



DISCUSSION PAPERS IN ACCOUNTING AND FINANCE

The Role of Financial Institutions in the Corporate Governance of Listed Chinese Companies

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Abstract

This paper explores the role of Chinese financial institutions in corporate governance of listed companies through interviews with both senior managers of financial institutions and directors of listed companies. Our results show that while most securities companies are passive investors, a good proportion of the active mutual funds help their portfolio companies prepare financial forecasts, standardise their operations, raise external funds and strengthen their company image in the capital markets. This limited role can be attributed to a number of factors specific to the Chinese context including highly concentrated state ownership, an immature regulatory environment, inadequate transparency and disclosure of financial information, and weak corporate governance within financial institutions themselves. It could also be affected by several other factors that are considered to cause institutional passivity in developed countries such as conflict of interest, monitoring costs, and lack of expertise.

Key words: China, Corporate governance, Financial institutions, State ownership, Funds, Securities companies

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1. Introduction

Substantial regulatory effort has recently been made in China to accord financial institutions an important role in improving corporate governance and stabilising the stock market. For example, in 2000, the government made a strategic decision to devote major efforts to developing financial institutions (China Securities Regulatory Commission, 2000). It encouraged financial institutions, especially mutual funds and securities companies, to invest in listed companies so that they can monitor corporate management and counter opportunistic behaviors of individual investors. In this context, mutual funds and securities companies have experienced an unprecedented growth.

Recent legal and finance literature highlights that a central agency problem in a setting like China with poor corporate governance and weak investor protection is the expropriation of minority shareholders by controlling shareholders (e.g., La Porta et al., 2000; Sun and Tong, 2003; Bai et al., 2004; Wei et al., 2005). Indeed, Xiao et al (2004) report that there are widespread corporate malpractices in China (e.g., illegal insider trading, market manipulation, and corporate reporting frauds) that are detrimental to minority shareholders. Acting as an intermediary in pooling the investment of various individuals, mutual funds can help strengthen the bargaining power of minority shareholders in the corporate governance process of their investee companies (Belev, 2003). This helps explain why regulators in China are keen to develop the role of financial institutions - particularly, mutual funds - in improving corporate governance and stabilising stock markets.

The role of financial institutions in China so far has attracted little academic attention, partly because financial institutions are not perceived to play any significant role in corporate governance (Gen, 2002). However, the literature offers no empirical evidence to support such a perception. Indeed, financial institutions' recent attempts to intervene in corporate governance issues suggest that some of them are exercising an important role in protecting the rights of minority shareholders. Thus, it is important to empirically reassess their current role in corporate governance in China and the effectiveness of the recent regulatory effort. This study represents a first attempt towards filling a gap in the literature. If empirical evidence suggests that financial institutions play a certain role in corporate governance, then this would be an indication that the regulatory efforts have achieved some measure of success and such efforts should probably be extended. If the evidence confirms prior perceptions that financial institutions play little or no role in corporate governance, then it would be useful to identify the reasons why this is the case and ways to overcome the difficulties.

To explore the role of financial institutions in the governance of listed Chinese companies, we interviewed both senior managers of financial institutions and directors of listed companies. From their perspectives, we are able to provide balanced and/or comprehensive evidence on the participation and role of financial institutions in corporate governance. The interview evidence indicates that most securities companies are passive investors, while some active mutual funds attempt to get involved in the governance of their portfolio firms. This finding suggests that the regulatory efforts in promoting the development of mutual funds seem to have generated positive, albeit limited, impacts on corporate governance. This paper also indicates that this limited role can be attributed to a number of factors. Some of the

factors are consistent with the arguments put forward by studies undertaken in other economies. These include conflicts of interest with investee companies, high monitoring costs, and lack of expertise. Others appear to be specific to the Chinese context, for example, high concentration of state ownership, immature regulatory environment, inadequate disclosure of financial information, and weak corporate governance within financial institutions themselves.

The remainder of this paper is structured as follows. An overview of the Chinese institutional background is provided in Section 2. A review of related literature on the competing views about the role of corporate governance is presented in Section 3. The research questions are discussed in Section 4. A description of the research method and the sample used is presented in Section 5. The interview data are analysed in Section 6. Finally, the conclusions and policy recommendations are presented in Section 7.

2. Institutional background in China

2.1 Corporate governance in listed Chinese companies

The current legal framework of corporate governance in listed Chinese companies is mainly based upon the Company Law of the People's Republic of China, as well as dozens of regulations issued by various regulatory authorities.¹ Under this framework, there are three general levels of authority that govern a company. The shareholders' general meetings operate as the company's ultimate power function. The second level of authority consists of the board of directors and the supervisory

¹ These regulations include “*Suspending and Terminating the Listing of Loss-making Listed Companies Implementing Procedures* (2001),” “*Guidelines for Introducing Independent Directors to the Board of Directors* (2001),” “*Code of Corporate Governance for Listed Companies in China* (2002),” and “*Notice of the Pilot Projects of Reform of the Segmented Share Structure* (2005).”

board, both appointed by, and report to, shareholders. The supervisory board is responsible for supervising directors and senior officers. To protect small shareholders' interests, the China Securities Regulatory Commission (CSRC) requires that one third of all board members are "independent" in the sense that they are not related to the listed company or its controlling shareholders. The third level of authority consists of managers, who are responsible for daily operations. This framework is meant to protect shareholders' interests. However in practice, this purpose has not yet been fully achieved (Xiao et al., 2004).

In China, since most listed companies have been transformed from former state-owned enterprises (SOEs), there is a high proportion of state ownership and legal person ownership (i.e., shares held by institutional promoters and other legal persons, most of which are also state-owned or controlled through SOEs or other state-owned institutions) and a great degree of ownership concentration (Xiao et al., 2004). Data from 2003² indicate that state shares and legal person shares accounted for over 64 percent of total share ownership in listed firms. By law, these shares are not publicly tradable although they could be exchanged by agreement approved by the government, thus leaving only about one-third of shares publicly tradable. Moreover, the largest three shareholders held, on average, about 48 percent of total shares, of which the average shareholding by the largest shareholders is about 42 per cent. The high proportion of state ownership, the concentrated ownership, and the segmented share structure have some important implications for corporate governance. First, under the concentrated ownership structure, the agency problem mainly becomes the conflict between controlling owners and minority shareholders (Claessens and Fan, 2002). This structure in reality often leads to insider control. Second, because of the

² According to the *Sinofin* database compiled by Peking University in China.

low percentage of tradable shares, and a severe segregation of the stock market, a hostile takeover is nearly impossible. As room for operations in the mergers and acquisitions market is severely limited, the efficiency and the quality of this market cannot be achieved. Third, the high proportion of state ownership provides the basis through which the government may exercise control of the corporate sector to pursue social and political objectives (Xu and Wang, 1999).

