

# A Study on the Effectiveness of the Independent Director System on the Governance of Financial Fraud Phenomenon: Taking Kangmei Pharmaceutical as an Example

Yang Xu<sup>1,\*</sup>

<sup>1</sup>Business School, Zhejiang Wanli University, Ningbo, 315100, China

**Abstract.** This paper explores the pervasive challenge of financial fraud in listed companies, emphasizing the vital role of the independent director system in corporate governance and fraud prevention. Beginning with a background overview and theoretical foundation, it assesses the status and significance of independent directors, analyzing factors influencing their involvement in preventing financial fraud. Using Kangmei Pharmaceuticals as a case study, the paper examines the corporate financial fraud methods and relevant risks, focusing on internal governance issues. Emphasis is placed on the independence of independent directors, their relationships with the board and supervisory board, and their impact on Kangmei Pharmaceuticals' governance in the financial fraud context. The study uncovers reasons for perceived failures, concluding with recommendations to enhance independent directors' engagement in corporate governance. This research contributes to understanding financial fraud governance mechanisms, enriching the theory of independent directors, and proposing suggestions to improve the effectiveness of the independent director system.

## 1 Introduction

With the development of socialism in the new era and the growing maturity of the reform and opening-up policy, China's economic situation is changing day by day, and at the same time, it has also given rise to China's capital market. As the hub of finance, the capital market plays an important role in China's economic development. However, with the further development and expansion of the capital market, a series of problems have arisen. Corporate financial fraud as a capital market "tumour", has been widely concerned by all sectors of society, inflated funds, false disclosure of accounting information and other financial fraud phenomena also come one after another, in order to alleviate or even eliminate financial fraud phenomenon on the financial and economic market harm, has produced a number of new systems and policies, the independent directorship is one of them. The independent director system emerges as a pivotal element among various mechanisms in corporate governance. It assumes a crucial role, serving as a significant strategy to combat corporate financial fraud. The active participation of independent directors in corporate governance is a key means to thwart fraudulent practices within organizations. Therefore, studying the influence of independent directors on the governance of corporate financial fraud holds substantial theoretical and practical significance. This research seeks to unravel the nuanced dynamics surrounding the role of independent directors, acknowledging their

importance as a potent force in upholding corporate integrity and preventing financial misconduct. Exploring the involvement of independent directors not only carries profound theoretical implications but also holds practical importance, providing insights that can significantly contribute to enhancing corporate governance practices and fortifying defenses against financial fraud.

Drawing on principles of corporate governance, this paper employs a diverse set of research methodologies, encompassing case studies, literature reviews, and comprehensive analyses, to thoroughly examine the influence of the independent director system on financial fraud within Kangmei Pharmaceutical Co. Initially, the article introduces the research background and significance, organizing relevant literature on the involvement of independent directors in corporate governance. It then elucidates the position and role of independent directors in corporate governance, dissecting their impact on the company's financial misconduct governance. Utilizing Kangmei Pharmaceutical's financial malpractice case as a focal point, the paper meticulously analyzes the methods employed in financial malpractice and the specific influence of Kangmei Pharmaceutical's independent directors on such malpractice.

Subsequently, the study delves into the means and impact of financial fraud, ultimately concluding that independent directors alone cannot resolve the issue of financial fraud within the company. The paper concludes by proposing recommendations to enhance the

\* Corresponding author: amy20040323@hhu.edu.cn

independent director system's effectiveness in governing financial fraud. Despite the widespread adoption of the independent director system globally, recent years have witnessed its failure to meet expectations in averting the risk of financial fraud, with such incidents persisting. The opacity of listed companies poses a significant challenge for investors, prompting an exploration of the ultimate impact of the independent director system on financial fraud. This paper concentrates on addressing these issues, examining the role of independent directors and identifying shortcomings in CombiPharma's financial fraud. It concludes by offering judicious enhancements to the independent director system for more effective governance.

