Corporate Governance of Chinese Fund Management Companies

A thesis submitted in fulfillment of the requirements for the degree of
Doctor of Philosophy

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DECLARATION

I certify that except where due acknowledgement has been made, the work is that of the author alone; the work has not been submitted previously, in whole or in part, to qualify for any other academic award; the content of thesis is the result of work which has been carried out since the official commencement date of approved research program; and any editorial work, paid or unpaid, carried out by a third party is acknowledged.

Signed:

Celina Ping Yu

February 2013

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LISTS OF ACRONYMS

AUM	Asset Under Management
BOD	Board of directors
CEF	Closed-end fund
CGI	Corporate Governance Index
CSRC	China Securities Regulatory Commission
FMC	Fund management companies
GMM	Generalized Method of Moments
ID	Independent directors
JENSENPF	Jensen's alpha
M2PF	Modigliani and Modigliani performance
NAV	Net asset value
OAPF	Objective-adjusted performance
OEF	Open end fund
OLS	Ordinary least square
QFII	Qualified foreign financial institutions
RDT	Resource dependency theory
RM	Random effect
SOE	State-owned enterprises
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
THL	Singapore's Temasek Holdings Limited

ABSTRACT

The growth of the fund management industry is an important part of China's financial development. The contractual form of fund management companies (FMC) organisation in China presents a variety of industry- and country- specific governance issues in addition to the conventional agency problems associated with modern corporations. The lack of fund investor's voice in the governance of FMC, coupled with a regulatory environment with weak enforcement of investor protection, heightens the need for effective FMC governance in protecting the interests of fund investors. Board effectiveness is usually considered in the literature as the central internal governance mechanisms to enhance investor protection. Therefore, how to improve FMC board effectiveness is critically important, and a better understanding of what makes the board of directors effective is vital to addressing some major agency issues faced by the burgeoning fund industry in China.

It is widely accepted that given the right institutional conditions the quality of corporate governance can enhance firm performance in conventional firms. Having good FMC performance is vital to attract and retain the interests of investors. There is however conflict of interests between FMC and fund investors because fund fees enrich FMC but can harm the interest of fund investors with poorer FMC performance. Examining how FMC performance may be enhanced by the quality of corporate governance therefore provides important clues to addressing the governance issues inherent in the fund industry.

Using panel data of 288 firm-year observations covering more than 98% of FMC in China from 2006 to 2010, this study presents the first in-depth systematic investigation on how the quality of corporate governance may matter in determining board effectiveness and financial performance of the contractual form of FMC organizations by investigating evidence from China where institutional and regulatory environment is quite different from those of funds in the U.S.

Using corporate governance index as the measure of overall quality of corporate governance to examine how corporate governance affects FMC performance, the results of empirical tests in this study suggest that corporate governance quality is important in determining FMC performance.

In examining how key internal governance mechanisms affect FMC board effectiveness and financial performance, we find that FMC with a listed controlling shareholder significantly enhances board effectiveness and improve FMC performance compared to those FMC with non-listed controlling shareholder. It could be explained that when the controlling shareholder is a listed company, high governance standards demanded of those controlling shareholders exert a significant positive impact on the effectiveness of FMC board and the functioning of governance mechanisms, thus enhancing FMC performance.

Even though the presence of foreign ownership in FMC increases FMC fees, the presence of foreign ownership substantially enhances FMC performance especially when using risk-adjusted returns as proxies to measure performance. Findings of this study also shows that the concentrated ownership in FMC has no impact on board effectiveness but harms FMC performance. It could be argued that having more diverse FMC shareholders from different financial background such as banks, insurance companies, and investment companies would facilitate access to more expertise and information, and greater capacity to identify and appoint qualified fund managers to attain good FMC performance.

This study finds that larger board has no effect on board effectiveness but harms FMC performance, affirming the ineffectiveness of board size in China and the higher coordination costs impacting negatively on FMC performance. The proportion of independent directors is found to have no impact on either board effectiveness or FMC performance. With its concentrated ownership among FMC and shortage of qualified independent directors in China, it is unlikely that independent directors plays an effective role in monitoring and control, thus resulting in ineffectual board independence in China's current circumstance.

While the presence of female senior executives is found to enhance FMC board effectiveness, the impact of female senior executives on FMC performance is not found. We found increasing number of females on board have no impact on board effectiveness but actually damages FMC performance. It suggests that having more female members on the board just for the sake of "Guan Xi" or "Gender diversity" would not enhance board effectiveness but is likely to incur costs. In China, the appointing of female and male is probably subject to the same shortcomings and constraints of the existing governance processes so that superficial diversity measures makes little difference.

This study shows the presence of remuneration committee could enhance board effectiveness but has limited power to influence FMC performance. While the presence of remuneration committee can help better align of interests between senior officers in FMC and

fund investors, it plays negligible role in retaining Chinese fund managers because of the high turnover rate in Chinese fund managers.

The number of FMC supervisors does not enhance either FMC board effectiveness or FMC performance. This affirms the general expectation that under the current environment supervisors are generally ineffective in performing their roles in China.

This thesis contributes to the existing literature in the following ways: First, presenting a systematic study with empirical evidence on the functioning and quality of corporate governance and its impact under the contractual form of FMC, this study extends the literature on the governance of fund companies beyond the focus of the corporate form of FMC, and provides new perspectives and findings in an area of research much neglected in the literature.

Second, this research represents a step forward from the extant studies focusing on how board characteristics and composition in fund companies by investigating a wider range of relevant governance mechanisms that affect board effectiveness which other studies have not attempted. For instance, this thesis incorporates governance mechanisms such as shareholder profile and shareholding structure, the role of the supervisory board, and presence of remuneration committee to capture more accurately the realities of the Chinese financial and regulatory systems.

Third, applying corporate governance scores to proxy for the overall corporate governance quality of FMC, this thesis is a first study to investigate the link between the governance rating and FMC performance.

Fourth, a set of unique but important variables is introduced in this study to which the literature has given relatively little attention. For instance, we test the impact of the presence of female directors, top executives, or board chair on board effectiveness. In fact, influence from female as top executive or board chair in general has not been studied at all in China even in the context of the non-FMC corporate boards.

Fifth, we use 5-year panel data while most of the existing studies usually on U.S. fund industry only use one-year data. The advantage of using panel data is the ability to control for individual-specific, time-invariant, unobserved heterogeneity, the presence of which could lead to bias in standard estimators like OLS. Finally, our data cover nearly all FMC that together account for more than 95% of AUM of the fund industry in China. Selection bias is therefore minimised.

CHAPTER 1

INTRODUCTION

1.1 Background

There is general anticipation for a country's fund industry to play an important role not only in capital market development (Klapper, Sulla & Vittas 2004) but more significantly as an active shareholder of investee firms to enhance corporate governance of those investee firms. Therefore, with fund management companies (FMC) as a major institutional investor, the corporate governance of FMC is vital to ensuring its ability to play such important role.

Corporate governance issues in the contractual form of FMC in China are usually more complex and intense compared to the more conventional public companies and corporate form of FMC in U.S. as explained in Chapter 5.2. However, research on how fund management companies are governed is scant. This thesis presents an analysis of the effectiveness of the board of director as the key internal governance mechanism of Chinese FMC in ameliorating the misalignment of the interests between FMC and its fund investors. The literature on fund management industry in the West has traditionally concentrated more on fund performance than governance. There are relatively limited studies on board effectiveness of mutual funds in the U.S., and very little is known about board performance of FMC in China. FMC performance is the key for protecting fund investor interest, and board effectiveness is often seen as vital to enhance performance.

This study explores how governance mechanisms help protect the interests of fund investors. It provides an in-depth analysis of the governance problems under the contractual form of FMC in China, and investigates how governance mechanisms in FMC affect FMC board effectiveness and financial performance, contributing new perspective, insights, and new empirical evidence to the literature.