Consequently, Chinese boards of directors have relatively little decision-making power compared to government ministries, commissions and securities regulatory authorities. Most supervisory boards are more “decorative” than functional; they either do nothing or merely provide advice (Tenev et al., 2002; Xiao et al., 2004). This governance structure facilitates immoral and opportunist behaviours aimed at pursuing private gains rather than the best interests of the company. Typical “behaviours” include collusion between managers and workers; channelling a company’s profit and assets through unfair related party transactions; engaging in self-dealing in pursuit of private gains; earnings management for meeting share listing requirements; manipulating initial public offering (IPO) and secondary market prices; and trading on insider information (Lee and Hahn, 2001; Qian, 1995). Corporate scandals such as “Yin Guang Xia”³ greatly damaged investor confidence and suggest that corporate governance is very weak in listed Chinese companies. In response to these problems, the Chinese regulators have encouraged the development of financial institutions (especially mutual funds) in the hope that they can help improve corporate governance.

³ In July 2001, a blue-chip high-tech company called “Yin Guang Xia” was found to have forged customs’ receipts and made up profit figures in order to support its extremely high and rising stock price. Since then, some other blue chip companies were also found to have falsified accounts and disclosed misleading financial information.

2.2 Securities companies and mutual funds in China

Chinese financial institutions include commercial banks, securities companies, mutual funds, trust and investment companies, insurance companies, pension funds and privately placed funds (Kim et al., 2003). This paper focuses on mutual funds and securities companies for two reasons. First, because of the legal restrictions by the *Commercial Bank Law* (1995, Article 43), banks do not play any significant ownership role in the governance of listed companies as they are forbidden to hold company shares directly and actively.⁴ Second, insurance companies were not allowed to invest in the stock market until the end of 2004 and are still subject to a strict investment-quota control over the amount of funds that they can invest in listed stocks. Therefore, they are unlikely to have played any significant ownership role in corporate governance in China.

As of December 2003, 133 securities companies were operating in China. According to the *Securities Law* of 1998 (Article 6), securities companies must be established separately from banks, trust companies and insurance companies. Before 2000, securities companies experienced a glorious development (Zhu et al., 2002). After that, their operating environment deteriorated with a sharp drop in the turnover and in the funds raised from stock markets. For example, in 2003, 122 of 133 securities companies reported a total loss of more than 900 million *yuan* (US\$ 109 million) (*China Daily*, 4th February 2004).

Mutual funds have a short history in China, and hence represent an immature, though emerging, sector. The regulations limit a mutual fund to investing no more than 10 per cent of its total funds in one listed company, and its holdings of that

⁴ However, banks may occasionally and passively become shareholders of listed companies when such shareholdings are used as collateral for bank loans and the borrowing firm cannot meet its liabilities.

company should not exceed 10 per cent of that company's total shares. Since September 2001, when the first open-end fund was introduced (*China Economic Times*, 20th August 2002), this industry has experienced a rapid growth. By the end of 2003, 54 closed-end and 41 open-end mutual funds had been established. The net assets of mutual funds accounted for nearly 25 per cent, and the assets invested in shares made up 13 per cent, of the total tradable share market capitalisation in the two domestic stock exchanges by the end of 2004 (*Securities Daily*, 4th January 2005).

3. Two competing views on the role of financial institutions in corporate governance

3.1 Active monitors

Proponents of active institutional monitoring (e.g., Mackenzie, 1993; Monks and Minow, 1991) consider that financial institutions should become actively involved to resolve the incentive and control problems that characterise large, diffusely held corporations, and compel incumbent managers to improve the firm's operation.

Black (1992) and Pound (1992) view active institutional monitoring as a natural reaction to the decline in the efficacy of corporate takeovers to discipline managers. As the size and concentration of the average institutional shareholdings increases, it becomes difficult to sell off large blocks of shares. An attempt to offload large blocks of shares in a single firm adversely affects its stock price. As such, the selling institution is confronted with an even greater loss in the value of its holdings. Therefore, financial institutions would seek to protect their stakes through intervening in the governance of investee firms (Shleifer and Vishny, 1986; Watts, 1988). Meanwhile, being financial intermediaries entails the fiduciary duty that obligates them to monitor their holdings closely and to take action to protect investments

against erosion in value (Krikorian, 1991; Schneider, 2000).

In addition, it is claimed that financial institutions have the power to monitor corporate management. Stiglitz (1985) argues that individual shareholders with relatively small positions have little incentive to bear the relatively fixed costs of collecting information to enable them to monitor and control the behaviour of the board. In contrast, financial institutions have informational advantage over individual shareholders, and they have the necessary economic capacity to hire internal and external financial analysts to gather and digest information to enable them to take more informed decisions. Furthermore, financial institutions gain explicit and implicit power from the voting rights of their ownership stakes (Easterbrook and Fischel, 1983). They can select or dismiss the board of directors by voting for or against board members during the annual shareholder meetings. Meanwhile, a strong showing of votes that are unfavourable to management can increase the threat of takeover. In line with this reasoning, it is found that institutional owners that commit to holding a firm's equity have increased credibility and influence in monitoring management (Ayres and Cramton, 1993).

The large percentage of institutional shareholdings and the fiduciary duty encourage financial institutions to be active monitors. This vigilant institutional monitoring may enhance managerial efficiency and the quality of corporate decision-making. Furthermore, the involvement of financial institutions in a company may lead to improved corporate governance structures such as procedural reforms, and increased and quicker information disclosure (Pozen, 1994). Moreover, Lang et al. (1989) and Servaes (1991) provide evidence that financial institutions direct scarce capital to its most efficient use.

