

Foreign Strategic Investors in China:
The Role of Formal and Informal Internal Governance Mechanisms

Helen Wei HU¹ and Peter VERHEZEN² and Monica Guo-Sze TAN³

¹ Dr. Helen Wei HU
Department of Management and Marketing
University of Melbourne
5th Babel Building, Parkville, Victoria 3010, Australia
Tel: +61 3 83444108
Fax: +61 3 93494293
Email: hehu@unimelb.edu.au

² Dr. Peter VERHEZEN
Department of Management and Marketing
University of Melbourne
5th Babel Building, Parkville, Victoria 3010, Australia
Tel: +61 3 83444481
Fax: +61 3 93494293
Email: verhezen@unimelb.edu.au
Principal Verhezen & Associates
Tel : +62 21 5750836
Fax : +62 21 5750803
Email : peter@verhezen.net

³ Dr. Monica Guo-Sze TAN
Risk Services
Deloitte Touch Tohmatsu
180 Lonsdale St
Melbourne, VIC 3000
Tel: +61 3 9208 7000
E-mail: gutan@deloitte.com.au

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Abstract:

The Chinese corporate sector and capital market have been undergoing rapid reforms initiated by both the government and entrepreneurs giving in to or taking advantage of globalization. Since 2006, foreign investors have been allowed to enter the Chinese capital market through the establishment of strategic partnerships with publicly listed firms, officially defined as *foreign strategic investors*.

Given China's specific political and socio-economic model, which is formally distinctive from those in other major regions of the world, we argue that foreign strategic investors should employ both *formal internal governance mechanisms (FIGMs)* and *informal internal governance mechanisms (IIGMs)* as tools to safeguard investments and negotiate appropriate corporate controls. More specifically, we propose an internal corporate governance model that explicates how these investors can strengthen their monitoring role through FIGMs and enhance business partnership through IIGMs.

KEY WORDS: *foreign strategic investment, formal internal governance mechanism, informal internal governance mechanism, corporate governance, China*

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INTRODUCTION

From January 30, 2006, investing in Chinese publicly listed companies has become viable for foreign investors under the new regulation “Measures for Strategic Investment by Foreign Investors upon Listed Companies” (henceforth termed “the new regulation”) (CSRC, 2005b). The key objectives of the new regulation are “to bring in foreign advanced managerial experience, technology and capital, to improve corporate governance standard of listed company, and to protect the interests of listed companies and the shareholders” (Article 1, CSRC, 2005b), in doing so, *foreign strategic investors (FSIs)* are legally introduced at the Chinese stock exchanges. The new regulation defines:

A foreign strategic investor (FSI) is a foreign entity that has an equity interest of at least 10 percent with a holding period of more than three years in an existing Chinese publicly listed company (PLC) which has completed the non-tradable shares reform (Article 5, CSRC, 2005b).¹

The new regulation allows FSIs to gain access to the Chinese stock market through partnership with established PLCs, often the key players in the market. However, with the goal of reaping great profits in an emerging economy such as China, the question is: how do FSIs endeavor to protect their investments against the risk and volatility in this environment? Integrating agency theory and resource dependence theory, we argue that through the effective use of internal governance mechanisms, FSIs could provide support to their target PLCs on one hand, and embrace the need for some control of their investments on the other. In other words, finding a

subtle balance between control-based and collaborative approaches is the key to potential success in China (Sundaramurthy and Lewis, 2003).

Agency theory argues that the conventional governance mechanisms such as (1) ownership concentration, (2) board representation, (3) board leadership, and (4) CEO compensation, which this paper terms as the *formal internal governance mechanisms (FIGMs)*, are tasked to minimize the agency costs by imposing controls over managers and shareholders' opportunistic behavior, and to ensure value maximization in firms (Fama and Jensen, 1983a; 1983b; Jensen and Meckling, 1976; Shleifer and Vishny, 1997). As this theory was developed in the context of Anglo-American environment with firms dominated by dispersed ownership structure, the application of the agency-based FIGMs alone is unlikely to be sufficient in dealing with governance issues in emerging economies where ownership concentration is common, with families or governments as the controlling shareholders (La Porta et al., 1999; Tam, 2002; Young et al., 2008). Additionally, the enforcement of the rules, law and contracts, and the adherence by the Chinese organizations are more often guided and influenced by informal institutions and relationships. Resource dependence theory asserts that organizations are dependent on their environment, and particularly on scarce resources, for their survival; thus, they need to build 'behavioral dependencies' with other firms or utilize different sets of governance mechanisms to assure their success (see Hillman and Dalziel, 2003; Nahapiet and Ghoshal, 1998; Pfeffer and Salancik, 1978; Yiu et al., 2005). Given China's socio-economic institutional contexts, *informal internal governance mechanisms (IIGMs)*, including (5) integrity and reputation of the local firm, (6) the synergies of organizational culture of both the local firm and FSI, and (7) networks and relationships become crucial to FSIs to secure their investment by

having access to critical resources, develop personal connections, and by being aware of the role of informal constraints. Subsequently, we propose an internal corporate governance model that is composed of both FIGMs which are related to the agency model and IIGMs which are linked to resource dependence theory for FSIs to steer the firm in the most effective manner.