1.2 Research Motivation and Objectives of the Thesis

Given the significant important role of fund investors could play in capital market and the governance of investee firms, the quality of FMC governance is vital to playing such a role effectively. None of previous studies so far provide empirical studies on the governance issues of Chinese fund companies which differ from the U.S. mutual fund in terms of organizational structure and operating environment. The major motivation of this thesis is to

investigate the quality of governance in contractual form of Chinese fund companies and its impact.

The contractual form of FMC in China's emerging fund industry presents some complex governance issues in addition to the conventional agency problems associated with modern public corporations. This issue arises from the conflict of interests between FMC and fund investors arising from fund fees, lack of direct representation of fund investors in FMC, and operating under a regulatory environment with weak enforcement of investor protection.

Given the vulnerable position Chinese fund investors place, how to protect the interests of fund investors are vital to the healthy development of fund industry. It is well documented that emerging economies like China do not have well developed external governance mechanisms, such as the necessary market competition and social institutions, well-designed regulatory regime and efficient law enforcement (Kakabadse et al. 2010; Khanna & Palepu 2000; Peng 2003; Tam 1999).

China's FMC organisation form and the institutional and regulatory environment are at distinctly early stages of development compared to the more advanced economy such as the U.S. (Tam & Yu 2011). The generally ineffective external governance mechanisms therefore make internal governance mechanisms particularly important in protecting the interests of fund investors.

Studies on U.S. mutual fund also provide ample evidence that internal corporate governance can play a crucial role in protecting the interests of fund investors (Adams et al. 2010; Chou et al. 2007; Ferris & Yan 2007; Gompers et al. 2001; Wallison & Litan 2007; Wellman & Zhou 2007). There are however few studies on corporate governance of FMC in emerging countries like China where the fund management industry has only gradually gained importance in the financial system.

Commonly regarded as the central internal governance mechanism, the board of directors is charged with the responsibility of protecting the interests of fund investors. Superior board performance is expected to lead to reduction in fund fees, and improve fund performance in most studies of the U.S. (Ferris & Yan 2007; Khorana & Servaes 2004; Kong & Tang 2008; Meschke 2007). In China, board effectiveness is particularly important as fund investors are not shareholders and there is lack of direct representation of investors in FMC governance. The board is required by Chinese law to put the interests of fund investors ahead

of FMC shareholders who control board of directors' appointment, compensation, and tenure (Article 45, '*Codes of corporate governance for FMC*').

With a common feature of concentrated ownership in Chinese FMC, most of the board members especially the position of CEO or chairman are more likely to be appointed by the controlling shareholders. The question therefore arises whether these insiders could represent the interests of fund investors rather than FMC shareholders especially when there is a conflict of interests between fund investors and FMC shareholders. In most cases, the controlling shareholder in China's fund industry is the ultimately state, but the state's dual role as owner and regulator raises agency problem of how to motivate and monitor government appointed insiders to maximum the interests of fund investors in selecting, disciplining, and motivating management.

The role of board independence has received heightened attention after every financial crisis. This is particularly the case in the fund industry. For instance, SEC of the United States has required at least 75% of a FMC board be comprised of independent directors and chairman independence after the scandals of the late 1990s and early 2000s (Article 1(a)(7), 2004. "Investment Company Governance," by Securities and Exchange Commission.) But in China where there is a lack of qualified independent directors (ID), their role and their independence have been questioned all the time (Kakabadse et al. 2010; Yuan & Yuan 2007). Therefore, whether independent directors could perform their assigned functions to represent the interests of investors in fund industry is worthwhile to investigate.

Given the complex and intense corporate governance issues in Chinese FMC, how to improve FMC board effectiveness is critically important in China, and a better understanding of what makes board of directors' effective is vital to addressing some major agency issues faced by the burgeoning fund industry in China. This study contributes to the literature by examining how governance mechanisms matter in the development of an effective and well-functioning board in FMC.

FMC performance is the key for fund investors, enhancing performance is vital to attract and retain the interests of investors. FMC therefore would be willing to enhance their performance to attract fund investors in order to increase their AUM so that more revenues could be earned. Examining how fund performance may be enhanced by the quality of corporate governance therefore provides further clues to addressing the agency issues inherent in the fund industry. Most literature studying the corporate form of U.S. mutual funds shows that corporate governance matters in fund performance. However, to what extent overall

corporate governance quality is related to FMC performance in China is unknown. This study fills a gap in the literature by examining how the totality of FMC internal governance mechanisms affects FMC performance under the contractual form of fund industry in China where institutional and regulatory environment is quite different from those of funds in the U.S.

Even though the relation between the overall corporate governance quality and FMC performance is found, how specific internal governance mechanisms work is still unknown. It is widely accepted that different internal governance mechanisms may have different effect on performance. It is therefore worthwhile to identify and assesses what are the effective governance mechanisms in Chinese fund industry.

In brief, this study aims to contribute to literature by providing an empirical analysis of how governance mechanisms enhance board effectiveness and FMC performance; it is the first systematic study on the corporate governance of Chinese FMC. Our study sheds light on understanding the corporate governance of fund companies under the contractual form in China.

This dissertation will address two major research questions:

- (1) How do specific internal corporate governance mechanisms impact on board effectiveness?*
- (2) How does the quality of FMC corporate governance affect FMC performance?*

In examining the governance practices in China's fund industry, this thesis constructs a panel of 288 firm-year observations from 58 FMC (98% of Chinese FMC) and 2700 funds from 2006 to 2010, which covers more than 95% of industry's AUM in China. This thesis provides an in-depth analysis of the agency problems under the contractual form of FMC in China, and investigates how governance mechanisms in FMC affect FMC board effectiveness and financial performance. The thesis presents the first systematic study to investigate how governance settings work in Chinese FMC, which can provide insights for FMC to improve their internal corporate governance, and consequently at the macro level, they will gain increased ability to implement their expected functions in the capital markets and corporate governance of investee companies.

1.3 Structure of the Thesis

This thesis is organised as shown in Figure 1. Chapter 2 reviews relevant literature in corporate governance, which provides a theoretical foundation for identifying and analysis of key governance issues in the Chinese fund industry. The role of institutional investors in capital market development is examined to outline the important role they could play in the international context. In Chapter 3, various key corporate governance mechanisms in China are investigated. Chapter 4 presents an overview of FMC evolution and importance of FMC in China, which offers a foundation to understand the environmental context and issues of fund industry in China.

Chapter 5 starts by analysing agency problems in Chinese FMC, and then develops hypotheses to be empirically tested in Chapter 7 and 8. Chapter 6 presents the data set employed throughout the thesis, and the methodology used for the analysis in this thesis. The empirical tests are performed through Chapter 7 and 8. Chapter 7 examines the impact of specific governance mechanisms on board effectiveness, using FMC total expense ratio as a measure of board effectiveness. Chapter 8 presents an examination of the impact of governance quality on FMC performance. Chapter 9 concludes the thesis, summarising the main findings, emphasizing the major contributions of the study and outlining future research directions.

Figure 1: Thesis outline.

CHAPTER 2

BACKGROUND

2.1 Introduction

This chapter provides a theoretical background of corporate governance for a better understanding and analysis of corporate governance of Chinese FMC. Theories of corporate governance including agency theory, stewardship theory, resource dependence theory and global governance theory are explored. Board effectiveness as the central governance mechanisms is discussed. The role of institutional investors in capital market development and corporate governance of investee firms are highlighted. Corporate governance in Asia is also reviewed to better understand the business environment context for Chinese FMC.