On the other hand, there is a need for institutional participation in corporate issues. Companies with poor financial or stock price performance, or companies with poor governance, are usually selected as targets of shareholder activism (Romano, 2001; Choi and Cho, 2003). Poor performance has created a need for top managers to justify their performance to investors and analysts (Bromiley, 1991). In fact, when faced with pressure from external sources, top managers seek to comply in a way that safeguards their own autonomy (Edelman, 1992). The intervention of financial institutions can buffer them from external scrutiny, and enable top managers to signal commitment to investor rights (Rao and Sivakumar, 1999).

Several instances of active institutions' efforts to influence firm policy and monitor corporate performance have been reported in the popular press. For example, institutional owners of the Honeywell Corporation and Lockheed Corporation used the proxy voting mechanism to oppose management attempts to block a takeover (Wallace, 1998). With a similar motive, California Public Employees Retirement System (CalPERS) widely publicises an annual "hit list" of under-performing firms (Smith, 1996). However, practical constraints may make institutional monitoring ineffective. Bhide (1993) argues that closer access to management may designate institutional owners as "inside investors" and jeopardise the liquidity of their stock holdings. Taylor (1990) and Wohlstetter (1993) claim that financial institutions do not possess the technical expertise to improve on managers' decisions. Furthermore, Black (1990) and Admati et al. (1994) recognise that free-riding among several institutional owners may also deter the capacity for collective action against managers.

3.2 Passive investors

In contrast to active monitoring, financial institutions may choose to be passive because they are more likely to sell their holdings in poorly performing companies than to expend their resources in monitoring and improving the performance of their investees.

Several factors, such as myopic goals, conflicts of interest, cost and benefit analysis, and different role expectations may motivate institutions to behave like passive and transient investors disinterested in overseeing management. Graves (1988) argues that fund managers cannot afford to take a long term view in their investment decisions since they are reviewed and rewarded on the basis of quarterly, or at most, annual performance measures. Drucker (1986) points out that defined benefit pension plans are often compelled by employers to liquidate the plan's stock holdings and realise short term gains. Since retiring employees receive fixed annual payments, short term gains reduce the employer's annual contribution to the plan. David and Kochhar (1996) argue that business relationships with firms for some financial institutions can act as barriers to effective corporate governance by changing the proclivity towards intervention. Pozen (1994) claims that financial institutions are generally passive shareholders, only becoming active when expected benefits exceed the costs incurred. Webb et al. (2003) attribute the low degree of active participation in the UK to such factors as shareholders being not large enough to be concerned about monitoring overall performance, and prohibitive transaction costs involved in monitoring.

In addition, different role expectations from a myriad of stakeholder groups would lead to role conflicts for institutional owners (Boatright, 1992; Katz and Kahn, 1978; Schneider, 2000), which inhibit financial institutions from being as active as

they might otherwise be in corporate governance issues. Eaton (2002) argues that some financial institutions may be pressed by the government to invest in the local community, to support local businesses, and to create jobs, while also being one of its owners. Clearly, political pressure could restrain institutions' tendency toward active monitoring of portfolio firms.

One school of thought blames mistrust of powerful financial institutions for a number of laws and regulations that restrict institutional ownership of public corporations and discourage institutional monitoring of managers (Duggal and Millar, 1999; Roe, 1990). For example, pension regulators may discourage pension managers from being appointed to the firms' boards of directors fearing collusion between potentially unscrupulous fiduciary bodies and firm management.

3.3 Prior studies about the role of financial institutions in China

The extant literature concludes that Chinese financial institutions are passive and transient investors. Tenev et al. (2002) argue that financial institutions in China have a small market presence and cannot play a stabilising role. As a result, corporate control mechanisms and shareholder activism can do little to mitigate agency problems under the existing highly concentrated and segmented ownership structure. Zhang (2002) holds the same opinion about the current role of financial institutions, and attributes their limited role to two main reasons, the small number and market capitalisation of Chinese financial institutions, and the immature legal system. According to Gen (2002), financial institutions would not play any role at all in corporate governance in listed companies because of the volatile securities market. Specifically, Tam (2002) points out that managed funds have not been able to play the anticipated role in lifting corporate performance nor instilling an element of stability

in the often volatile Chinese stock markets. However, no study has provided any empirical evidence to support these claims.

4. Research questions

This paper investigates the role that Chinese financial institutions play in the governance of listed companies. On the one hand, financial institutions may be expected to act as shareholders and monitor corporate management on behalf of small shareholders and to take a long-term view of their shareholding positions, and, where necessary, incur expenses to discipline management. On the other hand, financial institutions must also act as investors with investment flexibility to maximise returns for their beneficiaries. In this respect, it is difficult to argue that institutions should continue to hold equity positions in inefficient companies and incur the additional expenses of intervening in management, particularly when there is no guarantee that intervention will be successful. Our question here is to identify which role Chinese financial institutions play, the role of shareholders, or the role of investors? To gain an understanding on this issue, it is necessary and important to identify the processes by which financial institutions monitor and influence listed companies, and the factors that facilitate or hinder the processes and effectiveness of financial institutions' role in corporate governance. In particular, we address the following three questions:

First, *what are the characteristics of firms that attract institutional investment?*

It can be argued that financial institutions' participation in the governance of listed companies starts when they perform quality research prior to investing. This process identifies efficient firms and directs scarce capital to its most efficient use. It is therefore important to identify the characteristics of the firms that attract Chinese financial institutions and whether these include performance and governance issues.

Second, *what are the expected and practical roles of financial institutions in corporate governance?* Theoretically, financial institutions are delegated monitors for their beneficial owners, and are expected to monitor their holdings closely and to take action to protect their value. However, Versteegen and Marguerite (2002) argue that a mix of financial, legal, and social influences affect financial institutions' activism. As the institutional structures in transitional economies differ significantly from those familiar in developed countries (Hoskisson et al., 2000; Peng, 2003), there may exist a difference between the expected and the actual role of financial institutions in corporate governance. To explore their actual role in corporate governance, it is necessary to analyse the steps they take to influence the decision making of their investee companies. For example, when they are not satisfied with their portfolio companies, do they immediately sell their holdings or do they voice their dissatisfaction and intervene in corporate issues? The practice of managing their investment portfolio reflects their actual role in corporate governance.

