

## **INTRODUCTION**

### **China's Adaptation to Global Best Business Practices**

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## INTRODUCTION

### China's Adaptation to Global Best Business Practices

The metaphor “link up with the international track” (*yu guoji jiegui*) has been highly popular in Chinese media, official documents and academic publications since 1992. The metaphor implies that for China to function well in the globalization process, it must adapt to and/or adopt the norms and standards of international best practices, in a similar fashion as for a train to run smoothly across compatible track systems. Although the popularity of this metaphor is not evenly distributed across policy areas and social groups, the survey evidence presented in Wang (2007) indicates that while the policy makers and intellectuals focus on international norms and practices governing business, economics, and technical issues, the general public is interested in a wider range of international norms and standards. The consensus like popularity of this metaphor in the business and economic realm indicates the strong intention and willingness of Chinese policy makers, intellectuals, business community and general public to accept and adapt to the norms and standards of global best business practices.

Despite the expressed strong intention and willingness, scholarly works assessing the general advancement of the adaptation process suggest limited substantive progresses. In other words, notwithstanding major formal changes on paper in many areas, the spirit of global best business practices is still largely missing and old habits and practices remain remarkably resilient (Bergsten *et al.*, 2006; Tenev, *et al.*, 2002; Xi, 2006). While this general assessment may hold for the average firms, agents, actors, and sectors, there is a shortage of research which focuses on the leading players in Chinese business realm who are showing others the way towards a more global style of business conduct and corporate governance, albeit with Chinese characteristics. This special issue intends to make a contribution towards filling this gap. One may argue that these leading players are not statistically representative now. Nevertheless, their way towards global best business practices is indicative (and/or representative) of forthcoming trends and dynamics, given the strong desire of Chinese business leaders and the general public to “link up with the international track”.

The first two contributions in the special issue draw on case studies of leading corporations in two centrally regulated sectors: banking and petrochemicals. As state-owned large enterprises in these two sectors have enjoyed a near monopoly position and

retained strong ties to the state bureaucracy, they seem somewhat unlikely active participants in the process of adaptation to global best business practices. Yet, in each case international listing was used to induce a self-reinforcing process of active adaptation, albeit with the constraint of weak domestic institutions.

The first contribution, by Damian Tobin and Shikha Singh, assesses the extent to which Chinese state-owned commercial banks are converging with international best banking and corporate governance practices. It uses the OECD Principles of Corporate Governance and the Basel Committee Core Principles as benchmarks of the analysis and pays particular attention to the major inducement mechanism of international listing. Its findings suggest that leveraging on the institutions of more developed economies like Hong Kong has brought large state banks much closer to international best-practices, even in the absence of domestic institutional convergence. Furthermore, an in-depth case study of the Bank of China (Hong Kong), which, as the first international listing of a subsidiary of a large state-owned commercial bank, represented a pioneering banking reform, indicates a significant gap between formal and substantive convergence. While the achievements of formal convergence in terms of meeting listing and capital requirements, regulatory compliance and board composition have been impressive, there is still a long way to go before achieving substantive convergence in the areas of management practices in general and risk management and remedial action in particular. Although international listing puts in place a strong monitoring mechanism to enforce market-based commitments, it cannot completely preclude the discretionary behaviour of the government and prevent management from taking advantage of weaknesses in the domestic corporate governance framework.

The second contribution, by Damian Tobin, employs the resource-based paradigm of the firm to examine the progress of China's petrochemical sector in integrating the benchmarks of international best business practices. As part of China's oil industry, the petrochemical sector had enjoyed a prominent position in the pre-reform era. Mao Tse-tung identified it as one of China's strategic industries and distinguished Daqing oil field as a model of production for the rest of the economy. This contribution vividly illustrates how organizational cultures and resources inherited from the pre-reform era, if provided with the correct inducement incentives, can survive economic transition and successfully adapt to market developments. The key inducement mechanisms include the commitment of the state to expose the sector to international development where possible, and the international listing of the dominant players in the sector. The earlier exposure to

international market prices meant that enterprises in the petrochemical sector had to adapt to international benchmarks at an earlier stage of the reform process. The monitoring of international capital markets resulted in further changes in decision-making and corporate strategies, as shareholders require profits and production indices to be related to a sustainable cost reduction strategy. The diffusion of market-based learning through the organizational networks inherited from the central planning has enabled enterprises to adapt to the challenges posed by both economic transition and market competition. Despite the successful story of these adaptations, the new challenge for the sector has shifted from dealing with the legacies of central planning such as inefficiencies, capital constraints and excess labour, towards how to resolve capacity constraints and global energy supply issues. To successfully compete in an international market with high input prices, scarce resources and complex political motives necessitates further correction of the mismatch between the skills associated with bureaucratic coordination and those demanded by the dynamics of the global market.

The third and fourth contributions examine the interaction between global regulatory trends and local institutional and social context in the areas of banks' permissible business scope and the private sale of corporate control of listed companies. Different from the case of individual corporations, which may "escape", although not fully, their weak home-country institutions through foreign listing as demonstrated in the first two contributions, there is no route for regulatory development to escape from the constraints of domestic institutional and social context. Therefore, as suggested by these two contributions, to achieve an effective and efficient regulatory evolution, international best practices should serve as a reference rather than a target; and the outcome of the regulatory process should serve China's needs rather than confirming with a predetermined model.