2.2 Corporate Governance in general

“Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised¹.” “The central issues of corporate governance involve who controls the corporation, who makes the critical strategic decisions, who is responsible for those decisions, and who has claims against the revenues and assets of the firm” (Rubach 1999). Understanding the principles and issues of corporate governance is therefore important to making enterprise perform better and in a way that is consistent with the interest of its key stakeholders. As discussed in Chapter 4.2, in terms of the corporate form of FMC in China where fund investors are not FMC shareholders, it is critically important that the interests of fund investors be protected because it is more likely for FMC shareholders to exploit fund investors’ interests given the inherent conflict of interests between FMC shareholders and fund investors.

Corporate governance issues for publicly listed companies are well known and extensively researched. Whereas corporate governance problems of State-owned enterprises (SOEs) are the subject of a growing literature in recent years (Dong Sung & Fei 2012; Ho et al. 2011; Shen & Lin 2009), the corporate governance of FMC is however not as well understood in general, and poorly researched particularly in emerging economies like China. In order to understand the role of corporate governance in the context of FMC in China,

¹ ASX corporate governance council, 2010, report about “Corporate governance principals and recommendations with 2010 amendments”

corporate governance issues are reviewed and China corporate governance reforms are discussed.

2.3 Definition and Issues of Corporate Governance

A number of definitions of corporate governance are outlined here to highlighting its possible meanings in the context of FMC in China.

- a. ‘Corporate governance’ is used by Richard Eells, probably for the first time, in his book of “The Governance of Corporations” in 1962 (Eells 1962).
- b. ‘The purpose of corporate governance is to minimize the total cost in aligning managers and shareholders’ incentives, and in unavoidable self-interested managerial behavior (Jensen & Meckling 1976).’
- c. Corporate governance, according to one definition in the West, is the system or process by which companies are directed and controlled (Cadbury 1993).
- d. Farrar (2001) suggests that ‘Corporate Governance’, in its narrower and most usual, sense refers to the companies’ legislation but it is not only at legal control but also de facto control of corporations. It also involves accountabilities, from many dimensions such as legal restraints, self-regulations and best practices (Farrar 2001).
- e. ‘Corporate governance is ‘an umbrella term that includes specific issues arising from interactions among senior management, shareholders, boards of directors and controlled.’ (Cochran & Wartick 1994).

Conflict of interests arises between shareholders and management as a result of the separation of ownership and control in modern corporations with dispersed ownership and professional managers (Berle & Means 1932). Companies are therefore exposed to agency issues due to self-serving managers seeking their personal interests at the expense of those of shareholders (Fama & Jensen 1983). Because of information asymmetry with managers having more superior information about the firm and its prospects than investors, this encourages managers to divert funds in various ways away from those who inject equity capital in the firm. Lower profitability and dividends, poor investment allocation and low productivity may be the result of failure to address these corporate governance problems (Davis 2002).

The aim of corporate governance is to improve firm performance and reduce the conflicts of interests between different parties within the company (OECD 1998). Corporate governance mechanisms are employed to mitigate these issues, reduce agency costs and safeguard shareholders' interests (Bebchuk et al. 2009).

It has been argued that companies with the perception of better corporate governance gain more trust from investors and in general enjoy a lower cost of capital and higher market valuation than others (Bai et al. 2004). Notable corporate scandals such as Barings Bank, Enron, HHI and WorldCom, and the recent bank failures in the Global Financial Crisis highlight the urgent need to strengthen corporate governance practices (Mallin 2010).

As explained in more details in Chapter 4.2.3. of this thesis, FMC are established to offer different types of fund for various investment objectives. Fund investors are not FMC shareholders and have contractual relationship with FMC through the fund they buy. Therefore, fund investors are the key stakeholders to be looked after. The effectiveness of corporate governance within the FMC is therefore extremely important to protect the interests of investors in fund industry.

Agency relationships and governance settings are becoming more complex when corporate structures vary significantly from their conventional organizational and financial forms and from country to country (Dharwadkar et al. 2000; Hu & Izumida 2008)

Most studies in the literature focus on corporate governance of publicly listed companies. Major players in a country's financial system such as FMC have quite different organizational structures and corporate governance issues compared to public companies. The corporate governance issues of FMC are less understood and researched as academic research has lagged behind the phenomenal growth of the fund management industry. As will be discussed in the following Section, China's fund management industry is new and has developing with huge potential to play a key role in the country's financial development.

2.4 Theories of Corporate Governance

It has been argued that a wider range of theoretical perspectives to corporate governance can help recognize the mechanisms and structures that might enhance organizational functioning (Daily et al. 2003). As Mallin (2010) states, "the development of corporate governance is a global occurrence and, as such, is a complex area including legal, culture, ownership, and

other structural differences. Therefore, some theories may be more appropriate and relevant to some countries than others, or more relevant at different times depending on what stage on individual country, or group of countries, is at.”

The dominant theoretical perspective applied in the corporate governance literature is agency theory (Shleifer & Vishny 1997), but increasingly studies in psychology and sociology have suggested theoretical limits of agency theory. Major concerns have been raised because the assumption in agency theory that all managers are individualistic, opportunistic, and self-serving may not hold for all managers (Davis et al. 1997; Hirsch et al. 1987). Other theoretical perspectives are often intended as complements rather than substitutes for agency theory (Daily et al. 2003).

Agency theory asserts that the primary goal of corporate governance is to protect shareholders against management expropriation (Shleifer and Vishny 1997). Agency theory offers a solid foundation to explore the relationship between an owner and a manager in a stylized modern firm, and between shareholders and management in listed firms. In this study, the agency perspective will provide the main theoretical framework to examine the relationship between fund investors, shareholders and management as discussed in Chapter 5.2

Agency Theory

The concept of agency theory originates from Adam Smith (Smith 1937) who points out that a manager as an agent of the owner is more likely to be negligent or to act in self-interest. Berle and Means (1932) suggest that the structure of “a public corporation” was likely to cause problems of ownership and control. As a result of separation of control rights and shareholding, managers may act in their own self-interest instead of the interests of the corporation. In other words, opportunistic managerial decision-making could adversely impact company performance. This gave rise to agency theory that was further developed by Jensen and Meckling (1976) and Fama and Jensen (1983) who posit that senior managers are individualistic and seek to maximize their own utility may misuse corporate assets for their private benefit and at the expense of shareholders.

Eisenhardt (1989) identifies two major categories of problems in agency relationship. The first is agency problem itself rising from the conflict of interest between principal and agent. Agency costs occur due to the diverge interests between principal and agent and the

costs to identify or mitigate these agent inopportunities. The second problem is due to a conflict of risk sharing arising from the differences between principals and agents' risk preferences. As a result, principals and agents may prefer different actions to mitigate risk.

Shleifer and Vishny (1988) state that it is because of the distinct divergence of interest between shareholders and managers that leads to the owner-manager conflict of interests. This view is supported by Denis (2001). For instance, shareholders want to maximize the share value, whereas managers take advantages of their position in the company to seek other personal goals such as their power and recognition. It is thus vital to align the interests of managers to those of the principals in order to minimize agency costs. However, it is argued that due to asymmetric information and imperfect contracts, existence of managers' moral hazard problem and adverse selection behaviour would lead to agency costs (Fama and Jensen 1983; Coughlan 2001)

Agency costs are incurred when the delegated agent extracts private benefits during the course of firm operation, given information is asymmetric behavior (Jensen & Meckling 1976). "The problem is that most future contingencies are hard to describe and foresee", so that complete contracts between principal and the agent are technologically infeasible (Shleifer & Vishny 1997). Therefore, an unwanted agency cost occurs when management actions conflict with shareholder interests because of the presence of conflicts of interest and asymmetric information though the existence of contractual relationship between agent and principal. Such would be the case when managers put their own interests ahead of an owner's interests (e.g., manipulating short-term earnings.)