This paper offers two important contributions to the corporate governance literature. In practice, little has yet been said and found about recent legally endorsed foreign strategic investment in Chinese PLCs. To understand how FSIs operate not only fills the gap in the literature but also offers practical value to potential foreign investors who are attracted to the new regulation regarding entering the Chinese capital market.² Theoretically, past governance studies have tended to focus on the effectiveness of FIGMs and particularly on how these formal governance mechanisms can enhance firm value. IIGMs, on the contrary, have often been overlooked within the Anglo-American context, and they nonetheless are critical to the success of governing companies in emerging economies like China. To overcome these shortfalls, this study integrates both the formal and informal internal governance mechanisms into a single framework that would reflect more appropriately the various governance functions sought by FSIs. By doing so, it enables us (1) to describe more precisely the reality of business practices in China, (2) to link the different prevailing theoretical perspectives of corporate governance into a unified framework, and (3) to allow academics and practitioners alike to embrace a strategic, rather than a prescriptive, approach of governance to suit this fast-changing environment. As a result, this research is timely in proposing a model for improving viable (formal and informal) internal governance mechanisms for FSIs.

CHINA'S CORPORATE SECTOR DEVELOPMENT AND CAPITAL MARKET REFORMS

In the past three decades, China has undergone continuous changes and developments in its corporate sector. In 1992, the Chinese government began to reform its state-owned enterprises (SOEs) through corporatization and privatization, and some of them were selected to become PLCs on the basis of provincial/local government quotas. The separation of ownership and control may be adopted by these PLCs, but they failed to gain any improvements and advantages through their listed status since only one-third of a PLC's shares were circulated on the stock market, whereas the other two-third shares were owned by the state and legal person entities. In other words, the state is still the *de facto* owner of these PLCs, which had serious implications on their transformation. Empirical studies show that the state remains the largest shareholder in a vast number of PLCs and still exercises enormous if not ultimate power over those firms' policies (Liu and Sun, 2005; Xu et al., 2005). Research also reveals that many Chinese PLCs started to experience losses soon after going public or otherwise performed quite poorly, and it is not surprising that highly concentrated state ownership together with ineffective internal monitoring mechanisms were identified as the key reasons for such poor firm performance (Ding et al., 2007; Jefferson, 2000; Xu and Wang, 1997). Since 2000, some corporate governance legislations have been developed and implemented in PLCs, including the introduction of independent directors to boards (CSRC, 2001) and the compliance with the corporate governance code (CSRC, 2002).

In 2005, the Chinese government started to address this concentrated state ownership problem by launching a share reform of the split non-tradable share structure of its PLCs. On 29 April 2005,

the China Securities Regulatory Commission (CSRC) released the “Notice of China Securities Regulatory Commission on Relevant Issues of Pilot Reform of Equity Division of Listed Companies” to test the preliminary reform based on four invited PLCs (CSRC, 2005c). Subsequently, on 4 September 2005, the “Administrative Measures on the Split Share Structure Reform of Listed Companies” was released by the CSRC aiming to officially herald the share reform implementation to all PLCs by 2006 (Bortolotti and Beltratti 2006; CRI, 2007; CSRC, 2005a). Apart from attracting more domestic investors, the reform also made room for foreign investors, whose management know-how, advanced technology and better governance practices are seen as very valuable to Chinese PLCs, to enter the Chinese equity market. Subsequently, the new regulation was released by the CSRC on 31 December 2005 (CSRC, 2005b) and implemented one month later. As a result, foreign investors could for the first time since 2006 directly hold equity shares of a PLC that has undergone the non-tradable share reform. Nevertheless, China is operating under a distinctively different political and socio-economic model, the important questions facing FSIs are: (1) What could they do to optimize their investments and the firms’ value? (2) What advantages could they apply to their ventures with Chinese PLCs? We argue that some practical and conceptual answers might very well lie within the domain of corporate governance.

INTERNAL GOVERNANCE MECHANISMS AND PROPOSITIONS DEVELOPMENT

Corporate governance is meant to be a set of corporate mechanisms through which shareholders protect themselves against possible expropriation by insiders or controlling shareholders (OECD, 1999). On the one hand, FSIs do not have any direct influence on external governance mechanisms arising from regulatory oversight, governmental economic policies and institutional

and market environments. On the other hand, FSIs can determine the relative success of their investment by focusing on some formal and informal internal governance mechanisms which impact on their choice of investment. Working in China in general has taught foreign investors a valuable lesson: governance mechanisms gain momentum especially because of the premium attached to the implementation of FIGMs in organizations. Nonetheless, being embedded within a certain network – that can provide specific resources – and organizational culture – that is determined by socio-economic and judicial constraints – still continues to determine the success or failure of a firm in emerging economies like China, hence indicating the equally important role of IIGMs. This study aims to develop the contours of an internal governance model that emphasizes how FSIs could effectively exercise both FIGMs and IIGMs, which might consequently have some positive effect on the performance of their investments in Chinese PLCs.