## 2 Literature review and theoretical basis

The integral role of the independent director system in corporate governance is underscored by its significance. In 2022, the Securities and Futures Commission (SFC) issued the Rules for Independent Directors of Listed Companies, followed by the issuance of the Opinions on the Reform of the Independent Director System of Listed Companies by the General Office of the State Council (GOSC) in the subsequent year. These initiatives aimed to bolster the effectiveness of independent directors, enabling them to fulfill their duties and leverage their role to the fullest extent. Despite the introduction of independent directors in China, the existing legal protection framework is deemed insufficient. This deficiency raises concerns about the independence of these directors, sometimes leading them to be labeled as mere figureheads ("vase directors"), posing a significant threat to the rights and interests of small and medium-sized shareholders [1]. The fundamental distinction between independent directors and their counterparts lies in their independence, encompassing functional, legal status, and conceptual independence. Independent directors maintain no business or material affiliations with the company beyond their role as independent directors, and they operate independently of the company's management. Within their designated responsibilities, independent directors possess the authority and obligation to express unbiased opinions that prioritize the company's interests to the fullest extent [2]. Independent directors also use their professional knowledge and social reputations to independently review and make independent judgements on major issues of the company's decision-making and management [3]. In order to eliminate financial fraud scandals in Chinese listed companies, controlling shareholders must be effectively monitored, the independent director system must be improved, and mandatory rules must be enacted through the legislature or regulatory bodies. Through the formulation of regulatory rules and regulations, it is mandatory to increase the number of independent director seats until controlling shareholders or insider managers cannot control the board of directors by any means. The independent director system is an effective system for restraining controlling shareholders from using their

control position to make unfavourable behaviours, so it is necessary to supplement and amend the relevant regulations at the legal level, and to enhance the operability of the regulations according to the operation of the independent director system, so that the independent director becomes a clear statutory system, which is able to govern the financial fraud phenomenon in a more effective way [4].

## 3 The position and role of independent directors in corporate governance

### 3.1 History of the development of the independent director system in China

With the footsteps of reform and opening up, China's capital market has gradually developed, and in order to meet the needs of modern companies and economic development, corporate governance structure has been mentioned at an academic level, which helps the mutual coordination and unification of company's ownership and operation rights. Financial fraud, as a persistent problem in the capital market, has been regulated by different countries to different degrees, but this has also made the means of financial fraud more covert and changeable, increasing the difficulty of state supervision, while the number of proliferation of the same time remains high. To mitigate the risk of "one-share dominance," the state introduced the independent director system, aiming to prevent the encroachment of small shareholders' rights and interests by dominant large shareholders. Originating in the West, the independent director system holds a crucial role in advancing the governance of listed companies, constituting a vital component of the corporate governance framework. Upon establishment, independent directors were anticipated to play a pivotal role in scrutinizing internal management, curbing corporate misconduct, overseeing equity disputes, and offering professional counsel. Notably, in countries like the United States, Germany, Japan, and Italy, this system not only fosters the growth of local companies but also contributes to the broader economic development. However, while foreign countries have had extensive experience with the independent director system, along with a wealth of practical literature, China's adoption is still in an adaptive phase. Many theories and practices are yet to be perfected, requiring time to align with China's unique national conditions. The ongoing exploration aims to develop an independent director system tailored to the specific needs of China.

### 3.2 Status and role of independent directors

In 1993, Tsingtao Brewery Co., Ltd. set a precedent for Chinese listed companies by appointing two independent directors when it went public on the Hong Kong Stock Exchange. The status and role of independent directors have become a focal point across various market sectors. Within the capital market, independent directors have

effectively addressed gaps in corporate governance, enhancing operational efficiency, and concurrently safeguarding the interests of small and medium-sized investors in corporate governance participation. The introduction of the independent director system has notably ameliorated the internal governance structure of companies.