Based on the assumption of widely dispersed ownership of corporations, much of the literature focuses on agency problems that exist between managers and shareholders due to free rider problem, asymmetric information, and imperfect contract (Shleifer & Vishny 1986; Tam 1999). Corporate governance mechanisms could help align the actions and choices of managers to those of shareholders (Daily et al. 2003; Guay et al. 2002).

Whereas in countries with concentrated ownership, the fundamental agency problem may no longer be between shareholders and managers, but rather between minority investors and controlling shareholders. Principal-principal agency problem is prevalent in countries such as in Japan, Germany and China where ownership concentration is common (La Porta et al. 1998). Agency problems could be reduced by the presence of blockholders who have greater incentive and more power to monitor management (La Porta et al. 1998; Shleifer & Vishny 1986). Nevertheless, expropriation of minority shareholders' wealth could also be

prevalent in firms with concentrated ownership, but those expropriation technology will be less efficient if sufficient key mechanisms are in place through legal system (La Porta et al. 1999; Shleifer & Vishny 1986).

It is generally accepted that both internal and external governance mechanisms are used to mitigate agency costs. Internal mechanisms usually includes an effectively structured board (Fama & Jensen 1983; Hermalin & Weisbach 2003; Mallin 2010 ; Singh & Vinnicombe 2004; Smith et al. 2004; Srinidhi et al. 2011), executive compensations (Guay et al. 2002; Krawcheck 2012), concentrated ownership holdings (Burkart & Panunzi 2006; Holderness 2003; Mishra 2011), shareholder activism (Becht et al. 2008; Romano 2000); and external mechanisms such as competitive capital and labour markets (Daily et al. 2003; Fama 1980), acquisitions, divestitures, and ownership amendments (Davis et al. 1997), auditor quality (Liu & Lai 2012) and monitoring by business media (Bednar 2012; Core et al. 2008; Dyck et al. 2008; Johnson et al. 2005) to control self-serving managers.

The role of the mass media in corporate governance is one recent development in literature (Bednar 2012; Core et al. 2008; Dyck et al. 2008; Johnson et al. 2005). Finding of those studies imply that media could be viewed as an effective external mechanism to minimize agency costs by reducing “information asymmetry” between a firm’s management and outsider shareholders, and “inflicting reputational costs on firms and managers that act contrary to shareholder interests” .

Walsh and Seward (1990) argue that internal mechanisms are generally preferred because of the expense incurred from external mechanisms. However, the impact of corporate governance devices appears to be ineffective when the governance environment and protection of shareholders are weak which is more prevalent in emerging markets like China (Dharwadkar et al. 2000; Setia-Atmaja 2009; Young et al. 2008). Given the vulnerable position Chinese fund investors have, how corporate governance mechanisms work in Chinese fund industry is clearly worthwhile to investigate.

Agency theorists label all motivations as self-serving, and assume that principal-agent interest divergence arises because all managers are individualistic, opportunistic, and self-serving (Jensen & Meckling 1994). However, organizational relationships may be more complex than depicted held under agency theory, and propositions of agency theory may not apply in all situations (Davis et al. 1997). Knapp et al. (2011) argue that agency theory provides “a parsimonious view of what motivates human behaviour (i.e., economic utility), but it largely overlooks other extrinsic motivators, such as affiliation or belonging”. Therefore,

exclusive reliance upon agency theory has been considered undesirable and additional theory is needed to explain what situations/conditions interests of principal-managers to be aligned (Davis et al. 1997).

In a sample of 1064 firm-year observations from 14 EU countries over 1999-2003, RendersGaeremynck (2012)'s finding suggest that agency theory fail to consider the national institutional context, which is highly relevant for the quality and effectiveness of corporate governance practices.

Stewardship theory

“Stewardship theory has also garnered researcher’s attention, both as a complement and a contrast to agency theory” (Daily et al. 2003). Unlike agency theorists who view executives and directors as self-serving managers, stewardship theorists regard them as “frequently having interests that are isomorphic with those of shareholders” (Davis et al. 1997). Stewardship theory views human nature as altruistic, compared to agency theory that view human nature as opportunistic (Donaldson & Davis 1991).

There are many situations in which managers (executives, directors and senior officers) conclude that serving shareholders’ interests also align their own interests (Lane et al. 1998). Under the stewardship model of man, stewards maximize their utility as they achieve organizational rather than self-serving objectives and short term opportunistic behaviour. In other words, managers place interests of organizations ahead of individual self-interests, and there is trustworthy behaviour in managers (Hernandez 2012).

Managers acquire reputations on the basis of the financial performance of their firms (Baysinger & Hoskisson 1990). Therefore, senior managers (executives and directors) want to maximize financial performance indicators, including shareholder returns to protect their reputations. Managers effectively managing their own careers by working effectively for the organization (Fama 1980). Davis et al. (1997) extends previous stewardship theory by introducing new reasons from psychology and sociology perspectives. First, they suggest that managers who pursuit self-achievement, job-satisfaction and self-actualization may be motivated by maximizing organizational profits rather than personal benefits. Besides, managers who are highly committed and royal to organizational values are also more likely to serve the best interests of organization rather than self-interests. Finally, if a manager’s philosophy is based on involvement and being trustworthy (Davis et al. 1997), it would be

more likely to have a principal-steward relationship rather than principal-agent. Caldwell et al. (2002) argue that managers perform fiduciary obligations in protecting the interests of stakeholders and believe they are morally obliged to maximize those interests.

Rousseau (1989) and Housseau & Tijoriwala (1999) state that the perceived obligations by managers under a psychological contract between managers and organization are found to have a greater impact than do formal and explicit contractual agreements that managers perform the interests in organizations rather than private interests. Donaldson (2008) point out stewardship theorists contend that feelings of autonomy and responsibility motivate employees to perform in the best interests of organization rather than self-serving. Hernandez (2012) proposes that individual sense of obligation and responsibility is in part due to their emotional link to the beneficiaries of their decisions. From a psychological perspective, he state that “individuals’ willingness to subjugate their personal interests to behave in ways that serve long-term well-being of these beneficiaries”.

Under those reasons, managers are more likely to act in the best interests of shareholders and maximize shareholders’ interests. Accordingly, Hernandez (2012) points out that “control mechanisms may be not only unnecessary but also counterproductive”

However, there are criticisms of the stewardship theory. For instance, Jensen and Meckling (1994) argue that “stewardship’s approach of model of man is a simplification for mathematical modeling and its human behavior assumption is unrealistic”. Davis et al. (1997) argue that “the complexity of human behavior is not well explained and considered in stewardship theory”. Knapp et al. (2011) contend that stewardship theory focuses on how human nature shapes managers’ behaviours, but managers’ social context is largely overlooked.

Resource dependence theory (RDT)

Pfeffer and Salancik (1978) develop the resource dependency theory (RDT) that argues “organizations would act in self-interest, trying to gain access to, and ultimately control over, needed resources”. RDT recognizes that organizational behaviors are influenced by external factors; however, firms could reduce environmental uncertainty and dependence (Hillman et al. 2009). Pfeffer and Salancik (1978) propose five actions that managers can adopt to minimize environmental dependences: “megers/vertical intergration, JVs and other interorganizational relationships, boards of directors, political action, and executive

succession". Pfeffer and Salancik's (1978) and Hillman et al. (2009) provides a detailed review of those five perspective. This dissertation will focus on the perspective of board of directors.

It is argued that resource dependency theory (RDT) paves a foundation for directors' resource role (Hillman et al. 2009). Pfeffer and Salancik (1978) suggests that directors could bring four benefits to organizations:

"(a) Information in the form of advice and counsel, (b) access to channels of information between the firm and environmental contingencies, (c) preferential access to resources, and (d) legitimacy." Pfeffer (1972) asserts that board members' contributions enable firms to minimize dependence or gain resources.