Finally, *what are the factors that affect the role of Chinese financial institutions in corporate governance?* One cannot take it for granted that if financial institutions have the incentive to intervene in corporate governance affairs, they will be able to do so successfully. It is quite possible that various structural and regulatory barriers can impede this influence. These barriers can prevent them from fully exercising their power or may motivate them to exercise it in different directions. Exploring these factors can further demonstrate that shareholder activism is the result of a mix of financial, legal, and social influences. It can also help to provide recommendations so that financial institutions can play a greater role in corporate governance in the future.

5. Research method

Our research objective and questions require us to gain an insight into the contextual and procedural issues and underlying factors that affect the interactions between financial institutions and their portfolio companies. Interviews were considered as an appropriate method to fulfil our purpose to a degree unattainable through such research methods as statistical analysis and surveys of the existing literature.

We relied on our social contacts to obtain interviewees in financial institutions and listed companies. We interviewed twenty senior managers from financial institutions and ten directors of listed firms over the period from June to October 2004. The interviewees were drawn from the two main types of financial institutions, ten from fund management companies and ten from securities companies. The information about the twenty senior managers and their companies is listed in Table 1.

To preserve anonymity, the names of interviewees and their companies are not disclosed. Instead, they are designated as, for instance, IM1 (i.e., Investment Manager One) and FM1 (i.e., Fund Manager One). All senior managers were well qualified academically and professionally, each holding a masters or doctoral degree in the areas of accounting, finance, statistics, or economics. Four of them had educational or work experience abroad. While all had at least five years' work experience, 15 of them had more than five years' work experience specifically in the financial industry.

Table 1: Interviewees from financial institutions and their companies

Code	Location	Registered Capital (RMB yuan)	Qualification	Work experience
IM1	Beijing	2.721 billion	Doctor in finance	6 years
IM2	Guangdong	3.450 billion	Master in finance	6 years
IM3	Beijing	1.282 billion	Master in maths	5 years
IM4	Beijing	1.005 billion	Doctor in accounting	9 years
IM5	Shanghai	3.727 billion	Master in accounting	6 years
IM6	Guangdong	2.015 billion	Master economics	10 years
IM7	Beijing	1.048 billion	Master in economics	5 years
IM8	Beijing	2.482 billion	Master in maths	8 years
IM9	Beijing	1.510 billion	Doctor in economics	9 years
IM10	Beijing	4.501 billion	Master in finance	5 years
FM1	Shanghai	0.132 billion	Master in finance	7 years
FM2	Shanghai	0.121 billion	Master in economics	8 years
FM3	Beijing	0.152 billion	Doctor in finance	11 years
FM4	Shanghai	0.117 billion	Doctor in economics	5 years
FM5	Beijing	0.138 billion	Doctor in maths	7 years
FM6	Beijing	0.124 billion	Master in accounting	10 years
FM7	Shanghai	0.113 billion	Doctor in finance	5 years
FM8	Beijing	0.125 billion	Master in maths	9 years
FM9	Beijing	0.138 billion	Doctor in finance	9 years
FM10	Beijing	0.150 billion	Master in finance	8 years

Key:

IM: Investment managers from securities companies; FM: Fund managers from fund management companies. RMB stands for Renminbi, i.e., people's currency in Chinese. In the end of 2003, the exchange rate was about £1=RMB ¥ 15.8. Source: the official website of the China Securities Regulatory Commission <http://www.csrc.gov.cn>.

Listed companies whose representatives participated in the interviews were selected by the following selection criteria: 1) A firm should not be a financial company (e.g., banks, insurance companies, and investment trusts) as financial firms account and report under different rules from other listed companies; 2) A firm should have been listed at least one full year as of the end of 2003 in order to ensure that performance and capital structure are not significantly affected by a new listing that may confound the results; and 3) A firm should have securities companies and/or mutual funds as their top ten shareholders. Among the ten directors, nine were

executive directors and one independent director (BD9) who was a professor from a prestigious university. Most of them had a bachelor degree. The average tenure of board members is 1.55. The information about the ten directors and their companies is listed in Table 2.

Table 2 Interviewees from listed companies

Code	Location	Industry	Institution	Qualification	Board experience
BD1	Beijing	Other Manufacturing	5 F	Bachelor in economics	1.5
BD2	Beijing	Transport	6 F	Bachelor in politics	1
BD3	Beijing	Social Services	1 F	Doctor in management	1
BD4*	Sichuan	Beverage	1 S	Master in accounting	2
BD5*	Guangdong	Electrical Equipment	1 F	Master in marketing	2
BD6*	Liaoning	Medicine	7 F	Bachelor in economics	2
BD7	Shanghai	Gas, water supply	1 F	Master in finance	2
BD8*	Hebei	Mining	4 F and 1S	Bachelor in accounting	1
BD9	Beijing	Medicine	2 S	Doctor in accounting	2
BD10*	Xinjiang	Metal	1 S	Bachelor in management	1

Key: BD: director of a listed company. *: from companies, whose head offices were in other provinces outside Beijing, but had established offices in Beijing. Institution: the number of financial institutions within the company's top ten shareholders. S: Securities companies; F: Fund management companies. Board experience: The number of years served at board level.

A pilot study was carried out to test out the interview questions and to gain a feel about the interview process. Two pilot interviews assessed reactions to the initial questions, the amount of time that the interviews would take, and any need to amend questions before commencing the main study interviews. The assessment process included comparing the actual pilot interview with initial expectations, reviewing the research design and objectives, and seeking feedback from the pilot interviewees directly. One fund manager from a fund management company and one director from a listed company were chosen for the pilot.⁵ The pilot study led to some changes to

⁵ The two interviewees were not included in Tables 1 and 2.

the questions, for example, a clarification of the definition of financial institutions. Furthermore, the use of a tape recorder was ruled out because the pilot interviewees suggested that the prospective interviewees might object to being recorded, and using it would alter consciously or unconsciously their responses. Extensive notes were taken during the interviews and subsequently transcribed.

In both the company and institutional cases, the interview questions (see Appendix) were semi-structured and designed to allow the interviewees to interpret and describe the phenomena in their own way. We contacted each interviewee in advance to secure participation and to provide them with the opportunities to consider the interview questions beforehand. Most interviews took place in the interviewees' offices. The time for the interviews ranged from 60 to 90 minutes.

A seven-stage approach (Easterby-Smith et al., 1991) was adopted to sift through and process the interview data. These stages were case familiarisation, reflection on contents, conceptualisation, cataloguing of concepts, recoding, linking, and re-evaluation. During these stages the interview responses of the various subjects were compared in order to identify common themes and problems which were compared to the researchers' own priors and extant literature. The approach is iterative in that data and analysis are revisited on several occasions over an extended period of time.