Examining the Chinese listed companies' independent director system reveals its three main components: legal provisions, departmental rules and regulations, and industry self-regulatory norms. Primarily, the independent director system plays a pivotal role in safeguarding the interests of small and medium-sized investors. It acts as a check and balance on controlling shareholders, overseeing company management, and maintaining the board of directors' independence. This helps limit the powers of major shareholders, protect the interests of smaller shareholders, and enhance overall shareholder value. Independent directors, devoid of ties to the company or specific interest groups, exhibit strong fairness and impartiality, ensuring collective decision-making on the board and mitigating potential "internal control" issues. Furthermore, the independent director system introduces expert independent judgment, with many independent directors possessing extensive knowledge of the financial market. Their multifaceted expertise aids decision-making by providing crucial insights for the company's development. Independent directors contribute valuable suggestions, enabling the board to make informed decisions, expand into new business areas, and formulate long-term plans. Additionally, they collaborate with the company's management to propel business activities forward, elevate the company's reputation, and augment its overall value.

Independent directors can also create tangible value through the use of intangible resources, creating substantial tangible value for the company in terms of general management, trade relations, and industry influence. The ability of the board to fulfil its fiduciary obligations is inextricably linked to a core group of professional and widely regarded independent directors. A company can build up its corporate image by virtue of the reputation of its independent directors, expand its communication channels with other companies by making use of the network of relationships behind the independent directors, and enter into co-operation with companies that can be of mutual benefit and win-win situation, which is of far-reaching significance for the long-term development of the company. Finally, independent directors also contribute a lot in enhancing the professional operation level of listed companies. Enterprises can make scientific decisions without professional knowledge involving the enterprise, relevant policies, laws and other expertise. Independent directors can provide consulting services, use the professional knowledge and independent judgement of independent directors to provide constructive opinions for the development of the company, increase the quality of information obtained by the management, and enhance the scientificity of decision-making while improving the quality of the company's operation.

## 4 Financial fraud case analysis in Kangmei Pharmaceuticals

### 4.1 Overview

Established in 1997 by private entrepreneur Ma Xingtian, Kangmei Pharmaceuticals stands as a prominent pharmaceutical enterprise with a primary focus on medicine sales and the integration of traditional Chinese medicinal drinks and medical devices within the private sector. The company boasts a contemporary production base for both Chinese medicine drinks and chemical drugs, contributing significantly to the production of numerous national new drugs, spanning thousands of Chinese medicine drinks and medicines. With offices strategically located across various provinces and cities nationwide, Kangmei Pharmaceuticals has cultivated an extensive marketing network. The company actively collaborates with multiple colleges and universities, playing a key role in spearheading the research and development projects for Chinese medicine drinks in Guangdong Province. This collaborative approach underscores Kangmei Pharmaceuticals' commitment to innovation and its integral role in advancing the pharmaceutical landscape.

Kangmei Pharmaceutical listed on the A-share market, with a wide range of sales business areas and attentive service level, the company's operating income once soared. 2008 quarterly sales revenue of Kangmei Pharmaceuticals increased by 43% year-on-year, earnings per share of 0.08 yuan, the formal implementation of the company's industrial integration. In 2007, the company continued to sales of traditional Chinese medicine tablets as the core business, and gradually to the upstream and downstream of the industrial chain, control of raw materials, Chinese medicine large area resources, the establishment of raw materials, and the development and development of the company's business. Chinese herbal medicine large area resources, the establishment of Chinese medicine logistics port and herbal medicine processing base. 2014 and 2015 Kangmei Pharmaceutical Co., Ltd.'s operating income reached about 16 billion, 18 billion, respectively, and net profit attributable to shareholders of listed companies increased by more than 20% year-on-year, and once in 2018 the market capitalisation exceeded 100 billion, which was favoured and recognised by countless funds. As a benchmark enterprise in China's pharmaceutical industry, its flourishing development trend has also received the attention of the general public, Kangmei's stock as the "white horse stock" in the pharmaceutical industry is sought after by investors from all sides. Until 2019, the Securities and Futures Commission announced the disclosure of the 2016-2018 financial report on the Kangmei Pharmaceuticals there are significant false and other circumstances, and then suspected of accounting information disclosure fraud by the Securities and Futures Commission investigation, the news, the market uproar, the company's share price plummeted.

