>					0.038 (0.05)	−0.670* (−1.75)		
<i>Divert</i>							0.446 (0.86)	−0.672** (−2.11)
<i>Target_type</i>	0.547 (0.58)	−0.562 (−1.03)	−0.286 (−0.42)	−0.416 (−0.81)	−0.096 (−0.12)	−0.231 (−0.41)	−0.072 (−0.11)	−0.095 (−0.19)
<i>ROA</i>	−2.180 (−0.48)	4.260** (2.30)	−9.076** (−2.03)	1.533 (0.94)	0.442 (0.11)	4.138** (2.13)	−8.081* (−1.91)	2.477 (1.38)
<i>Age</i>	−0.086 (−1.23)	−0.010 (−0.29)	−0.045 (−0.80)	−0.034 (−1.07)	−0.076 (−1.07)	−0.004 (−0.10)	−0.056 (−0.99)	−0.036 (−1.14)
<i>Payment</i>	0.867 (0.77)	−0.429 (−1.04)	1.008 (1.01)	−0.523 (−1.38)	1.268 (0.85)	−0.508 (−1.15)	0.848 (0.84)	−0.442 (−1.19)
<i>Size</i>	0.615* (1.92)	−0.149 (−0.87)	0.395 (1.40)	−0.391** (−2.33)	0.500 (1.59)	−0.226 (−1.23)	0.409 (1.48)	−0.234 (−1.44)
<i>Lev</i>	−1.335 (−0.99)	0.367 (0.64)	−2.989* (−1.87)	0.237 (0.43)	−1.048 (−0.93)	−0.017 (−0.03)	−2.662* (−1.80)	−0.243 (−0.42)
<i>First</i>	−2.755*** (−2.95)	−1.209** (−1.96)	1.261** (2.51)	−0.210 (−0.66)	−2.573** (−2.53)	−1.003 (−1.48)	1.031* (1.91)	−1.316** (−1.98)
<i>Soe</i>	−1.333* (−1.69)	−0.418 (−1.17)	−0.300 (−0.52)	−0.470 (−1.39)	−1.352 (−1.48)	−0.591 (−1.46)	−0.268 (−0.46)	−0.619* (−1.79)
<i>Ma_stock</i>	4.717 (1.42)	3.405** (2.41)	3.304 (1.29)	2.972** (2.21)	4.292 (1.49)	3.962*** (2.65)	4.196 (1.61)	2.318* (1.72)
<i>Growth</i>	0.104 (1.23)	0.117 (1.58)	1.638** (2.51)	0.534** (2.00)	0.077 (0.75)	0.089 (1.24)	1.453*** (2.58)	0.596** (2.11)
<i>Constant</i>	−4.022 (−0.52)	14.903*** (2.94)	−9.945 (−1.59)	8.489** (2.21)	−15.871 (−0.02)	5.404 (1.33)	−10.520* (−1.72)	6.366* (1.75)
<i>Year</i>	yes	yes	yes	yes	yes	yes	yes	yes
<i>Industry</i>	yes	yes	yes	yes	yes	yes	yes	yes
<i>Province</i>	yes	yes	yes	yes	yes	yes	yes	yes
Pseudo R ²	0.467	0.313	0.323	0.238	0.450	0.303	0.323	0.258
LR chi ²	35.696	47.235	24.717	35.905	34.421	45.676	24.716	38.874
N	136	176	136	176	136	176	136	176

Note: This table reports the regression results for the effect of reputation. All of the variables are defined in Table 1. The figures in parentheses are robust z-statistics adjusted for heteroskedasticity.

* Significance at the 10% level (two-tailed test).

** Significance at the 5% level (two-tailed test).

*** Significance at the 1% level (two-tailed test).

Table 5

The transaction role and firms' hiring decisions: Using ratio and number of connections/experience as dependent variables.