For example,

"Outside directors who are partners in a law firm provide legal advice, either in board meetings or in private communication with firm executives that may otherwise be more costly for the firm to secure; outside directors who are also executives of financial institutions may assist in securing favorable lines of credit. The provision of these resources enhances organizational functioning, firm performance, and survival (Daily et al. 2003)."

Pfeffer (1972) finds that those with greater interdependence on firm's environment require a higher ratio of outside directors. He concludes that board size and composition are rational organizational responses to the conditions of the external environment.

It is generally accepted that Guanxi which define as a social and business relationship network is the key factor to conduct successful business in China (Hellstrom 1997; Kao 1993; Luo 1997; Seligman 1999). Guanxi is not only properly associated with mainland China, but also associated with those economies where Chinese culture is dominant Taiwan, Hong Kong or Singapore. Compared with Western business culture where contracts is widely used as the governing authority, Chinese business culture is based on respect and care and more concern for the benefits of members of the entire network (Ai 2006). Ai (2006) concludes that "Guanxi relationship, with their unique code of conduct, will always be an ingredient of doing business in China."

Literature on corporate finance using RDT to study the function of board, and to explore the relationship between board characteristic and composition and firm performance as an indicator of a successful resource dependence strategy. Dalton, Daily, Johnson, & Ellstrand,

(1999) document board size positively related to firm financial performance. Pearce & Zahra (1992) state that “board size and composition are contingent not only on the external environment but also on the firm’s current strategy and prior financial performance”. Pfeffer’s (1972) find that board composition largely depends on resources provided by the board members and the need of the firm. Boyd (1990) point out that increasing board size may not always work but resource rich directors should be the focus of board composition. Thus, it is not just the number, but the type of directors on the board that matters (Hillman et al. 2009). Former government officials bring value to corporate boardrooms (Hillman 2005; Hillman & Hitt 1999). Kor & Misangyi (2008) document top management’s levels of industry experiences negatively associated with the board’s collective levels of industry experiences. “This suggests that the board supplements top management with vital advice and counsel”.

As discussed in Chapter 3.3.3, given that in China the board of directors are highly influenced by dominant shareholder who are in charge of appointment and removal of members on board of directors, it is generally accepted that board are unable to discipline and punish shareholders, leading to ineffectiveness of board of directors in Chinese context (Rajagopalan & Zhang 2007). Most studies in the literature document that board size has no impact on firm performance in Chinese firms. (Hou & Ren 2003; Li 2009; Song et al. 2009; Wang & Deng 2006). However, a majority of the literature also find that larger proportion of independent directors enhances firm performance in Chinese listed companies (Ma 2008; Wang et al. 2008; Yang 2007b; Zhao & Zeng 2008). Peng (2004) documents that resource-rich outside directors are likely to enhance firm performance, whereas resource-poor outside directors could not. It indicates board composition adjusts to meet firm’s environmental demands.

Hillman, et al. (2007) find that firms with specific forms of environmental dependencies are more likely to increase board diversity. They found the likelihood of female participation on board of directors is significantly influenced by organizational size, industry type, firm diversification strategy, and network effects (linkages to other boards with women directors). Studies also find that the need to change board composition is followed by the change of the firm environment (Boeker & Goodstein 1991; Lang & Lockhart 1990).

In a sample of 405 publicly Chinese listed firms and 1211 company–years, Peng (2004) suggests that outsider directors do make a difference in firm performance. He documents that resource-rich outside directors relate to firm performance positively, where resource-poor

outside directors are not, suggesting that board composition need to change to meet new environmental demands.

Based on a sample of 102 US electric firms and following resource dependence theory, Ortiz-de-Mandojana et al. (2012) find that director interlocks (serve on multiple directorship) with suppliers providing business knowledge-intensive services are associated with the adoption of proactive environmental strategies.

Do outside directors on corporate boards make a difference to firm performance? Agency theory suggests that a board comprised of a greater proportion of outside directors, due to their presumed independence, may theoretically lead to better firm performance (Jensen and Meckling, 1976; Shleifer and Vishny, 1997). However, empirical studies report that overall, there is little significant relationship between outside directors and firm performance (Dalton et al., 1998; Finkelstein and Hambrick, 1996). Consequently, Dalton et al. (1998: 285) argue that ‘consideration of multiple theories [beyond agency theory]... may lead to a more complete understanding. ’

This view is consistent with Chancharat et al. (2012) ’s argument that “no one theory clearly dominates the others in determining governance outcome” in their paper examining how board structural mechanisms influence firm survival in “new economy” Australian firms. They suggest “crucial elements of agency theory, stewardship theory, and resource dependence theory work in a complementary fashion to determine the optimal board composition for new economy firms”.

Global theory of corporate governance

Judge (2012) points out that it is important to identify a rigorous and relevant theory of corporate governance that could apply the global economy, and he argues the importance of considering national and industry context which could influence governance behaviour and outcomes

Carver (2010) argues that there is a lack of a theoretical base for board governance despite its crucial function they could play. Judge (2011b) thinks that Carver’s (2010) paper “introduces a new perspective on the need for conceptual coherence in the board’s role, practices, and relationships --- a perspective worthy of being called a global theory of governance”.

Judge (2011b) argue that “universal theories, such as agency theory, fail to consider national and industry-level context as many institutional researchers do, is insufficient given substantial firm heterogeneity within a national context”. He believes a global theory that considers multiple levels of analysis, national-level factors as well as firm-level factors, and he suggests that “multiple-level “meso” studies of corporate governance will prove to be most influential in future research”.

Using an sample of 15,648 firms from 47 countries from 1996 to 2007, Chen (2011a) finds that firm value is enhanced in countries with more effective legal system or stricter or greater control of corruption. They suggest country level legal system and control of corruption play important roles in determining firm value. In addition, they suggest internal agency problems could be reduced by the reinforce effect of securities law and control of corruption.

Judge (2011a) point out that “a global theory of corporate governance must account for national level differences in the effective enforcement of national laws and regulations.” Boytsun et al. (2011) documents that countries’ informal rules such as social norms and cohesion play an important role on firm-level corporate governance. Their findings suggest social norms and values could be considered as external corporate governance mechanisms. There are still ongoing debates on which theory offer the best way to study and understand corporate governance.

While there is an increasing interest seeking to create a “Global Governance Theory” (Chen 2011a; Judge 2011b), it is still a new theory at an initial stage to be developed. Following the extant literature in corporate governance of fund management companies in Western studies (Ferris & Yan 2009; Wellman & Zhou 2007), this study will apply the agency theory to examine the relationship between fund investors, shareholders and management.

2.5 Effectiveness of Board of Directors

Corporate governance addresses the nature of interactions and relationship between the firm and its stakeholders in the process of decision making and control over firm resources. The boards of directors is the link between fund investors and managers, and board effectiveness is essential to establish and exercise good corporate governance practices and maintain a sound investor-management relations (Mallin 2010 ; Monks & Minow 2000). The extant

literature highlights that the globalization and liberalization of financial markets, high-profile financial and accounting scandals, and stronger demands for accountability and transparency have placed the duties and functioning of board of directors at the center of the corporate governance debates and reforms (Ingley & Van der Walt 2005; Kiel & Nicholson 2003; Pugliese et al. 2009).

Academics, investors and others have put increasing emphasis on the importance of independent directors. Independent directors as outsiders who are relatively free from conflict of interest is expected to be able to raise their voice against management. However, even in a relatively mature capital market in the West with well-written regulations and proper enforcement, to what extent independent directors could perform their role is often unknown. For instance, a very experienced director (William George, former CEO of Medtronic and a veteran of ten corporate boards) with chief executive background offers an insider's perspective that it is a challenge to play the anticipated role as an independent director because of information asymmetry, limited engagement with the company, limited industry-specific knowledge and the dominant position management have in board (George 2013).