6. Analysis and discussion of interview data

6.1 Firm characteristics that attract institutional investment

Before making an investment, financial institutions routinely perform quality research on listed companies to identify investment opportunities. Jing (2004) argues that because of different fund size and business structure, securities companies and

mutual funds exhibit different investment preferences. In addition to considering macroeconomic factors, most mutual funds had used a combination of governance issues and performance measures as their selection criteria, while most securities companies had targeted firms solely on performance.

All interviewees from financial institutions considered face-to-face meetings with managers of their portfolio companies as the most effective way to get information from the companies. As a result, the financial institutions' representatives were very serious and cautious with each of such meetings. They would explain why the company was chosen and what action the institution would expect from the selected company by means of sending a formal letter, giving a formal phone call, or going out with company management. Generally, they met the CFO, the secretary to the board of directors (equivalent to company secretary in the UK), or managers from related departments. Information collection was focused in the areas of corporate financial performance, corporate strategy, and corporate growth opportunities.

Eighteen of the twenty interviewees from financial institutions employed on-the-spot investigation to collect information that was probably not included in the documents and reports. In such an example, investment manager "IM8" found himself cheated by the corporate management when he inspected a reportedly new production line of the company and found that the line was already outdated. This information helped him discard the company from the investment portfolio. Further analysis in this subsection is based on questions 1 and 2 of Panel A in the Appendix.

6.1.1 Good performance

All interviewees selected firms with good performance as their portfolio companies. In greater detail, they considered the need to maintain an upward trend in

the company's earnings per share, a healthy cash flow and a reasonable level of gearing as key factors in their decision to invest. The results are not unexpected as profitability, cash flows and gearing are key indicators of a company's financial standing. The explanation of fund manager "FM4" was typical:

"As fund managers, we know that invested funds are essentially 'other people's money' so we have a fiduciary duty to holders of tradable shares. A healthy cash flow and good profitability can ensure a high investment return, so that we can get a good return for our clients."

Investment manager "IM4" added another key point:

"We need to be free to move funds around so that we can get the best return for the beneficiaries of our funds. The Chinese security market is very volatile and unpredictable. We expect that companies with good performance will have good prospects. It is our job to invest the beneficiaries' money in the most profitable investment. "

6.1.2 Tradable shareholdings

Di (2004) argues that tradability of shares is one of the factors that financial institutions consider when making investment decisions. Support for this comes from ten fund managers and two investment managers.

According to their views, as more shares are tradable, more voting rights are in the hands of trading shareholders and this leads to increased monitoring from individual investors and financial institutions. Accordingly, investee companies are under greater pressure to standardise their practice and improve their performance. As fund manager "FM5" said:

"More tradable shareholdings indicate less state or legal person holdings in China. Consequently, less political pressure will intervene in the practice of companies. Thus, companies can operate to maximise the profit on behalf of the company and shareholders."

However, it is important to notice that most investment managers had a different criterion to select portfolio companies. Eight of the ten investment managers

did not care much about tradable shareholdings in a company, because tradable ownership accounts for only about one third of all shares in the current ownership structure of listed companies. With such a low volume of shares, holders of tradable shares are still very weak, and their rights are always expropriated by controlling shareholders.

6.1.3 Financial statements and annual report

Prior research indicates that investors rely on the information sent out from the company to make investment decisions (Leland and Pyle, 1977; Poitevin, 1990; Ravid and Sarig, 1991). In practice, companies with good operating performance often disclose information to the public to promote positive impressions of their company (Chiang, 2005), and the most tangible form of investor communication is the financial statements and annual report.

Twelve interviewees, including nine fund managers and three investment managers, considered that the quality of financial statements and annual report was clearly a key criterion for them to select portfolio companies. Of the twelve interviewees, eight also considered the disclosure of the company's strategies and initiatives, and the quality of management's discussion and analysis of the year's results and financial position in the annual reports to be just as important. This indicates that firms with enhanced disclosures in their annual reports beyond the basic mandatory requirements can attract institutional ownership.

Most interviewees considered the poor quality of information disclosure by listed companies as a fairly common problem. Investment manager "IM1" thought it was useless to consider the quality of information disclosure, as a significant number of listed companies only complied with the disclosure standards in form but not in

substance. Some did not even bother to comply with the form; they might make up their financial statements by manipulating accruals. Fund manager “FM1” said:

“One of the most important reasons why we had so many financial scandals recently is the current poor quality of financial statements and annual reports of listed companies. This implies that any further legislative changes should not ignore this point while seeking to prevent recurrence of the highly publicised cases of fraud, error, and crime in the corporate governance process.”

6.1.4 Quality of management

Holland (1998) identifies the ‘quality of management’ as one of the most important ingredients in expected corporate financial performance. Management was the medium to change other factors such as strategy, innovation, the quality of financial reports and the functioning of board committees. In a similar vein, twelve interviewees, including eight fund managers and four investment managers, held the same opinion.

Chinese corporate managers do not suffer the pressure from external governance mechanisms such as the market for corporate control and managerial labour market (Chiou and Lin, 2005). Most shares in China cannot be traded freely and thus corporate managers do not have to worry about poor management that may cause their enterprise’s stock price to fall, or that their company will be faced with a take over threat as the market for corporate control is absent in China, and the managerial labour market is still immature. Instead, being fired by the board of directors seems to be a more serious threat to managers than an outside takeover (Bai et al., 2004). Moreover, other studies have found evidence that the decision-making duty of the board of directors cannot really be separated from the managers’ duty of implementing the decisions (Chen and Huang, 2001). Also, there is serious overlap

between board members and managers as executive board members are dominant in the boardroom. Therefore, the quality of Chinese corporate management is of great importance for investors to consider. Meetings were seen as a key opportunity to collect data on the quality of the management team and their attitudes and managerial skills (Holland, 1998). This approach was also used by twelve of our interviewees to gather information about the company and its management.

Investment manager “IM7” was not satisfied with the current quality of the management in some listed companies. He said:

“When companies come to the market to raise additional equity funds, the onus is on management to negotiate with the institutional shareholders. But in practice, it was always the management of listed companies that were reluctant to exchange their ideas and ignored us. Sometimes we were forced to take collective actions against their corporate proposals.”