Next recounts the specific development of the whole incident. On 16 October 2018, Kangmei Pharmaceuticals was exposed as a financial fraud, and the share price of Kangmei Corporation Limited plummeted from 22 yuan to 12 yuan in 10 trading days, with heavy losses. On 28 December, Kangmei Pharmaceuticals Corporation Limited formally received a notification of filing an investigation letter from the China Securities Regulatory Commission (CSRC), and this matter caused an uproar as soon as it came out, and the share price fell from 12 yuan to less than 6 yuan. 30 April 2019, Ma Xingtian director denied financial fraud, claiming that there are 3 billion funds of accounting errors, but the relevant accounting firm Zhengzhong Pearl River held a qualified opinion. After the Securities and Futures Commission (SFC) opened a case for investigation, it found that Kangmei Pharmaceuticals had falsely inflated bank deposits, falsified income, and bought and sold the Company's shares, among other irregularities. The results of the investigation showed that Kangmei Pharmaceuticals has been commencing financial falsification since 2016, and currency fund income falsification, which involves a huge amount of money and is in a bad situation. After a day of suspension, on 21 May, Kangmei applied for a cap, "ST Kangmei" up and down decline, three days later fell below three yuan. 16 August, the SFC issued a penalty notice, found that Kangmei Co., Ltd. and 2016 began financial fraud, money funds and income counterfeiting amount is huge, the situation is bad. 13 May 2020, the Securities and Futures Commission announced a fine of 600,000 yuan on Kangmei Pharmaceuticals, the main responsible

persons were also fined and securities market banned and other penalties. and penalties such as securities market debarment; on 12 November of the same year, Guangzhou Intermediate People's Court made a first-instance judgement on the Kangmei Pharmaceutical Special Representative Litigation case, which showed that ST Kangmei assumed a liability of 2.459 billion in damages, four former executives such as Mr. and Mrs. Ma Xingtian assumed a 100% joint and several liability, and thirteen senior executives assumed a joint and several liability, which included five of Kangmei Pharmaceutical's then independent directors.

#### 4.2 Measures of financial fraud of Kangmei Pharmaceuticals

First of all, Kangmei achieved the purpose of financial fraud by inflated monetary funds. since 2010, Kangmei's investment scope has been expanding, on the basis of traditional Chinese medicine segment, expanded to real estate and warehousing logistics and other fields, and has not stopped expanding, which has brought great risks to the cash flow of Kangmei. Kangmei Pharmaceuticals has taken the means of inflating currency funds and bank deposits to whitewash its financial statements and inflate its share price, so as to achieve the purpose of financing. Inflated money funds through bill forgery, financial non-record keeping, false bookkeeping, forgery, falsification of large amount of time deposit certificates or bank statements, with operating income forgery falsification of sales returns and so on.