In principle, the board of directors are accountable to shareholders in implementing a governance system, and shareholders are in charge of appointing qualified and effective directors to the board (Cadbury 1993). It is generally accepted that board of directors have two main roles: control (appoint, supervise and remunerate senior executives, reporting to shareholders, and ensuring compliance with the law) and direction (endorsing the firm's strategies and develop directional policy) (Bhagat et al. 1999; Farrar 2001; Monks & Minow 2000). Given the significant role of the board in the corporate governance of Chinese FMC and the special vulnerable position of Chinese fund investors, what mechanisms and structure are used to keep the directors accountable to the fund investors is an important subject for investigation and better understanding.

The majority of works in the existing literature on board of directors has been dominated by the well-known agency theory perspective (Fama and Jensen 1983; Jensen and Meckling 1976; Jensen 1993). Researchers following this track commonly emphasize the formal incentives and control mechanisms, with a focus on what the optimal composition and structure of board of directors (Weir & Laing 2003), what the appropriate role of board of directors should be (Pugliese et al. 2009), how to set an appropriate level of compensation and incentives for independent directors (Bryan et al. 2000; Gerety et al. 1999; Yermack 2003), and how board of directors may protect shareholder interests from opportunistic and self-

serving managers through bonding or monitoring activities, particularly in situations where contracts are incomplete (Van Ees et al. 2009).

This study investigates what specific governance settings could enhance board effectiveness in Chinese FMC and how the quality of corporate governance may impact on FMC performance.

2.6 Corporate Governance in Asia

Corporate governance approaches vary across different institutional environments, reflecting differences in historical, political, industrial, culture context, traditional financing options, corporate ownership patterns, and legal origin (Aguilera & Jackson 2003; Hua et al. 2006; Lubatkin et al. 2005; Weimer & Pape 1999; Zattoni & Cuomo 2008). “These contextual elements are relevant for efficient corporate governance because they help in reducing the uncertainties associated with economic transitions” (Burki 2012).

Asian countries are a diverse group, with a range of economic, legal and political systems (OECD 2011) (Table 1). As discussed in Chapter 2.2.4., Concentrated ownership is prevalent in Asian countries, and the fundamental agency problem is no longer just between shareholders and managers, but rather between minority investors and controlling shareholders (La Porta et al. 1998).

Legal protection affects the expropriation of shareholders and the blockholder’s incentives to monitor (Burkart & Panunzi 2006). La Porta et al (1998, 1999) further find that ownership is, on average, more concentrated in countries with poor legal investor protection. Due to the absence of sound legal system (legal regulation and enforcement), ownership concentration could be a substitute for legal protection, so that only controlling shareholders could obtain adequate investment returns (Burkart and Panunzi 2006; La Porta et al 1999). Further, firm level corporate governance can substitute country-level shareholder protection in emerging markets in reducing the cost of equity (Chen et al. 2009b).

Corporate governance is contingent upon the presence of formal and informal institutions (Tam 2002). Under business environments where formal institutions are either weak or non-functional due to legal or market imperfections, Asian firms rely considerably on informal institutions such as business groups and networks in reducing uncertainty and enhancing reliability between social and business factors (Hitt et al. 2002; Khanna & Palepu 2000).

Table 1: GDP, Market Capitalization, Listed Companies in Asian Roundtable Economies, 2010

Jurisdiction	GDP (2010) (USD Billions, PPP)	Market Capitalisation (USD millions)	Market Cap/Nominal GDP	Number of all Listed Companies
Bangladesh*	244.33	46 999	47%	302
China**	10 085.71	4 762 836	81%	2 063
Chinese Taipei**	821.78	818 490	190%	784
Hong Kong, China*	326.23	2 711 333	1208%	1 413
India*	4 198.60	3 228 455	210%	6 586
Indonesia**	1 029.79	360 388	51%	420
Korea**	1 417.54	1 089 216	108%	1 798
Malaysia*	414.43	410 534	172%	956
Pakistan*	464.20	38 168	21.80%	644
Philippines*	367.43	157 320	78%	253
Singapore*	291.94	647 226	291%	778
Thailand**	586.82	277 731	87%	541
Vietnam**	276.57	20 385	19.70%	164

Source: OECD report “Reform Prioritized in Asia: Taking Corporate Governance to a Higher Level”, 2011.

*Common law traditions and **Civil law traditions.

Controlling insiders divert resources for their personal use or invest unprofitable projects that provide personal benefits (Lemmon & Lins 2003). Controlling insiders increase their wealth without sharing full cost of these actions and exploit minority shareholders, resulting in agency problems between controlling shareholders and minority shareholders. Poor corporate governance is widely regarded as one of main reason for the outbreak of the 1997 Asian crisis (Johnson et al. 2000a). Some empirical studies have shown that corporate governance could explain a significant fraction of cross-firm variation in stock price performance during the East Asian financial crisis of 1997 -1998 (Harvey & Roper 1999; Johnson et al. 2000a; Mitton 2001, 2002).

The importance of corporate governance has been widely recognized in Asian countries after the Asian Crisis in 1997, an issue not addressed widely before (Harvey & Roper 1999). International bodies such as OECD established a code of best practices in corporate governance after the Asia crisis to help firms improve their corporate governance practices. After the Asian financial crisis, it was found that East Asian firms and governments were converging towards the presumed more “efficient” Anglo-American model of conducting economic activities (Jomo 2004, 2005; Mishra & Bhattacharya 2011; Redding 2005).

Over the last decade, most Asian countries have substantially revamped their regulations and other formal corporate governance norms. It is now well recognized by regulators, listed companies and asset managers that good corporate governance enhances performance, makes companies more attractive to investors and lenders (OECD 2011). Companies in Singapore, Malaysia and Thailand were leaders in setting up independent audit committee. The family-owned businesses are introducing independent audit committee in this development. Nowland (2007) documents that since 1998 the average board independence has increased by 30% in countries such as Korea, Malaysia, Singapore and HK.

Mishra (2011) states that the problems of efficient corporate governance will not be eradicated by simply adopting the Anglo-American model. The Anglo-American model is characterized as based on having dispersed ownership with a clear separation of ownership and control (Choon Yin 2007) and competitive markets for corporate control and senior managers, and products produced by the firm (Tam 1999). Corporate governance mechanism seek to better protect shareholder's interest from expropriation.

It is also important to note that the Asian business landscape is dominated by large and publicly traded business firms that are either owned/controlled by families or are a part of business group that are embedded in the socio-cultural features (Peng & Jiang 2010). The extant literature demonstrates that unique institutional setting of East Asian countries is characterized by the prevalence of family-controlled businesses, close ties between controlling families and top executives, relationship-based business networks, and high levels of government power and political influence, all of which have been shown to increase information asymmetry and earning opacity (Ball et al. 2003; Claessens et al. 2000).

Local values, beliefs, and attitudes from East Asia have been ignored by simply adopting Anglo-American model (Carney 2005; Yeung, 2006). Adoption of Anglo-American model in East Asia where organizational structure and institutions are very different from those of U.S. may introduce a plethora of new managerial and organizational problems for East Asian firms.

For instance, Choon Yin (2007) investigates Singapore's Temasek Holdings Limited (THL), a state-owned enterprises (SOE) in charge the government's investments in business, - find some indications of deviation between corporate governance practices in the THL and those advocated by the Singapore government which is recommended under Anglo-American model. Even though THL is required to provide annual reports, there is a lack of regulations or rules regarding what to and not to report, and has yet to provide auditor's report or a

detailed balance sheet (Choon Yin 2007). Even though the revised Singapore Code of Corporate Governance (2005) strongly recommend the disclosure of exact remuneration of key directors, how an entity calculated the base or fixed portion salary of their key executives, or how the entire package is determined is missing.

While stock options plans are generally viewed as an important source of compensation to align the interests of principals with that of the agents, THL refuses to adopt that and has argued that the stock option plan can encourage manager to misinform the true condition of the corporation, causing its share price to rise to allow managers to exercise the call options (Choon Yin 2007).