6.1.5 Investor communications

Seven fund managers valued the willingness of companies to provide additional information to investors, analysts and other commentators, their prompt release of information about transactions affecting minority shareholders and the existence of other transparency mechanisms that help ensure fair treatment of all shareholders. Fund manager “FM10,” by contrast, was disappointed with the investor relations departments in most listed companies, as they did not always do what they were saying.

6.2 The role of financial institutions in corporate governance

After investment, financial institutions kept close touch with their portfolio companies and paid a great deal of attention to each change of stock prices to safeguard their investment. The objective expressed by the majority of the financial

institutions was to contribute to their long-term investment performance. However, because of barriers to effective governance, our interview data, based on Questions 3, 4 and 6 of Panel A, and Questions 1, 2 and 3 of Panel B in the Appendix, show that the majority of financial institutions are still passive shareholders.

6.2.1 The expected role of financial institutions

When asked what kind of role Chinese financial institutions should play in the governance of listed companies, eighteen managers from financial institutions and eight directors of listed companies asserted that the financial institutions should monitor and check controlling shareholders and corporate management to protect the rights of minority shareholders, to improve firm performance and to enhance the value of shareholders. This is well encapsulated by the remarks of director “BD6” and fund manager “FM2”:

“Financial institutions should bring their potential into play. For example, since they are professional investors, they should make suggestions and help us to make scientific decisions when we seeking advice or when raising funds. Also, they should prevent large shareholders from carving out assets of listed companies and should check collusion between controlling shareholders and other large shareholders.” (Director “BD6”)

“We have realised that we (financial institutions) cannot rely on traditional mechanisms to safeguard our investments. Instead, we have a responsibility to make considered use of our votes. Accordingly, we should encourage the firm to change its policy when we feel one of our portfolio companies is poorly managed. Recent attempts by some active mutual funds to exert corporate control indicate that our behaviour is changing.” (Fund manager “FM2”)

The other interviewees did not think that financial institutions should play a role in the governance of listed companies. In their opinion, financial institutions are only professional investors, and have neither the skills nor the experience to improve

on managers' decisions. Therefore, their attempts to influence corporate decisions tend to disrupt the firm's operations. Furthermore, their myopic focus on short-term earnings would deter the firm's long-term financial health.

6.2.2 The actual role of financial institutions in China

6.2.2.1 Active shareholders

Some mutual funds reportedly exercised their monitoring role in corporate governance. Five mutual funds managers "FM2," "FM3," "FM5," "FM8," and "FM9" claimed that they were becoming active shareholders (or quasi-active monitors, more precisely). They helped listed companies to raise funds, to standardise their practices, and to establish good images in the secondary capital market by means of constructive communication with corporate management and by exercising their voting rights at shareholders' meetings. In particular, they went so far as to intervene in corporate issues (1) when the financing arrangements violated the company constitutions, or (2) when investment decisions were inconsistent with the proposal, or (3) when the financing arrangements violated the rights of minority shareholders.

According to fund managers "FM2" and "FM8," the main purpose of some mutual funds interfering into corporate affairs is to improve the governance of listed companies, as they believed that such changes would eventually improve firm performance. The following remarks by director "BD2" echoed these views of the fund managers:

"In many cases mutual funds helped us make financial forecasts, pushed us to provide voluntary disclosures, and standardised our operations. Occasionally, they made suggestions and attempted to veto some of our proposals that would affect the rights of minority shareholders in general shareholders' meetings. To a certain degree, their behaviour pushed us to improve corporate governance practices and firm performance as well."

Directors “BD4” and “BD7” also agreed that mutual funds’ intervention in corporate issues had improved the performance and governance of their companies. For example, mutual funds influenced their attitudes towards increasing shareholder benefits, suggested cost-cutting that boosted profits, and pushed them to improve the quality of financial disclosure.

Active mutual funds generally begin with constructive, but frank, communications with corporate management about firm performance and strategy. They discussed with the secretary to the board of directors, sometimes with the company chairman, general managers or managers from functional departments. They explained why they might not be satisfied and what action they desired from the portfolio companies. However, when a constructive dialogue fails, mutual funds might voice their dissatisfaction to the public either independently or in conjunction with other institutional shareholders, because taking such steps is considered to be consistent with small shareholders’ best interests.

In terms of voting, they usually supported the voting recommendation of a company’s board. In the event of voting against a proposal, they always informed the company beforehand and explained the reasons for so doing. They used reasonable endeavours to seek responses from the company to address the underlying concern before they actually put their cross in the box.

When portfolio companies asked for funds, help or advice; or when they faced unusual circumstances, mutual funds increased their pressure and exercised their influence via the board and senior management on problematic aspects of strategy, management quality, and financial reporting, in the expectation that this would contribute to improved financial performance. When the influence process failed, the mutual funds resorted to complete sales of stock.

The five fund managers pointed out that the areas they would like to intervene in include influencing attitudes towards increasing shareholder benefits, boosting profits, cutting costs, and especially improving the quality of corporate disclosure, an area where they have expertise and their intervention costs are low. They were very careful only to attempt to influence a firm on matters of the principle in the *Code of Corporate Governance* (CSRC, 2001), such as the separation of chairman and CEO roles. In their opinion, influencing corporate strategy was not part of their competence and, besides, it created serious conflicts with portfolio companies. They attempt to do so only in exceptional cases when such corporate strategies seriously harm minority shareholders.

Fund manager “FM9” noted that mutual funds employed very few methods effectively to monitor corporate management. They seldom initiated litigation against companies, although they are the common ways of institutional intervention in the market economies, especially in the US and UK (Wahal, 1996).

However, these mutual funds were active monitors, not activists. “We talk to the management, and if things are not going the way they should be going, we can make suggestions,” Fund manager “FM3” explained, “but we are not activists in the sense of trying to get involved in management to enforce those issues.” He expressed his dissatisfaction to the public when China Merchants Bank (CMB) proposed to issue 10 billion convertible bonds in September 2003 without any communication with its financial institutions beforehand, as this proposal would expropriate the rights of minority shareholders. More than forty mutual funds, including “FM2,” “FM3,” “FM5,” “FM8,” and “FM9,” took an unprecedented collective action to vote against this proposal. During the interview “FM3” added with excitement, “From the recent

cases that challenged corporate managements, we seem to hear the bugle call for institutional activism.” Furthermore, fund manager “FM9” expressed his confidence:

“Though we eventually achieved a very limited amount of success [in the CMB case], the fight has just started and will become much fiercer, from a long term perspective. We believe that we would win in the end, as we are becoming stronger in the capital market, looking for our own stage, and getting our voice heard.”