Formal internal governance mechanisms (FIGMs)

FIGMs are derived from agency theory that supports the use of external and internal formal governance mechanisms to mitigate the principal-agent problem (Fama and Jensen, 1983a; 1983b; Jensen and Meckling, 1976; Shleifer and Vishny, 1997). In emerging economies where concentrated family or state ownership is prevalent, the principal-agent conflict as a result of separation of ownership and control in developed countries was overshadowed by a different set of conflict. It is the conflict of interest between controlling shareholders and minority shareholders or “principal-principal” conflict that needs to be resolved in emerging economies (Dharwadkar et al., 2000; Young et al., 2008). Coupled with ineffective external governance mechanisms in these countries, there are heightened opportunities for controlling shareholders to

exploit minority shareholders through high ownership and control (Claessens et al., 2000; La Porta et al., 1999).

The same “principal-principal” conflict is manifested through the concentrated ownership structure in China. In the case of foreign strategic investment in China, the agency hazard is perceived as the struggle between FSIs and the local controlling shareholders who are considered insiders. With this in mind, we propose four major FIGMs, which are all agency-based determinants of governance. First, FSIs can concentrate their *equity ownership* to protect themselves and safeguard their endowments. In other words, being large foreign shareholders, they would have the incentives, power and abilities to monitor and control the target firms (Fama and Jensen, 1983a; Shleifer and Vishny, 1997). Second, *board representation* is often regarded as the primary way for FSIs (or any large equity holders) to keep partner-firms in check while seeking to increase returns of investment through participation in major decision making (Hellman, 2002; Holderness and Sheehan, 1988; Johnson et al., 1996). Third, in line with the growing trend of separating governance roles between CEO and chairman as a way to improve oversight of management (Combined Code, 2003), we also argue that FSIs may adhere to this international trend and obtain a *board leadership* role when possible. Finally, an appropriate performance-related *CEO compensation* would better align managers’ interests with those of shareholders and hence reduce investment costs and risk (Gomes, 2000; Morck et al., 1988; Stanwick and Stanwick, 2001).

Ownership concentration

Ownership entitles a capital provider to potential profits, which has typically been a driving force for investment (Hellman, 2002). As majority Chinese PLCs are often held by a single controlling shareholder, there is a high risk of ‘tunneling’ and inappropriate transfer of resources among the PLCs’ related firms (Bai et al., 2004; Johnson et al., 2000). Therefore, holding large enough stakes in a firm enables investors (or FSIs in this study) to prevent this problem by internalizing monitoring costs and reducing agency costs (La Porta et al., 1999). Research on firms’ ownership structure has found that more monitoring, better management style and more focused profit-maximization goals result from foreign ownership (Xu et al., 2005). It is further suggested that foreign investors tend to concentrate their ownership to maintain major (equity) influence over the strategic planning process and to look for possible future expansions in a large market like China (Berglöf and von Thadden, 1999; Chen et al., 2002). More importantly, the level of ownership concentration held by FSIs reflects their governance power relative to their domestic counterparts and indicates how dependent the latter are on FSIs for the transfer of capital and technology (Chen et al., 2002).

Merely examining the absolute level of ownership concentration by FSIs might not provide a complete picture of the interaction of power and control between them and their target firms, particularly given China’s minimum requirement of 10 percent ownership. In a mature and liquid market, an investor with 10 percent ownership might be considered a block-holder of the firm, who may enjoy control rights even in excess of its cash flow rights. However, a 10 percent ownership in a Chinese firm might only give an FSI a secondary position because its Chinese partner is almost certain to be the controlling shareholder of the firm. On average, the largest

shareholder owns a substantial amount of shares in a typical PLC, with measures of 47 percent on average found by Tenev and Zhang (2002) and 42 percent on average found by Tian and Estrin (2008).³ Therefore, the focus here is not on outright ownership concentration but the relative governance power between the two shareholding parties resulting from their equity holdings. We argue that relative governance power is measured in terms of relative ownership concentration between an FSI and the largest shareholder in the target firm.

Relative ownership concentration (ROC) = ratio of ownership concentration between an FSI and the domestic largest shareholder in a target firm

In other words, ROC indicates the relative position of power and control that each side has. We propose that a strategic collaboration should be successful if the relative governance power is deemed to be at a healthy balance between both parties involved; this would be indicated by a low ROC. The associated benefits of a low ROC include FSIs' actively engaging in the management and governance functions of their target firms. A lower ROC ratio also implies a higher dependency of the target firms on the FSIs for financial (equity) resources, which may lead to a higher likelihood of long-term collaboration between the two parties. As a result, FSIs could affect the performance and growth of the target firm through involvement in governance decisions of the firm.

Proposition 1: The lower the ROC, the more balanced is the governance power between an FSI and the largest shareholder of the target PLC, which subsequently results in better target firm performance after investment.

Board representation

The second determining factor of effective monitoring and collaboration is board representation. In addition to equity holding, engaging in business planning through appointing oneself or representatives to the board of directors is the key advantage FSIs have over institutional investors (Lu and Heard, 1995; Neumann and Voetmann, 2003). In firms that are closely held and controlled by institutional investors, transaction costs due to contracting costs from cumbersome bureaucracy will increase, and monitoring becomes less effective as the problem of “agents watching agents” arises (Woidtke, 2002, p. 99). There is a deficiency in board representation by large institutional investors as compared to large individual investors because with the former, there is no single controlling shareholder who is able to internalize the transaction and monitoring costs. Furthermore, governmental activism in corporate sector diminishes incentives for institutional investors to actively monitor the return on their investments, leading to larger information asymmetry and increased free-rider problems (Suto, 2003).