Rosser (Rosser 2003, 2004) report that conglomerates were opposed to regulatory and institutional reform in the Indonesian capital market because they did not want to disclose their activities and report accurately. Indonesian government did little to ensure that accounting regulations were properly enforced. Hence, as far as convergence to US/UK system is concerned, it has been convergence in form rather than substance (Choon Yin 2007). In Thailand, regulations to improve transparency were in place but have never been enforced (Overholt 1999).

The high profile corporate scandals involving several large private corporations such as Enron, WorldCom, Adelphia, Tyco, and Global Crossing in the U.S. and U.K. raised concerns about the merits of the Anglo-American system.

Ownership

Asian business system is not similar to the US/UK. One feature of Asian companies is the presence of a large and controlling shareholder either by individual, family or state-related owner. For instance, the Chinese state held approximately 83.1% of the country's stock market capitalization in 2007 (OECD 2011). A relatively high proportion of firms in East Asia are family owned, for example, with families owning ultimate 67.9% of share in South Korea, 68.6% in Indonesia, 64.7% in Hong Kong, 52.5% in Malaysia, 65.5% in Taiwan, 56.5% in Thailand and 52.0% in Singapore (Caessens et al., 2002). Iyer (1999) reports that 90% of all private sector Indian business firms are family owned.

As discussed above, with concentrated ownership, the fundamental agency problem is primarily between minority investors and controlling shareholders, and how to protect the interests of minority shareholders is vital to the corporate governance. Using a sample of 800

firms in eight East Asian countries to study the effect of ownership structure on firm value during the region's financial crisis in the late 1990s, Lemmon and Lins (2003) find that ownership structure influences dramatically how insiders expropriate minority shareholders. Love and Rachinsky (2009) find that in emerging markets such as Russia and Ukraine, banks with more concentrated ownership have lower rankings on corporate governance.

Therefore, in East Asia, it could be argued that there is a significant proportion of minority shareholders who have limited power to overturn any decisions made by the majority shareholders. However, adoption of Western practices and adjustments to international norms are deemed necessary for Asian firms for reasons of legitimacy, to gain access to international markets and global finance (Ahlstrom et al. 2004; Carney 2005).

In a sample of 1,686 firms from nine East Asian countries, Mishra (2011) find that presence of a dominant shareholder is associated with lower risk taking by firms. They suggest that the presence of multiple large shareholders help promote a more optimal investment policy and enhance internal governance by mitigating agency problems between the dominant shareholder and minority shareholders. Using sample of 3992 firm-year observations from eight East Asian economies, Haw et. Al., (2011) find that controlling shareholders exploit firm opacity through less visible misclassification means to accrue the private benefits of control. They also emphasize the importance of sound legal institutions and effectiveness of external auditing firms in mitigating misclassification behavior. Francis and Wang (2008) find that auditors could play an effective role in mitigating misclassification in countries with strong legal institutions.

In China where concentrated ownership with the presence of state as the dominant shareholder, the major governance problems are associated with the issue of state ownership, insider control and the weak enforcement of law and regulations (Tam and Yu 2011).

Related party transaction

With the prevalent of concentrated ownership structure in Asian countries, how to protect minority shareholders is a key issue. Evidence on extensive expropriation of minority shareholders and creditors by the controlling shareholders has been unveiled (Gao & Kling 2008). This expropriation could happen in a variety of forms, for instance, excessive executive compensation, loan guarantees, and transfer pricing between related companies, and dilution by new share issues (Bai et al. 2004). The term “tunnelling” was introduced by

Johnson et al.(2000) to describe asset appropriation by large shareholder (Johnson et al. 2000b). Tunnelling is more severe and frequently occurred in concentrated ownership firms where block-holding shareholders are more likely to transfer assets and profits to themselves (Gao & Kling 2008; Johnson et al. 2000b).

In China, a series of scandals related to assets exploitation by large shareholders have been reported frequently, such as the incident of ‘Qiongminyinuan’ in 1997 to the scandal of the ‘Sanjiu Group’ in 2005 (Gao & Kling 2008; Liu & Lu 2007). Those serious corporate governance issues could hinder the development of Chinese capital market.

Board of directors

The functions and responsibilities of board of directors are regulated in very similar way across Asia countries and to those of boards in most other market-based economies.

Key formal duties of the board normally include (OECD 2011):

1. Call for shareholder meetings, and regular report to shareholders; implement decisions from shareholders.
2. Determine the organization structure of the firm; set up rules and principles for company management; select, regularly evaluate, replace senior management; determine management tenure and compensation; overseeing succession planning.
3. Review, guide and approve the financial objectives, major strategies, risk policy, annual budgets and business plans, monitoring implementation and corporate performance, and overseeing major capital expenditures, merges and acquisitions.
4. Review the adequacy of the system to comply with all applicable laws/regulations.

One of the important roles of the board is to review and make decisions about related-party transactions. In many Asian countries, managers could be forced to enter into transactions which benefit controlling shareholder but at the expense of minority shareholders (Nam & Nam 2004). It is generally accepted that board independence is essential to exercise objective independent judgment. The definition and process of appointing independent directors are certainly established on paper. However, the controlling shareholders commonly nominate the board, the real objectivity and independence of judgment of independent directors members can often be undermined. In addition, even if the independent directors is truly independent at the time they are appointed, it is questionable whether independent

directors members could raise their voice against controlling shareholders for long period when the controlling shareholder is practically in charge of board appointment, compensation and replacement.

Therefore, how to ensure that board exercise its duty of monitoring performance, preventing and managing conflicts of interests objectively is a key issue. (Hu & Tam 2012) find that 52% of the independent directors in China possess expertise in one or more professional fields such as law, accounting, and finance, which is much lower compared to 87% in Hong Kong. It is difficult to find competent candidates for independent directors who have the relevant knowledge, and experience and are able to devote adequately to their independent directors work.

Improvements in corporate governance can enhance investor confidence in firms in emerging economies and increase these firms' access to capital (Rajagopalan & Zhang 2007). Each country is at a different stage of establishing a democratic, market-based economy and a corporate governance system. It is important to stress that solutions derived purely from a principal-agent perspective may sometimes fail to address the corporate governance problems in a different institutional setting. Therefore, an appropriate well designed corporate governance system is vital to strengthen economy and socio-economic development. As recognized by most scholars of corporate governance, a one-size- fits-all model is probably not the right approach to the development of corporate governance system in any country.

2.7 The Role of Institutional Investor in Capital Markets Development and Corporate Governance of Investee Firms

With the ever increasing proportion of institutional investors in corporate ownership in mature market economies, institutional investors are expected to influence not only the development of capital market but also corporate governance of investee firms.

Role of Institutional Investors in Capital Market

Institutional investors have traditionally played an instrumental role in capital market development. First, it has been pointed out that the major advantage of the presence of institutional investors in the capital market is that they provide absorption capacity for the issues of public and private debt and equity, thus boosting the rapid development of a country's economy and corporations' expansion (Franklin & Gale 2001). Klapper et al. (2004)

state that securities investment funds also provide investors with effective portfolio diversification and professional management at low cost. It is considered particularly important where both portfolio diversification and professional management have the potential to add value. Bond and money market funds have been boosted by gains in transaction efficiency through professional management, tax incentives and regulatory factors (Klapper et al. 2004). Further, institutional investors are considered to have better capacity to allocate savings more efficiently, and have a profound impact on the structure and functioning of the world's capital market (Blommestein & Funke 1998). More importantly, institution shareholding provides a means of channelling finance with typically medium to long term horizons, enabling a notable shift away from the more speculative individual shareholding (Philip et al. 2001).