According to directors “BD2,” “BD5” and “BD8”, some mutual funds really participated in improving the governance of listed companies, but there was much room for them to improve the effectiveness of participation. All fund managers and six investment managers suggested that efforts were needed to promote international exchanges, to organise training and consulting, to provide better education, and to realise global sharing of related experience and resources.

6.2.2.2 Passive investors

Drucker (1976, p 82) states that “pension funds are not ‘owners’, they are investors. They do not want control ...The pension funds are trustees. It is their job to invest the beneficiaries’ money in the most profitable investment. They have no business trying to ‘manage’. If they do not like a company or management, their duty is to sell the stock.” Supporting this quotation, there is much anecdotal evidence to suggest that institutional shareholders do not even adopt a monitoring role, preferring to sell their holdings in “problem” companies rather than intervening in the management of that company (Short and Keasey, 1997). This is also the case with the majority of Chinese financial institutions.

All investment managers from securities companies and the remaining fund managers (excluding those in the five active funds mentioned above) admitted that they were just passive investors and did not take much interest in the governance of

their portfolio companies. They tried to achieve the best return for their clients by buying and selling shares in a short period of time, relying on their judgement of the underlying strength of companies and their ability to exploit share price anomalies. Generally, these financial institutions seldom attended shareholders' meetings. They had almost no communications with the corporate management of their portfolio companies. They tolerated the problems in corporate governance as long as profits remained acceptable, and preferred to take the "Wall Street Rule"; i.e., to sell when faced with serious problems.

Investment manager "IM8" said, "We have little interest in monitoring the management, showing up at shareholders' meetings and taking an active role in the company. What we are interested in is a better return from the share price gap." However, as fund manager "FM2" explained, only in extreme cases, for example, when their interests were seriously damaged, did some financial institutions have to fight.

In summary, the majority of financial institutions were passive investors although a good proportion of mutual funds claimed that they were becoming active monitors. Thus, there is a gap between this actual role and the role that the majority interviewees' expected financial institutions to play. This general passivity warrants a detailed examination of the underlying reasons, which is undertaken below.

6.3 Factors that influence the role of financial institutions in corporate governance

Our interviews identify three groups of interrelated factors that hinder the role of financial institutions in corporate governance: environmental, supply side (financial institutions), and demand side (listed firms).

6.3.1 Environmental factors

The first environmental factor that all interviewees agreed is the problematic ownership structure. The low level of shareholdings held by financial institutions prevents them from monitoring corporate management. Compared with state and legal person shareholders, financial institutions are minority shareholders, and the voting powers are not large enough for corporate control. “We are so weak that it was useless to put forward our proposals or express our concern.” Investment manager “IM9” explained, “As far as I know, few suggestions were accepted in shareholders’ meetings. Since we all know the result of our effort, why do we work in vain?” Investment manager “FM6” concurred: “Though we would like to intervene, it is very obvious that our interference does not produce any effect, as we have a very small size of shareholdings.” The thought of director “BD3” was typical:

“Most listed companies have excessive concentration of non-tradable shares, and overly dispersed holders of tradable shares are in an inferior position relative to controlling shareholders. The interests of minority shareholders and other stakeholders are not always respected and protected. The situation makes the voice of financial institutions irrelevant.”

The above remark by director “BD3” alluded to the second environmental factor: China’s weak regulatory environment (Pistor and Xu, 2005). Zhang (2002) argues that because of the imperfect legal and supervisory environment, Chinese financial institutions are just traders, and prefer short-term investments. One particular weakness of the current legal system that was pointed out by many interviewees is the poor legal protection of minority shareholders. “Although we are large holders of tradable shares, we are also the minority.” Investment manager “IM5” said, “Since it is the common fact that our concern is always ignored by listed companies, we are not willing to incur expenses in intervening in listed companies’ governance issues.”

Director “BD1” echoed,

“It is true that we always neglected the voice of financial institutions. Major strategic decisions were mostly agreed upon beforehand among the key shareholders, typically the state, often outside the boardroom. We are usually the representatives of the largest shareholder who indirectly exerts control over shareholders’ meetings.”

Third, there may be a Chinese cultural aversion to resorting to litigation that is regarded as confrontational and aggressive. Procter (1998) notes that financial institutions tend not to become involved in corporate governance issues affecting their investments. There is a genuine reluctance to litigate issues. Investment manager “IM3” pointed out that minority shareholders tend to accept the convention that they are often not fellow stakeholders with equal rights and interests and not to “interfere” into the company’s “internal affairs”. This cultural factor may influence financial institutions’ role in corporate governance.

6.3.2 Supply side factors

Agency problems within financial institutions were considered to prevent them from being active shareholders. Directors “BD3” and “BD9” argued that financial institutions might be imperfect monitors due to their own internal agency problems.

Director “BD1” explained:

“Financial companies, especially securities companies, have not established sound corporate governance systems and there is insufficient checks and balances among the board of directors, shareholders, the supervisory board and the management. Currently many financial institutions suffer the same problems as our listed companies. The weak corporate governance within financial institutions necessarily affects their role in the governance of portfolio companies.”

Moreover, institutional owners are agents themselves with their own goals, separate from the goals of their clients. Due to information asymmetry, such agency problems as collusion and share-price manipulation arise when institutional owners

find it mutually advantageous to co-operate with corporate management on certain issues. Their current or potential business relationships with the firm make them less willing to curb management discretion actively.

Another supply side factor relates to financial institutions' lack of expertise to improve managerial decisions (Taylor, 1990; Wohlstetter, 1993). As investment manager "IM4" argued, financial institutions are undoubtedly skilled investors but lack expertise in corporate governance, and activism would detract from their primary role, which is managing money for their clients. He also questioned the incentives for some active mutual funds to undertake activism. According to his view, the attempts to intervene in corporate issues might be motivated more by social influence than by firm performance.