The third contribution, by Sebastian Brück and Laixiang Sun, suggests an analytical framework to capture the country-specific cost-benefit dynamics of regulating the permissible business scope of commercial banks. The framework explicitly incorporates the sophistication-level constraint of a country's financial system into the regulatory trade-off calculation between bank's need for new growth opportunities and an increased risk of financial instability. On the one hand, granting banks greater freedom in setting their activity scope would enable them to pursue new growth opportunities in the face of credit disintermediation. On the other hand, a bank's involvement in non-bank financial services may breed conflicts of interest across its different service lines and consequently lead to increased risk of financial instability, as happened in China in the early 1990s (before

China's 1995 Commercial Bank Law). How the net pay-off plays out in a specific country depends on the level of sophistication the country's financial system has achieved. An application of this framework to the case of China shows that the recent gradual emergence of a more liberal banking scope regulatory framework in the country not only represents a convergence towards the global and regional regulatory trends in the industry, but also reflects the growing sophistication of China's financial industry and the increasing ability of local institutions in risk-management. However, the previous bitter lesson with integrated financial services provision reminds us that before the problem of persistent soft-constraint in the state-dominated financial sector is reasonably resolved, a formal regulatory move to integrated financial services provision would aggravate moral hazard and provoke destabilizing forces.

The fiduciary duty of corporate officers, directors, and controlling shareholders in the American corporate setting,<sup>1</sup> as a product of case law, has been developed into a broad body of rules that define the bounds of acceptable conduct for these dominant corporate players in carrying out their individual and collective duty to manage the corporation. As highlighted by Allen *et al.* (2001), "... what emerged as a counterpoint to the evolution of the enabling model of corporation law was the second key function of the law of corporations: the *ex post* judicial review of the actions of corporate officers and directors, measured by fiduciary principle. Fiduciary review imported into corporate law the centuries-old equity tradition that subjected the conduct of fiduciaries to judicial supervision." Given the prominent position of fiduciary duty in the corporation law of the US (as well as in the UK and Hong Kong) and the widespread predatory and opportunistic behaviours of controlling shareholders in China's listed companies, Chinese regulators have increasingly exerted efforts to impose fiduciary duties on controlling shareholders. While the 1993 Company Law mentions a duty of loyalty only, the 2005 Company Law seemingly establishes the fiduciary duty owed by the controlling shareholders to the minority shareholders. Among various laws and regulatory provisions involving the fiduciary duties, the 2002 Takeover Measures and its 2006 revised version, together with the Code of Target Board Reports and the Code of Takeover Reports, provide relatively the most comprehensive application of the fiduciary duty rules borrowed from the US. The contribution of Chao Xi to this special issue assesses the real-world effect of these borrowed rules in China.

Xi's assessment indicates that unfortunately in China there is an absence of the social context that supports the ethic norm of fiduciary duties and there is a lack of the

requisite complementary institutions that enable the fiduciary duties to function in the donor jurisdictions. In the US it is the existing cases of fair judicial review of the actions of corporate officers and directors and the convincing threat of the *ex post* judicial review of any misconduct of the fiduciaries that make the fiduciary duties enforceable. In contrast, the fiduciary standards by which the trading behaviours of controlling shareholders are measured *ex post* by the courts are virtually non-existent in China. Even if such standards and measures can be borrowed from other jurisdictions as a result of the cross-listing of Chinese companies, there is little evidence suggesting that Chinese courts would be able and willing to exercise the kind of discretion required to impose the open-ended fiduciary duties. For example, from 2001 to 2003, the Supreme People's Court issued three documents in sequence to govern shareholders' suits against corporations and their managers. The cumulative effect of these documents has been to limit rather than enhance the right of shareholders to bring suit for violation of rules: would-be private plaintiffs must first get a key to the courthouse from a government agency (Clarke, 2007). These observations cast doubt on simple transplantation of foreign legal rules and are in favour of organic adaptations that stimulate desired changes in the conduct and attitude of the local corporate actors.

The common methodological approach employed in these four contributions is case study. From a methodological perspective, the analysis of interactions between rule changes and adaptive behaviours faces a number of difficulties because the phenomenon under study is not easily distinguishable from its environment and it is impossible to establish a counterfactual setting for contrasting. The case study is typically regarded as appropriate under such circumstances (Yin, 2003). The rapidly changing environment, under which China's state enterprises operate, also implies that there are likely to be more variables than data points and that qualitative data prevail. As such no single method of data collection will be enough to capture the richness of the context. Empirical data for these four studies come from two main sources. First, formal semi-structured interviews were conducted in Hong Kong, Beijing, Shanghai and Taipei with senior enterprise directors, industry experts, rating agencies, regulators, and analysts. The second source consists mainly of published data and documents as well as media reports.

A common theme throughout these four contributions is the attempt to reveal the fundamental tradeoffs underlying China's adaptation to global best business practices and regulatory trends and to highlight the way towards more substantive progress in the adaptation process. The findings confirm China's incremental approach to reform and

development. International listing has served as a mechanism to bond those listed firms to a more stringent regulatory environment and lead to the transfer of better corporate governance practices in China's large corporations. These findings are in line with those on internationally listed stocks of Central and Eastern European firms (Korczak & Bohl, 2005), foreign firms listed on the New York Stock Exchange (Coffee, 2002) and survey evidence from UNCTAD (2006). While the leading firms can overcome the constraint of weak domestic institutions, secure access to international capital market and in doing so learn from international best business practices, it is impossible for domestic regulatory regimes to find such a short-cut for development. The regulatory process must evolve in tandem with the development of the requisite complementary institutions and social context. The effectiveness of regulatory outcomes is bound to depend on the level of sophistication the market system has achieved.

## Notes

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<sup>1</sup> A fiduciary is held to a standard of conduct above that of a stranger or casual business person and must avoid "self-dealing" or "conflict of interests" where his/her potential benefits conflicts with what is best for the person who trusts him/her. Commonly as a legal matter, these are duties of care and loyalty on the part of the fiduciary (Feinerman, 2007).

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