In contrast, representatives of FSIs, commonly regarded as outside (affiliated) directors, can exert effective control and monitoring over the strategic planning process of a target firm. Through board representation, FSIs can reduce the asymmetric information between domestic shareholders and foreign shareholders as well as the asymmetric information between shareholders and managers. In return, they can achieve the monitoring objective of being able to closely supervise the management and thus safeguard their investment (Huse, 1994; Jensen and Meckling, 1976; Pearce and Zahra, 1991). Additionally, Hillman and Dalziel (2003) point out that boards not only monitor the organization but also enable organizations to find the needed

resources in the form of strengthening the public image of the firm. In other words, FSIs can bring in expertise and knowledge external to the firm and provide advice and resources in helping the firm to succeed (Dalton et al., 1998; Pfeffer and Salancik, 1978; Young et al., 2001). Practically, these governance roles are extremely valuable to Chinese firms as noted by researchers and regulators (CSRC, 2005b; Hawes and Chiu, 2007; Wei et al., 2005).

Selecting a PLC and consequently seeking to negotiate effective control of the target firm's board is not easy. Nevertheless, it is equally difficult for the target firm to identify the level of support that the FSI is willing and effectively able to provide. Helmann (2002) argues that the level of 'intangible support' is often the key to the success of strategic collaboration between the two firms. The most prominent types of intangible support an FSI can provide to its target firm are management know-how, access to overseas markets and international governance practices, while the Chinese partners can provide access to domestic resources, local markets and knowledge about the host country. Most of these intangible assets are often embedded in the expertise and experience of managers and directors and in the operations of firms. Therefore, that professional knowledge and good governance practices brought in by an FSI via board representation would give valuable support to the target firm and hence would improve the performance of the firm.

Proposition 2: A higher proportion of board representation by an FSI would enhance its monitoring and supporting role in the target PLC, which subsequently results in better target firm performance after investment.

Board leadership: Chairman and vice-chairman

The role of the chairman seems to be universally accepted as crucial for monitoring and controlling top management and thus for the legitimacy of the firm. Although the board of directors needs to hire, fire, compensate and monitor managers, it is the chairman who is responsible for the overall functioning of the board (Combined Code, 2003). In Western countries, there is an increased preference for the appointment of an outside chairman, as shown in many corporate governance codes and guidelines. In principle, an independent chairman can enhance board's objectivity in terms of monitoring as well as evaluating the performance of its management (Higgs Review, 2003). In the situation of 'poison pill' adoptions, Coles and Hesterly (2000) have found that a firm with an independent chairman gives shareholders a better return on stock price than does a non-independent chairman. Likewise, Finkelstein and D'Aveni (1994) suggest that fewer monitoring activities are needed from outsiders when an outside chairman is on the board.

In the context of Chinese business, the incidence of an outside chairman is relatively rare. A company is often required to have one chairman who is also the legal representative of the company and to have one or two vice-chairmen who will exercise the chairman's roles when the former is unable to do so (China Company Law, 1994, Article 113-114). Both the chairman and vice-chairmen can be insiders from the company or its controlling shareholder or an outsider such as a representative of various government agencies or even other shareholders.⁴ Additionally, having a chairman representing the Chinese company and a vice-chairman representing the foreign company is also a common practice among Chinese joint ventures (State Council, 2001, Article 34). Research by Tam (1999) has documented that Chinese board

chairmen often lack the business savvy with a quarter of the chairmen having had political background, resulting in business decisions that may give way to political interests and pressure (Firth et al., 2006). Subsequently, we argue that in a strategic collaboration, if an FSI assumes the position of the vice-chairman, it would not only provide expertise and advice to the board, but also bring a sense of ‘outside’ independence that is valuable to the target firm. In line with the earlier discussion, we propose that vice-chairman representation would enhance boardroom collaboration between the two firms and hence improve firm performance.

Proposition 3: Vice-chairman representation by an FSI would enhance its monitoring and supporting role in the target PLC, which subsequently results in better target firm performance after investment.

CEO compensation

To align the interests of managers and shareholders, CEO compensation has received considerable interest in corporate governance literature. Jensen and Murphy argue that ‘the serious problem with CEO compensation is not how much CEOs are paid but how CEOs are paid’ (1990, p. 138). Empirically, a high level of CEO compensation has been shown to be associated with either good or bad firm performance. For instance, a positive correlation between CEO compensation and firm performance is observed by several studies (Buchholtz et al., 1998; Stanwick and Stanwick, 2001), whereas other studies have found a negative relationship between the two (Core et al., 1999). Despite the inconclusive empirical findings, it is widely agreed that a stronger and closer link between executive compensation and performance criteria is critical to achieve long term organizational value (Hall and Liebman, 1997; Main et al., 1996). In addition, research has found that a competitive and relatively well-paid compensation package –

emphasizing the relative and not absolute amount of total compensation – could also lead to good management and better firm performance (Buchholtz et al., 1998; Stanwick and Stanwick, 2001). In fact, the more the proportion of the compensation of the CEO is related to the performance of the firm, the more one can expect the firm to be ruled by international best practices. The yardstick could be any form of six-sigma to a 360° overview, and several different performance measurements can be used to design a CEO's compensation package (Mallin, 2007). With China's booming economy, to attract and retain good executives, we argue that a competitive compensation package is important. We suggest that by implementing a competitive performance-based compensation package through adopting an appropriate market benchmark and specifying a clear link between beneficiary incentives and performance, one can expect improved firm performance.