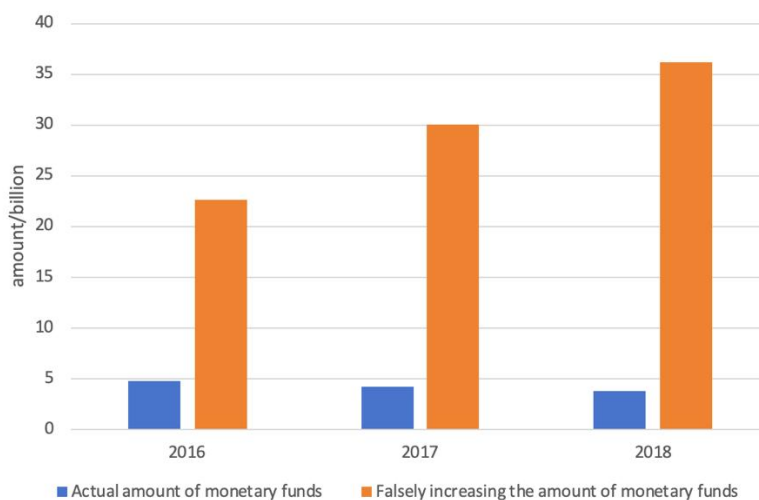
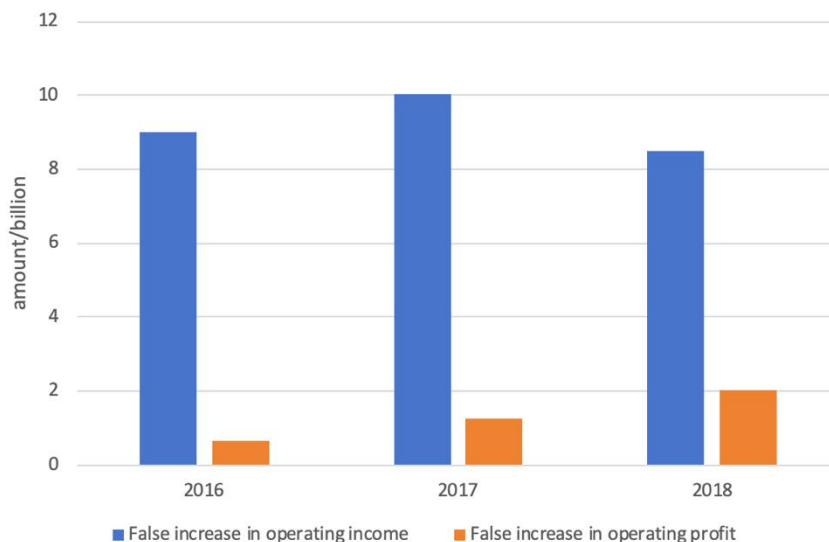


Fig. 1. Comparison of Kangmei Pharmaceutical's monetary fund correction from 2016-2018 (Picture/Photo Credit: Original).

From Figure 1, the money funds were overstated by 29.944 billion in 2017, the inventory was understated by 19.546 billion, the operating income was overstated by 8.898 billion, the operating cost was overstated by 7.662 billion, the selling expenses were understated by 0.497 billion, and the management expenses were understated by .228 billion, the amount of correction is staggering. At the end of the first half of 2018, the total amount of inflated Kangmei Pharmaceuticals was more than 36 billion, and its inflated amount even reached half of the

total assets, far more than the net assets of the company. Secondly, the purpose of cost reduction is falsified by inflating operating income. Kangmei Pharmaceuticals has taken relevant means in operating income by falsifying the data related to the main revenue and cost, i.e., pre-determining the amount of revenue items and delaying the review time of the amount spent, so as to achieve the purpose of inflating revenue and reducing cost.



**Fig. 2.** Kangmei Pharmaceutical Industry's Increase in Operating Revenue after correction (Picture/Photo Credit: Original).

From Figure 2, it can be seen through the icon that Kangmei Pharmaceuticals allegedly inflated its operating income by nearly 29.1 billion, and during the three years from 2016 to 2018, it inflated its profit by about 9, 10 and 8.5 billion respectively, with the inflated profit being higher than 0.1 billion in all cases. Furthermore, by using information disclosure falsification, Kangmei Pharmaceuticals failed to disclose the transactions of non-operating funds occupied by shareholders and their related parties in accordance with the regulations. It provided non-operational funds of about 11.6 billion to the controlling party and related parties for speculation, repayment of financing principal and interest, etc. Kangmei Pharmaceuticals also made use of the means of property forgery to deceive records of the company's private inflated fixed assets and investment properties, etc. The incident leads not only to the company itself, but also because of the consequences of the influence of the company, investors may lose trust in the accounting

information of other listed companies, which will hinder the good development of the domestic securities market. Various studies have marked that financial fraud incidents have a significant impact on the reputation of the company as well as the reputation of the independent directors and have an impact on the valuation of other companies that are connected to the indicted company through cross-director appointments [5]. Therefore, the financial malpractice case of Kangmei Pharmaceuticals not only damaged the reputation of the company itself, but also disrupted the normal market trading order.