	<i>Same_ratio</i>	<i>Exper_ratio</i>	<i>Same_ratio</i>	<i>Exper_ratio</i>	<i>Same_number</i>	<i>Exper_number</i>	<i>Same_number</i>	<i>Exper_number</i>
<i>Expense</i>	−0.497*** (−3.43)	0.166** (1.97)			−0.510*** (−3.81)	0.151** (2.23)		
Test of differences Chi ²		16.80***				19.95***		
<i>Ifunrelate</i>			−0.520* (−1.67)	0.429** (2.09)			−0.607** (−1.97)	0.472** (2.39)
Test of differences Chi ²				6.66***				8.79***
<i>Target_type</i>	−0.800* (−1.96)	0.091 (0.45)	−0.108 (−0.25)	0.546** (1.97)	−0.223 (−0.50)	−0.068 (−0.30)	−0.092 (−0.21)	0.414 (1.62)
<i>ROA</i>	0.922 (0.59)	0.986 (1.19)	−1.019 (−0.68)	0.395 (0.49)	1.880 (1.20)	0.247 (0.33)	−0.814 (−0.51)	−0.667 (−0.91)
<i>Age</i>	−0.036 (−1.19)	−0.007 (−0.35)	−0.029 (−1.06)	−0.008 (−0.40)	−0.041 (−1.38)	0.003 (0.16)	−0.024 (−0.87)	−0.026 (−0.05)
<i>Payment</i>	−0.318 (−0.80)	0.142 (0.57)	−0.234 (−0.73)	0.252 (1.12)	−0.208 (−0.57)	0.147 (0.80)	−0.148 (−0.45)	0.257 (1.24)
<i>Size</i>	0.092 (0.74)	0.020 (0.24)	−0.082 (−0.74)	0.077 (0.97)	0.108 (0.90)	−0.148** (−2.39)	−0.150 (−1.34)	0.126* (1.94)
<i>Lev</i>	−0.256 (−0.56)	−0.031 (−0.12)	−0.717 (−1.48)	0.004 (0.02)	−0.343 (−0.77)	−0.064 (−1.54)	−0.805 (−1.61)	−0.018 (−0.37)
<i>First</i>	−1.763*** (−3.77)	−0.676* (−1.67)	0.235 (0.92)	−0.348 (−1.01)	−1.951*** (−4.35)	−0.163 (−0.60)	0.170 (0.67)	−0.295 (−1.55)
<i>Soe</i>	−0.377 (−1.19)	0.106 (0.55)	−0.220 (−0.79)	0.135 (0.74)	−0.483 (−1.52)	0.114 (0.71)	−0.285 (−0.96)	−0.106 (−0.59)
<i>Ma_stock</i>	3.209** (2.45)	1.397 (1.26)	2.909** (2.48)	1.757 (1.63)	2.585** (2.06)	2.560*** (3.02)	3.464*** (2.76)	0.458 (0.82)
<i>Growth</i>	0.063 (1.26)	0.023 (1.28)	0.800*** (3.05)	0.034* (1.92)	0.032 (0.75)	−0.063 (−0.96)	0.888*** (3.38)	−0.057 (−0.32)
<i>Constant</i>	10.138*** (2.89)	−3.704* (−1.67)	1.354 (0.53)	−2.379 (−1.32)	—	—	—	—
<i>Year</i>	yes	Yes	yes	yes	yes	yes	yes	yes
<i>Industry</i>	yes	Yes	yes	yes	yes	yes	yes	yes
<i>Province</i>	yes	Yes	yes	yes	yes	yes	yes	yes
LR chi ²		167.527				155.549		228.824
N		312		312		312		312

Note: This table reports the regression results for using ratio and number of connections/experience as dependent variables. All of the variables are defined in Table 1. The figures in parentheses are robust z-statistics adjusted for heteroskedasticity.

* Significance at the 10% level (two-tailed test).

** Significance at the 5% level (two-tailed test).

*** Significance at the 1% level (two-tailed test).

This paper then re-examines H1 and H3 based on different groupings of the independent financial advisors' reputation. The results are shown in Table 4. The reputation data are collected from the League table in the Mergermarket database, which is a limited company that provides information about the M&A market. The number and size of projects in which the independent financial advisors have acted as financial advisors for all the Chinese acquirers in M&A events from 1998 to 2013 are ranked. If an independent financial advisor is in the top 10 in both rankings, it is deemed as a high-reputation independent financial advisor. Otherwise, it is a low-reputation independent financial advisor. The results in Table 4 show that the negative correlation between the transaction costs of the restructuring and the connections exists only in the low-reputation group. The negative correlation between the major shareholders' tunneling and the connections also exists only in the

Table 6

The authentication role and firms' hiring decisions: Using ratio and number of connections/experience as dependent variables.