Proposition 4: A CEO's compensation package following the performance-based principle would better align the interests of the CEO and the target PLC, which subsequently results in better target firm performance after investment.

Informal internal governance mechanisms (IIGMs)

Although much has been said and tested of FIGMs, the full potential gains through business partnership are less likely to be realized without making proper use of IIGMs. For instance, corporate abuses such as China Kejian, Xin Jiang Hops, Dongting Aquaculture have shown that relying on FIGMs alone is insufficient to protect the interest of minority shareholders (Chen and Zhu, 2007; Xu, 2005).⁵ Whereas, lessons learnt from business ventures like Sino-Singaporean Suzhou Industrial Park and New Zealand's Fonterra Group have exemplified the importance of understanding the informal institutions and relationships that operate within the Chinese business

context (Inkpen and Wang, 2006; Spencer, 2008; Tian, 2007).⁶ Addressing this, resource dependence theory corroborates the role of IIGMs, especially in emerging economies where the determination of business success is largely contingent upon social environmental and institutional factors including culture, values, customs, rituals and relationships (Hillman et al., 2000; Hillman and Dalziel, 2003; Luo, 2005; Pfeffer, 1972).

In essence, IIGMs help FSIs build ‘behavioral dependencies’ with other organizations in order to reduce business risk (Pfeffer and Salancik, 1978). By doing so, FSIs need to establish a trust relationship with their partners and have a balance of accountability between them (Caldwell and Karri, 2005). This is particularly important in China, where contracts are largely implicit, personal, and enforced outside the courtroom and where governments, banks and firms have close relationships (Li, 2003). Nevertheless, building and managing such informal trust relationships can be quite daunting and not without significant costs and definitely time absorbing, taking into account the uncertainty related to developing such relationships (Wood, 2001). Therefore, FSIs employ IIGMs with the objective to increase the binding force of trust between their domestic partners and them, hence strengthening the collaboration of the venture and improving firm performance. Subsequently, three main IIGMs, namely *integrity and reputation*, *organizational culture*, and *networks and relationships*, are formulated based on resource dependence perspective within the Chinese institutional setting.

The first IIGM formulated is the *integrity and reputation* of the target PLC. Wheeler and Davies (2007) point out that in addressing social business relationships, one cannot ignore the reputational factors such as goodwill and social capital of a firm. In a rapidly developing and

changing business environment, the most effective way to minimize risk is to search for a reputable local partner with whom to venture. The second IIGM is *organizational culture*, which reflects the social and often invisible role of rituals and narratives within the organization. It is important for FSIs to align with and to consciously underwrite the underlying objectives and assumptions of the local organizational culture simply because this is the key element of any successful partnership. Finally, building, managing and maintaining *networks and relationships* is the third IIGM. Networking and *guanxi* relationship have a long tradition in nurturing Chinese business transactions, which help firms to countervail the institutional uncertainties in this complex and often ambiguous business environment (Peng, 2003). Therefore, establishing and having a good network and maintaining a long term oriented relationship with a local partner beyond mere short term profit orientation is a *sine qua non* for any FSIs to succeed in China.

Integrity and reputation

The values of a firm are a set of shared moral beliefs about how the firm should serve its primary stakeholders (Verhezen, 2008). Institutionalized reputational capital derived from normative principles or moral values can drastically reduce information asymmetry between the firm and its stakeholders (Fombrun, 1996; Peng et al., 2005). But, merely relying on legal compliance mechanisms is insufficient to boost the firm's moral reputation. Rather, corporate responsibility and sustainable development usually generate an enlightened approach that positively affects the reputation of the firm (Stainer, 2004; Treviño et al., 1999). Research has found that the negative publicity and damaging reputational effect follows illegal or immoral behavior has been shown to seriously damage a company's share value (Rao and Hamilton, 1996), whereas corporate leaders or board members who have a good reputation of being people of high integrity and who

live the corporate goals, values and purpose of the firm are acknowledged as effective leaders (Chan et al., 2002; Huang and Snell, 2003). A survey by McKinsey (2002) also shows that investors are willing to pay a premium of 10-20 percent more for a well-governed organization in a developed country, and that premium raises up to 30 percent when they invest in well governed companies in emerging economies.

Certainly, an FSI should partner with a well governed domestic firm and cooperate rather than press the partner into compliance through (perceived) oppressive governance systems. In doing so, the FSI can take initiatives to influence its Chinese partner to take business integrity and corporate governance practices seriously and to act accordingly. Though the FSI may find it difficult to spot the well governed target firm from the poorly governed one, some resources are always useful such as the company's annual reports, announcements and market reports. Additionally, there are various forms of corporate governance rating of PLCs either provided by stock exchanges including "SSE Corporate Governance Index" by Shanghai Stock Exchange and "SZSE Corporate Governance Index" by Shenzhen Stock Exchange, or from professional providers like Standard and Poor's Corporate Governance Score and China Corporate Governance Index Nan Kai (CCGINK), which can be used as yardstick to evaluate the reputation and governance effect of the targeted PLC. Therefore, we propose that good corporate governance practice is an effective means of projecting the integrity and reputational capital of domestic firms, thus helping FSIs find the right partner.