## 5 Governance mechanism of independent directors on financial fraud of Kangmei Pharmaceuticals

### 5.1 Independent directors

**Table 1.** Profile of the Company's Independent Directors.

Gender	Name	Title	Employment period	Professional background	Academic background	Social background
Male	Li Ding'an	Professor	2003-2005 2012-2018	Master of Economics (MSc degree)	School of Business Administration, South China University of Technology	Director, Sino-Swiss CPAs
Male	Zhang Hong	Associate Professor	2006-2012 2014-2018	Post-doctoral fellowship in human resources management	School of Management, Southwest University of Political Science and Law	
Male	Jiang Zhenping		2006-2012 2015-2021			
Male	Guo Chonghui	Professor	2018-2021		PhD in Management Science and Engineering	

Zhang Ping	male	Associate Professor	2018-2019		School of Business Administration, South China University of Technology	
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As can be seen from Table 1, the size of the board of directors before the disclosure of the financial fraud of Kangmei Pharmaceuticals has been maintained at about 9 people all year round, and the independent directors are constant 3 people, the ratio is 1/3. Between 2016 and 2018, five people, namely, Li Ding'an, Zhang Hong, Jiang Zhenping, Guo Chonghui, and Zhang Ping, held the position of independent director of Kangmei Pharmaceuticals.

### 5.2 Effectiveness of independent directorship on financial fraud governance

According to the independent directors' debriefing report of Kangmei Pharmaceuticals in each year, each independent director has shown that he has fully utilised his experience and knowledge to participate in corporate governance and play a role in scientific decision-making [6]. However, it is worth noting that in the 2016-2018 annual independent director debriefing report shows that no problems have arisen in various matters, while the exposure of financial fraud in 2018, in particular, indicates that the failure to meet the requirements of the "Basic Norms for Internal Control of Enterprises" and related regulations, and the failure to form an effective governance of important financial aspects of the financial report. Kangmei Pharmaceutical's 2018 annual independent director's duty report was signed on 30 April 2019, and at the same time, an announcement on the correction of accounting errors in the previous period was released, and the independent directors also expressed their opinion that the whole process was legal and compliant, and agreed with the correction of accounting errors [7]. However, the investigation results notified by the Securities and Futures Commission (SFC) shortly after on 17 May illustrated the existence of financial fraud in CombiPharma from 2016 to 2018, and these could indicate that the independent directors conferred too much confidence in the implementation of CombiPharma's internal control, and failed to make timely disclosure of the risk of financial fraud. Many studies have found a significant negative correlation between financial fraud and independent directors [8].

The independent directors have also failed to take any action in order to be able to identify financial fraud, which is usually possible by identifying, for example, financial information and business motives, supplemented by big data from the industry, to identify the company's propensity to commit financial fraud.

## 6 Problems of the independent director system of Kangmei Pharmaceutical

The first is that the independence of independent directors is not complete enough. Kangmei's shareholding structure has an obvious trend of centralisation, and the major shareholders have absolute controlling power, which makes the company's independent director system questioned and unable to play its due role. After investigation, it is found that independent directors of Kangmei are mainly selected by the company's shareholders and management personnel. Only a very few independent directors are elected by other shareholders. This practice not only fails to ensure the independence of the shares of Kangmei Pharmaceuticals, but also fails to meet the needs of the company's long-term development. Therefore, the independent director system of Kangmei is regarded as an empty name by all circles. Despite having the status of independent director, the actual influence is limited and cannot really promote the implementation of the company's management mechanism. Studies have shown that independent directors provide a valuable service to shareholders and that the value of their contribution depends on their independence and may be influenced by the actions of a powerful CEO [9].