	<i>Same_ratio</i>	<i>Exper_ratio</i>	<i>Same_ratio</i>	<i>Exper_ratio</i>	<i>Same_number</i>	<i>Exper_number</i>	<i>Same_number</i>	<i>Exper_number</i>
<i>Relate</i>	-0.661** (-2.21)	0.108 (0.44)			-0.710** (-2.38)	0.195 (0.97)		
Test of differences Chi ²		4.33**				6.64***		
<i>Divert</i>			-0.619** (-2.05)	0.129 (0.77)			-0.715** (-2.03)	0.050 (0.37)
Test of differences Chi ²				4.71**				4.04**
<i>Target_type</i>	-0.828** (-2.20)	0.213 (1.16)	-1.050*** (-2.59)	0.229 (1.23)	-0.233 (-0.55)	0.157 (1.02)	-1.245*** (-2.71)	0.158 (1.04)
<i>ROA</i>	0.755 (0.55)	0.337 (0.43)	1.923 (1.21)	0.548 (0.68)	1.664 (1.16)	-0.082 (-0.13)	1.609 (0.88)	-0.098 (-0.15)
<i>Age</i>	-0.022 (-0.78)	-0.009 (-0.51)	-0.045 (-1.49)	-0.025 (-1.34)	-0.035 (-1.21)	0.005 (0.32)	-0.052 (-1.53)	0.008 (0.57)
<i>Payment</i>	-0.346 (-0.95)	0.116 (0.53)	-0.313 (-0.84)	0.160 (0.72)	-0.166 (-0.48)	0.068 (0.37)	-0.326 (-0.78)	0.080 (0.44)
<i>Size</i>	-0.044 (-0.40)	-0.032 (-0.52)	0.035 (0.28)	-0.079 (-1.20)	-0.009 (-0.09)	-0.006 (-0.12)	-0.028 (-0.21)	-0.006 (-0.11)
<i>Lev</i>	-0.466 (-1.09)	0.050 (0.22)	-0.812* (-1.65)	0.219 (0.91)	-0.456 (-1.11)	-0.039 (-0.21)	-0.688 (-1.62)	-0.029 (-0.15)
<i>First</i>	-1.348*** (-3.17)	-0.264 (-0.82)	-1.249** (-2.47)	-0.196 (-0.59)	-1.644*** (-3.83)	-0.365 (-1.44)	-2.140*** (-3.21)	-0.321 (-1.27)
<i>Soe</i>	-0.252 (-0.85)	0.147 (0.83)	-0.792** (-2.31)	0.312 (1.64)	-0.376 (-1.21)	0.064 (0.44)	-0.779* (-1.95)	0.115 (0.77)
<i>Ma_stock</i>	3.493*** (2.77)	2.480** (2.31)	2.444** (2.30)	2.005* (1.80)	3.024** (2.46)	3.161*** (3.99)	1.853 (1.56)	3.112*** (3.91)
<i>Growth</i>	0.049 (1.18)	0.020 (1.20)	0.029 (0.61)	0.022 (1.30)	0.024 (0.59)	0.014 (0.97)	0.035 (0.61)	0.014 (1.00)
<i>Constant</i>	-3.147 (-0.00)	0.842 (0.59)	-4.018 (-0.00)	2.046 (1.34)	-	-	-	-
<i>Year</i>	yes	Yes	yes	yes	yes	yes	yes	yes
<i>Industry</i>	yes	Yes	yes	yes	yes	yes	yes	yes
<i>Province</i>	yes	Yes	yes	yes	yes	yes	yes	yes
LR chi ²		83.840		95.089		93.000		117.371
N		312		312		312		312

Note: This table reports the regression results for using ratio and number of connections/experience as dependent variables. All of the variables are defined in Table 1. The figures in parentheses are robust z-statistics adjusted for heteroskedasticity.