Proposition 5: The corporate governance practices that derive from core values of integrity and reputation of the target PLC send a signal that the firm is a better partner, which subsequently results in better target firm performance after investment.

Organizational culture

An organizational culture is a pattern of basic assumptions that have been functional for a certain group of people and therefore are perceived as valid (Schein, 1985). Organizational culture is one of the key factors in determining board effectiveness, but it is often overlooked in the debate regarding good corporate governance (Wheeler and Davies, 2007). It is acknowledged that well-adapted and embedded organizational cultures enable boards to improve and to engender transparency and accountability. More importantly, an organizational culture, encompassing an appropriate governance culture, guides employees, executives and directors to identify and rectify organizational challenges that are associated with ethics and accountability and thus with corporate governance in general (Luo, 2005).

Despite the fact that FSIs only have a secondary stake in a PLC, it is important enough to consider the potential pitfalls posed by different organizational cultures. Hence, acknowledging a Confucian framework with embedded hierarchical structures, different power dynamisms, and a more collective approach focusing on social harmony in China will help align potentially different perspectives (Francesco and Gold, 2005). Typical elements including trust, which seems to rapidly emerge as a trans-cultural value for understanding and managing behavior within organizations and for avoiding the loss of prestige and face in the local business community, are of the utmost importance in Chinese business practice (Redding and Ng, 1983; Wang et al., 2008). Trust functions both as a substitute and as a complementary force in such emerging countries especially there with weak legal enforcement. In fact, it would be easier for FSIs to engage with their Chinese partners to neutralize and cultivate good organizational culture

provided that the trust level between both is sufficiently high. In other words, possible synergies between the FSI and the PLC should be based on the assumption that the organizational culture of each firm is not too different in terms of moral values, business integrity, or that both different organizational cultures can be aligned to a high extent. In addition to the cultural perspective of the local partner, one should also be aware of a firm's business processes and communication structure, which may deviate significantly from those of its foreign counterpart. Thus, paying attention to these cultural sensitivities of target PLCs and the institutional context are important for FSIs attempting to positively influence corporate governance structure within these organizations. We therefore propose that acknowledging the complexities of Chinese PLCs and aligning with the local organizational culture will enhance the partnership and may result in more honest and realistic collaboration between the two parties.

Proposition 6: An FSI properly synergizing and or aligning with the organizational culture of its target PLC is more likely to improve co-operative partner relationship, which subsequently results in better target firm performance after investment.

Networks and relationships (guanxi)

Networks and relationships (*guanxi* in the Chinese term) remain important in China. They are often considered alternatives for survival in a business environment with weak legal institutions and little enforced regulations. Unlike agency theory, resource dependence theory argues that in uncertain environments, boards of directors rather than evaluators or controllers of management are providers of resources and multiple kinds of capital (Hillman and Dalziel, 2003; Pfeffer and Salancik, 1978). Relational networks, business groups, family connections, and government contacts all provide valuable intangible capital to organizations. In other words, informal

network strategies that focus on intangible assets in interpersonal connections and inter-organizational relationships among various entities are crucial for the survival of the firms (Meyer and Peng, 2005; Peng and Heath, 1996). Additionally, a well established network also allows board members and senior managers to develop and utilize their social ties, contacts, and connections with executives and officials in external entities and hence to reduce transaction costs or increase investment returns (Luo, 2003; Zhou et al., 2007).

In the Chinese context, the importance of networks or *guanxi* as an invaluable resource in business dealings has been widely acknowledged. Although the role of relationship and particularly the term '*guanxi*' has sometimes gained a negative ethical connotation of corruption and nepotism (Fan, 2002; Yang, 1989), well tuned *guanxi* practices are perceived to be valuable, particularly in securing scarce resources (Luo, 2000; Tian, 2007). This dependence on relationship becomes extremely important in fast changing environments as a result of competition and deregulation, especially where weak legal enforcement does not provide formal protection, as is the case in China. Literature on corporate governance also suggests that social or human capital of board members and managers is linked to the provision of intangible resources, mainly reflected in the form of networks and relationships (Hillman and Dalziel, 2003). Likewise, Westphal (1999) suggests that good social ties between the board and CEO increase the frequency of exchanges of advice and enhance firm performance. It can be argued that an informal collaborative approach used by the board, in contrast to taking on a monitoring and controlling role, stresses the resource role of board members and can enhance strategy formulation (Sundaramurthy and Lewis, 2003). Therefore, we assert that the FSI should

appropriately manage its network and relationship with its domestic partner to help ensure the success of the joint business venture.

Proposition 7: An FSI effectively managing the network and relationship with the key decision makers of its target PLC is more likely to generate more intangible resources and benefits, which subsequently results in better target firm performance after investment.

In order to optimize the investment of FSIs in China, an internal governance mechanism model – combining both FIGMs and IIGMs – outlines the propositions we suggest in this paper, as shown in Figure 1.