Independent directors have only few proposals and voting rights in corporate development matters. Due to the lack of truly independent directors, they are unable to fully perform their monitoring and building functions and do not have a positive impact on the development of the company. Since most independent directors are experts from academia or industry sectors, they value their reputation and social influence more, which may also affect their independence in making decisions and recommendations. Secondly, the risk of execution is not compatible with the remuneration. Independent directors face many challenges in performing their duties, but boards do not give them adequate protection. There are many scruples when independent directors exercise their duties, which makes it difficult for them to perform decision-making and monitoring tasks from an objective perspective [10]. There is no direct link between independent directors and the financial interests of the company, but in order for them to do their job better, the company will link the compensation of independent directors to their performance in order to motivate independent directors from providing developmental advice and monitoring. Despite their heavy responsibilities, independent directors must also face great risks, so their rewards are often not proportional to the risks they take. Only by resolving the interrelationship between risk and remuneration that exists in the execution of independent directors in Kangmei Pharmaceutical Co. can independent directors better provide quality services to the company. Furthermore, the delineation of responsibilities between independent directors and the supervisory board remains

ambiguous. The supervisory board system and the independent director system emerge from distinct legal frameworks, shaped by diverse economic, political, and cultural environments. China's adoption of the independent director system without concurrent adjustments to the existing supervisory board system has resulted in a lack of clarity regarding the respective functions of the two entities in the operational dynamics of listed companies. This absence of alignment between the two systems has contributed to challenges in defining their roles and responsibilities within the corporate governance framework.

## 7 Conclusion

Along with the introduction of the independent director system, the research on the participation of independent directors in corporate governance has been ongoing. The independent director of Kangmei Pharmaceuticals was sentenced to huge joint and several compensations for financial malpractice and triggered the trend of the departure of the independent director as a typical case of the association between independent directors and financial malpractice in recent years has aroused people's heated discussion again and again. Through the case study, this paper draws the following conclusions: firstly, the independent director system can effectively govern the financial fraud phenomenon to a certain extent. However, in the case of Kangmei Pharmaceutical Company, there are problems such as over-concentration of shareholding, failure of the board of directors to supervise the management, and lack of independence of the audit department. These problems have led to the low functionality and lack of independence of the independent director system of CombiPharma, which in turn affects the effectiveness of the governance of financial fraud.

Through the case study, this paper draws the following conclusions: firstly, the independence of independent directors should be improved and a series of measures can be taken. For example, the selection and appointment procedures of independent directors should be strengthened to ensure their independence and professionalism; effective communication channels between independent directors and the company's management should be established to enable them to exercise their supervisory duties independently; and clear exit regulations should be formulated to prevent independent directors from being interfered with or manipulated. Secondly, to improve and perfect the incentive and restraint mechanism, we can consider introducing equity incentive plans to make independent directors conform to the interests of the company. Independent directors manipulate their option grants like company executives, who use backdating pricing, early announcement and circumvention techniques to increase the value of their options. Techniques such as backdating pricing have resulted in significant profits for independent directors. In a typical year, approximately 20% of independent directors exhibit significant distractions, manifesting in reduced meeting attendance,

decreased stock trading activity, and a higher frequency of board resignations. These signs indicate diminished firm-specific knowledge and a lower level of commitment to board responsibilities. Companies with a higher proportion of distracted independent directors tend to experience lower valuation and operating performance, coupled with weaknesses in M&A profitability and accounting quality. To enhance the effectiveness of the independent director system, it is recommended to bolster the reputation incentive mechanism. This involves implementing a reputation assessment mechanism and a preferential recommendation system for independent directors, aligning their personal reputation with their professional status to strengthen their supervisory role in operating management.

Furthermore, establishing a regular performance evaluation system for independent directors can stimulate motivation and accountability. Lastly, a crucial aspect involves reinforcing a clear functional orientation. This entails delineating the duties and power boundaries of independent directors to ensure their effective performance in monitoring and providing advice. In summary, enhancing the independence of independent directors, refining incentive and restraint mechanisms, and reinforcing clear functional orientation can collectively elevate the effectiveness of the independent director system, contributing to better management of financial fraud occurrences.

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