In addition, investment manager "IM10" argued that, due to the recent recession of the securities industry in China, securities companies had no incentive and no power to participate in the governance of listed companies. "We are like clay idols fording a river—hardly able to save ourselves," "IM5" said, "let alone anyone else."

Fourth, being a shareholder and a current or potential business service provider creates goal conflicts (David and Kochhar, 1996). Such goal conflicts also reduce Chinese financial institutions' willingness to put pressure on company management in the event of corporate governance deficiencies. Investment manager "IM5" told of his dilemma which might change the proclivity towards intervention. In addition to holding equity in a listed company, his securities company also provided financial services to that company. Accordingly, he had to safeguard his company's investment and maintain a business relationship with the investee company. The dual roles of these activities may pose for him a conflict of interest. Furthermore, in fear of

retaliation, he might be compelled to vote with the management even though contrary to his fiduciary duty.

Furthermore, according to investment manager “IM6”, the costs of monitoring and checking corporate management can lead to passivity. As is the case in the UK (Webb et al., 2003), the costs are prohibitive in China compared to the stake that a financial institution has in the company.

6.3.3 Demand side factors

Two demand side factors emerged from our interview data: inadequate transparency and disclosure and poor investor relations. It is widely believed that false accounting and financial misreporting are pervasive among Chinese companies. Hence, the lack of true, accurate and complete information required to analyse portfolio companies become a barrier to effective governance. Investment manager “IM2” and fund manager “FM7” attributed the poor disclosure to the lack of effective legal punishment for reporting companies, weak competition in the capital market, and inadequate internal control systems for disclosure within the companies.

Relating to disclosure is the issue of investor relations. Listed Chinese companies have only recently begun to establish an “Investor Relations Department”. Director “BD5” who was also the secretary to the board of directors and the director of the investor relations department in his company, revealed that in practice it was difficult to carry out the function of this department. For example, whether companies could provide additional information to investors, such as information about transactions affecting minority shareholders, was up to the willingness of controlling shareholders. However, all directors in our sample considered an investor relations function as an important means to ensure effective communication between managers

and investors. Directors “BD7” and “BD10” admitted that until recently it had been very difficult to communicate, but now there is more cooperation with financial institutions.

All interviewees from financial institutions also viewed an investor relations department as important as it provides a convenient and natural media for financial institutions to monitor and influence firm performance and accountability. They acknowledged that the establishment of an investor relations management function had improved their communications with their portfolio companies.

7. Conclusion

This study has investigated the expected and actual roles of financial institutions in corporate governance and the factors that affect their role. The majority of our interviewees expected financial institutions to play an active monitoring or interventionist role in corporate governance while a minority of our interviewees argued that they should remain passive investors.

Our interviews show two phases at which financial institutions could affect corporate governance. Prior to making an investment, financial institutions performed quality research in order to identify efficient firms, thus directing scarce capital to its most efficient use and consequently enhancing corporate efficiency. Indeed, most fund managers considered firm performance, tradable shareholdings, financial statements and annual report, quality of management, and investor communications as important factors that affect institutional investment decisions.

The interview data also indicate that five mutual funds seemed to be active monitors and exercised their influence on corporate management and that some directors confirmed the positive effect of financial institutions’ participation in

corporate governance. By contrast, the other mutual funds and all securities companies in our sample appeared to be passive shareholders and did not play any role in the governance of listed companies. Overall, there appears to be an expectations gap between the actual role and the expected role.

The interview data also suggest that a number of factors account for this limited role played by financial institutions. These are the high concentration of state ownership, the immature regulatory environment, the inadequate disclosure of financial information, the weak corporate governance within financial institutions themselves, conflicts of interest with investee companies, high monitoring costs, and lack of expertise. The most important determinant is the high degree of state ownership concentration. This causes severe insider control and pursuance of non-economic objectives in listed companies, which limits the role of financial institutions in corporate governance (Zhou, 2004). The next three determinants listed above are specific to the Chinese context while the remaining factors have also been found to influence shareholder activism in developed economies (e.g., Roe, 1990; David and Kochhar, 1996).

This study makes several contributions. It is the first study to provide interview-based empirical evidence on the role of financial institutions in the governance of listed Chinese firms. This evidence suggests that the prior perception that they do not play any role should be modified. Second, we are able to show that securities companies and mutual funds could play differing roles in corporate governance in China. Third, we have identified a set of determinants of the role of financial institutions in corporate governance that are specific to the Chinese context.

In addition, the findings have a number of policy implications. First, they suggest that the regulatory efforts in promoting the development of mutual funds

seem to have generated positive, albeit limited, impacts on corporate governance. Second, the governance, monitoring and incentive mechanisms for financial institutions themselves need be perfected. Third, there is a need to improve legal protection of minority investors including financial institutions. Moreover, there is a need to nurture a culture of trust and ethics in both financial institutions and their portfolio firms to prevent insider trading, collusion, and false reporting. Finally, improved investor relations may help to enhance the role of financial institutions in corporate governance.

Further research is needed to identify the reasons why various financial institutions in China play differing roles in corporate governance. It would also be useful to provide empirical tests of whether mutual funds' positive role actually improves the performance of their portfolio firms. Finally, in-depth case studies would help uncover more detailed procedural aspects as to how mutual funds actually engage in corporate governance.

Appendix: Interview schedule

Panel A: Questions to financial institutions :

1. What factors do you consider in deciding on an investment in a company?
2. How do you communicate with your portfolio companies before investment?
 - (1) How often, by what means and with whom do you contact with your target before investment?
 - (2) What topics are generally covered during the communication before investment?
 - (3) What benefits do you get from the communication?
3. How do you communicate with portfolio companies after investment?
 - (1) How often, by what means and with whom do you contact with your target(s) after investment?
 - (2) What topics are generally covered during the communication after investment?
 - (3) How is attendance at shareholder meetings and voting? (Have you sat on the board of directors or supervisory board of your portfolio companies?)
4. What role do you expect financial institutions to play in the governance of listed companies?
5. What factors affect your intervention in the governance of listed companies?
6. What role do you play in governance of your portfolio firms?
7. What is your opinion about the investor relations management in your portfolio firms?

Panel B: Questions to listed companies

1. What roles does your financial institution(s) play in the governance of your companies?
2. What does your company do if the financial institution wants to communicate with you about corporate governance?
3. How does your company deal with a financial institution's demand for change?
4. What is your opinion about your company's investor relations management?

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