[Insert Figure 1 here]

DISCUSSION AND CONCLUSION

Governance exists so that individual stakeholders – investors, creditors, directors, management and employees – as well as broader industries and economic sectors can benefit (Banks, 2004). Given that strategic investment in Chinese PLCs has now become viable for foreigners, one of the key goals of Chinese regulators is to promote an effective governance system that positively affect corporate performance while allowing FSIs to gain some control and provide incentives in the effort to produce successful partnerships.

As Chinese business is still characterized by weak external governance mechanisms coupled with the practice of informal institutions, we argue that FSIs should employ both FIGMs and IIGMs to reduce business uncertainties and ensure long term investment. Moreover, this study

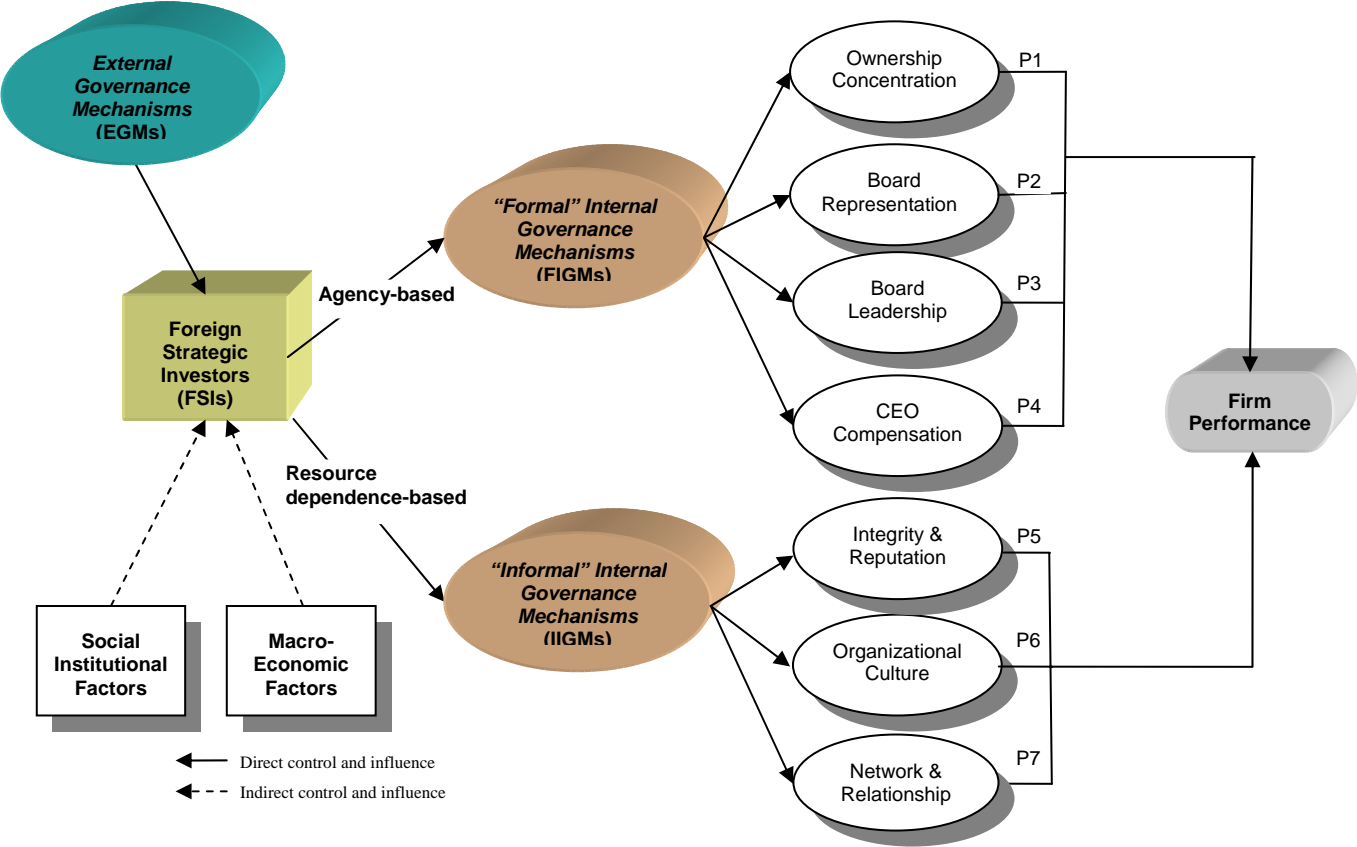
suggests that there exist positive relationships between a firm performance on one hand and FIGMs and IIGMs on the other hand. FIGMs focus on (1) the relative position of ownership concentration, (2) board representation by the FSIs, (3) board leadership, particularly the vice-chairman representation by the FSIs, and (4) appropriate executive compensation package. The IIGMs emphasize the importance of (5) integrity and reputation of local firms, (6) aligning foreign investment with the local organizational culture, and (7) managing networks and relationships, especially in fast-changing or competitive environments. Through these governance mechanisms, FSIs can positively and effectively influence local firms, which consequently may result in improved long term performance of their investment in China.