* Significance at the 10% level (two-tailed test).

** Significance at the 5% level (two-tailed test).

*** Significance at the 1% level (two-tailed test).

low-reputation group. Thus, the above inference that reputation can alleviate the adverse effects of connections can be confirmed to a certain extent.

5.3.2. Using ratio and number of connections/experience as dependent variables

In the above tests of H1 to H4, the existence of connections (*Same*) and the existence of industry experience (*Exper*) have been chosen as the dependent variables. This paper also expands the connotation of connections (industry experience) and considers the ratio and number of connections (experience). The higher the ratio or the greater the number is, the stronger the connections (experience). The dependent variables of models (1)–(4) are replaced with ratio and number and SUR is used to estimate the OLS model and the ordered probit model, respectively. The results are shown in Tables 5 and 6. The results reflect those in Table 3. In both cases, when

the dependent variable is replaced by ratio and number, the higher the transaction costs of the restructuring, the more the listed companies tend to hire independent financial advisors with weaker connections and more industry experience. Furthermore, the greater the suspicion of the major shareholders' tunneling is, the more likely the listed companies are to hire independent financial advisors with weaker connections. There is no significant preference for industry experience.

5.4. Robustness test

The following tests are also carried out, but the regression results are not reported to conserve space. First, based on the findings of [Chang et al. \(2016\)](#), the connections and the industry experience variables in the above analysis are limited to the previous 5 years. In the robustness test, the time limit is eased. The time interval for connection as a variable is changed from the earliest date when the data are accessible at <http://www.cninfo.com.cn> (i.e., January 1, 2000) to the previous year of the sample's year. Furthermore, the time interval for industry experience as a variable is changed from the time when the CSMAR M&A database can provide eligible samples (i.e., January 1, 1999) to the previous year of the sample's year. H1 to H4 are re-examined and the test results are consistent with the previous. Second, as the reputation of financial advisors affects the probability of being hired ([Francis et al., 2014](#)), the reputation of independent financial advisors is controlled in models (1) to (4) in this paper. The results remain unchanged. Third, the results of [Table 4](#) stem from using SUR to estimate the probit model. Here, the logit model is used to estimate models (1)–(4). The results remain unchanged.

6. Conclusions

After providing a description of the institutional background related to independent financial advisors, this paper studies how listed companies in MAR choose between industry experience (meritocracy) and connections (nepotism) in hiring independent financial advisors. Based on the empirical tests of the MAR of A-share listed companies in 2008 to 2013, this paper finds that the higher the transaction costs of restructuring are (i.e., the more the listed companies need the transaction role of independent financial advisors), the more they are inclined to hire independent financial advisors with weaker connections and better industry experience. Furthermore, the greater the suspicion of major shareholders' tunneling is (i.e., the more listed companies need the authentication role of independent financial advisors to pass the signal of fairness), the more they tend to hire independent financial advisors with weaker connections, although no significant preference for industry experience has been found. Further research finds that reputation has a certain governance effect on the adverse impacts of connection and that the negative correlation between connections and the probability of hiring of listed companies exists only in the group of independent financial advisors with low reputation.

The bonding from established connections can foster mutual trust and thus facilitate information communication. However, the fundamental motivation for the behavior of independent financial advisors is to pursue the maximization of their own interests, which is the root cause of the negative correlation between connections and the probability of hiring by the listed companies. It is also why the governance effect of reputation helps alleviate the negative impacts of connections and increase the probability that independent financial advisors with connections get hired. Industry experience is related to the capabilities of independent financial advisors. However, due to the endogenous conflict between the transaction role and the authentication role, it is difficult for independent financial advisors to maintain an independent and objective position in playing the authentication role. Greater industry experience means only that the independent financial advisor has greater ability in his/her transaction role, which is not necessarily so in his/her authentication role. This is the main reason why the industry experience of independent financial advisors is not related to the probability of them being hired when there is a high suspicion of major shareholders' tunneling. This indicates the need for further study to address whether the scope of independent financial advisors' business is reasonably set and the authentication role under the mandatory policy is truly effective. Future research may focus on ways to mitigate the endogenous conflict between the two roles and improve the effectiveness of the authentication role.

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