To the best of our knowledge, this study is the first to propose simultaneously both formal and informal internal governance mechanisms that have equal importance to foreign investors in local investments in China. However, there are two limitations in our study. First, a strategic collaboration that involves two firms would naturally inherit agency problems from both sides respectively. This study focuses merely on the governance aspects of FSIs, but research on the governance tools of PLCs is equally important, as these firms face similar risks and concerns regarding joint partnerships. Second, this study was developed immediately after the release of the new regulation. The true efficacy and efficiency of these internal governance mechanisms by FSIs could only be tested in the coming time when negotiations between FSIs and PLCs are completed and the information being made public. At this point of writing the paper, relevant data were yet to be made available for any empirical testing. Nevertheless, the propositions developed in the current conceptual study offer a clear indication of governance strategy which is

of particular importance in FSIs' business venture in emerging economies. In addition, it sheds light on how both formal and informal governance mechanisms can improve firm performance.

In summary, any successful investment will need to be protected and based on a combination of internal and external governance mechanisms. Ignoring either one will likely be perilous for the foreign investor. With competition growing and with an expected retraction of financial resources following the 2008 financial crisis, important FIGMs and IIGMs as analyzed in this study will become an effective risk management tool to reduce the inherent and unavoidable uncertainty in this global, interdependent economy. Nonetheless, steering the firm towards sustainable growth with good corporate governance mechanisms as the necessary compass will remain a challenge in a fast developing economy like China.

Figure 1. Foreign Strategic Investors' Internal Corporate Governance Model



APPENDIX 1

Measures for Strategic Investment by Foreign Investors upon Listed Companies

Article 5 The following circumstances shall be met for investor to conduct strategic investment:

- (1) To acquire A-shares of listed company by means of contract transfer, regular, issuing of new shares by listed company or otherwise prescribed by national laws and rules;
- (2) Investment may be conducted by stages, with the proportion of shares obtained after the initial investment no less than 10% of the shares issued by the company, except special provisions for special industry or the approval by related competent authorities;
- (3) A-shares obtained by listed company shall not be transferred within three years;
- (4) As for the industries with specific provisions on share proportion of foreign investors, shares held by the above-mentioned investors shall accord with the related provisions; as for the regions prohibited from foreign investment, investors shall not invest in the above-mentioned regions;
- (5) Investment related to state shareholder of listed companies shall accord with the related provisions on state asset management.

Article 6 Investors shall conform to the following requirements:

- (1) Foreign legal person or other organizations set and operated lawfully, steady finance, sound credit and experienced management;
- (2) The total amount of abroad real asset shall not be less than USD0.1 billion or the total amount of real asset under supervision no less than USD 0.5 billion; or the total amount possessed by its parent company no less than USD0.1 billion or the total amount of real asset under supervision no less than USD 0.5 billion;

- (3) Wholesome governance structure, sound inner control system, and standardized operation;
- (4) Without several penalty from abroad supervision organs within three years (including its parent company).

Source: CSRC, 2005b.

ENDNOTES

[1] “FSI” is the term used by the CSRC that specifies a type of foreign investors who have to comply with the stipulated criteria set for “FSI” (CSRC, 2005b). According to the regulator, FSI excludes the qualified foreign institutional investors (QFIIs) who are foreign financial institutions that can only have an equity stake in Chinese PLCs through approved custodian banks and brokers (CSRC, 2006; Tian, 2007). See Appendix 1 for the full version of the official definition on FSI.

[2] Based on our analysis of news coverage, it is found that although the new regulation came into effect in January 2006, FSIs were not able to start investment dialogues with their target PLCs immediately as most of the Chinese PLCs had only completed or undergone the non-tradable share reform towards the end of 2006 (Bortolotti and Beltratti, 2006; CRI, 2007). As of mid 2009, there are some FSIs which have shown their interest in PLCs including Guangzhou Baiyu International Airport Co Ltd, China Eastern Airlines Co Ltd etc. Nevertheless, most of these FSIs are still at the stage of negotiating with their target PLCs, thus, relevant information remained undisclosed.

[3] Chinese PLCs have a complex share structure. Although the calculation of the amount of shares owned by the largest shareholder of a PLC is straightforward, it often includes a combination of different types of shares, typically the state owned-, the legal person owned- and the state legal person owned-shares (Delios et al., 2006; Zou and Adams, 2008). Due to the conceptual nature of this study, we focus on ownership concentration rather than ownership types, which could be treated as a control variable via a dummy variable in future empirical study.

[4] It is common in China that a company's CEO also concurrently holds a vice-chairman position but not the chairman position, as CEO role duality is discouraged by the regulator (State Council, 2000).

[5] Besides, there are many other governance scandals uncovered in China indicated controlling shareholders colluded with the management to exploit minority shareholders even though proper FIGMs were in place. See Xu (2005) and Chen and Zhu (2007) for corporate abuses.

[6] Both Sino-Singaporean Suzhou Industrial Park and New Zealand's Fonterra Group have experienced obstacles in working with their Chinese partners. The former had not paid special attention to build good relationship with its local partner (i.e. the Suzhou government) and the latter partnering with a company that failed to uphold its integrity and reputation. See Tian (2007), Inkpen and Wang (2006) and Spencer (2008) for details of the above two cases.

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