Second, with their sophisticated investment analysts, institutional investors can contribute to financial innovations by creating new products, improving the accuracy in the pricing of financial assets, and enhancing better clearing and settlement (Kim, 2003). In the U.S., despite the recent backlash against the excesses of some financial institutions and their products, innovative products invented by institutional investors have played a key role in creating the modern financial markets (Fernando et al. 2003). While the recent global financial crisis may undermine the merits of some of those supposed benefits, the debates are still going on. Third, Klapper et al.(2004) argue that securities investment funds have the advantage of relatively higher operational transparency over other financial institutions, such as banks, thrifts, insurance companies and pension funds, compared to the service they provide for households. Beside, securities investment fund also bears no credit and insurance risks, thus no need to be concerned with risks such as non-performing loans.

More importantly, due to the growth in institutional ownership and influence, worldwide institutional investors have the potential to play an important role in investee firms in many markets. The Chinese government anticipate that institutional investors could stabilize the market by engaging in long term investment, and being an active shareholder for investee companies to enhance corporate governance of listed companies.

Institutional Investors' Activism in Investee Firms

As institutional investors own large portions of equities in many countries across the world, there is an increasing emphasis on the role and responsibilities of institutional investors in corporate governance (Mallin 2008).

For instance, institutional investor in the U.S. on average held 46.6% of total shares in 1987, 61.4% by 2000 and 76.4% by the end of 2007. At the beginning of 2010, U.K. domestic institutional investors own 43% of UK equity, and overseas shareholders (predominately institutional shareholders) own 42% (Mallin 2012). The ownership by international investors in Japanese firms rose from 7.7% in 1993 to 28% in 2006, which has significant impact on corporate governance in Japan (Mizuno 2010). Croce et al. (2011) report that institutional investors in OECD countries managed over USD 65 trillion in assets at the end of 2009. Becht et al. (2002) point out that institutional ownership rises significantly due to the growth in retirement savings in many countries so that more and more money are being invested into pension funds and mutual funds.

There have been considerable debates worldwide on the effectiveness and desirability of institutional investors activism in enhancing investee' corporate governance and corporate performance. Institutional investors with substantial shareholdings in a firm tend to have greater incentive and the resources to influence management decisions and monitor corporate performance since they are the direct beneficiaries from expected benefits of their active activisms (Chung et al. 2002; Shleifer & Vishny 1986). Others studies suggest that institutional investors could be effective monitor of the self-serving and opportunistic behaviors of managers of investee firms in mitigating the agency problem between shareholders and managers, thus strengthening investee companies' overall corporate governance and enhancing firms value in the long term (Chung et al. 2002; Gillian & Starks 2000; Guercio & Hawkins 1999; McConnell & Servaes 1990). Therefore, according to this theoretical perspective, institutional investors will strengthen corporate governance practices such as introducing performance-based executive compensation and limiting executive bonuses. For instance, it has been shown that institutional ownership concentration is positively related to the use of performance-based executive compensation and negatively related to the whole level of compensation (Hartzell & Starks 2003).

Earlier studies suggest that institutional investors are however in practice often incapable of monitoring corporate management efficiently because they are generally short of essential professional skills, and the prevalent free-rider problem also hinders their enthusiasm in acting actively (Bhide 1994; Coffee 1991; Maug 1998). Others argue that institutional investors only choose the firms with good corporate governance to invest in, and their limited activism has negligible impact on investee firms (Karpoff et al. 1996).

However, most studies especially in recent years provide different evidence. For instance, McConnell and Servaes (2001) find that the percentage of institutional holding is positively related to a firm's Tobin's Q. Cox and Thomas (2006) suggest that having the advantage over retail investors on litigations give institutional investors incentive to improve corporate governance of the investee firms. Invested firms will be more likely to improve their corporate governance to avoid the large financial penalty and reputation damage (Cox & Thomas 2006; Ferris et al. 2007). Institutional investors are found to “vote with their feet” when dissatisfied with a firm’s management, and that notable change of institutional shareholding will raise the awareness of board of directors in investee firms to take some actions such as replacement of the CEO (Parrino et al. 2003).

Using a comprehensive data set of equity holdings from 27 countries on 2000-2005, Ferreira & Matos (2008) report that institutional investors are becoming prominent shareholders in companies across the world. All institutional investors seek large firms and firms with strong governance indications. Findings from Davis et al. (2006) and Ferreira and Matos (2008) suggest that institutional investors are becoming more like “shareowners” and not just shareholders.

Chung et al. (2012) investigates the effect of institutional ownership on improving firm efficiency of Real Estate Investment Trusts (REITs). They find that institutional ownership can enhance the firm's corporate governance and reduce firm inefficiency. Moreover, they document that investment advisors are more effective institutional investors in reducing firm inefficiency than other types of institutional investors such as hedge funds and pension funds. Findings from Mizuno (2010) suggest that corporate governance has been enhanced by institutional investors in Japanese firms. On a sample of 124 companies from 2006 to 2008, Ismail & Rahman (2011) find that institutional investors are more effective in company’s risk management disclosure compared to the board of directors. Bushee et al. (2009) documents that firms with a high level of institutional shareholding exhibit significant future improvements in shareholder rights. They suggest institutional investors could enhance corporate governance through monitoring and disciplining managers through explicit actions or voting with their fee.

Analysing institutional shareholders in companies from 23 countries from 2003–2008, Aggarwal et al. (2011) document that foreign institutions from countries with strong shareholder protection could promote governance improvements outside U.S. They observe

that with higher institutional ownership, firms “are more likely to terminate poorly performing Chief Executive Officers and exhibit improvements in valuation over time”.

Therefore, most studies document and suggest that institutional shareholding promotes good corporate governance practices worldwide, not only because their activism restraints inappropriate behaviours, firms also enhance their corporate governance to attract institutional investors’ investment. Institutional investors are expected to be more "responsible" for investee firms and engage in longer-term investment.

In China where capital market is dominated by short-term opportunistic behaviours and poor corporate governance of the listed companies, it is urgent for China to stimulate the development of fund industry and make them engaging as active shareholders, considering environmental and other longer-term risks and by financing long-term, productive activities that support sustainable growth and enhance corporate governance of listed companies. The Chinese government has indeed recognized this and seems to be promoting the development of institutional investors partly because of this (Tam and Yu 2011).

There is a growing concern regarding the quality and efficacy of internal governance of the institutional investors themselves. The key issues associated with the internal governance of the institutional investors include transparency, which enables beneficiaries to understand that their funds are being handles appropriately; disclosure and management of conflicts of interest between institutional investors (fund custodian), fund managers and fund investors (Xi, 2006); and oversight structures that are suitably established so that decisions are taken in the interests of beneficiaries (Robert, Monks and Nell, 2004). Due to the conflict of interests between FMC and fund investors, how to enhance board effectiveness and improve FMC fund performance is vital to protect the interests of fund investors.

2.8 Conclusion

The global financial crisis which began in 2007 has led to a renewed emphasis that corporate governance might help improve the situation by restoring investor confidence (Mallin 2012). Different strands of corporate governance theories are reviewed in this chapter to explore their relevant applications for investigating corporate governance performance of FMC in China. Agency theory helps scholars understand the conflicts of interest that can arise between principals and agents, and the potential problems from opportunism. This study uses agency theory as theoretical perspective to examine whether certain governance settings in Chinese FMC could mitigate the conflict of interests between fund investors and FMC.

With concentrated ownership, the agency problem is primarily between majority shareholder and minority shareholder. Poor investor protection environments increase the opportunities for insider to expropriate interest of other major stakeholders. How to protect interest of investors is vital in most of Asian economies. The board of directors is widely accepted as the central governance mechanism to protect the interests of minority shareholders in Asian countries. How to enhance board effectiveness is therefore vital. Given the ever-increasing ownership by institutional investors in listed companies, they are expected to raise their voice and enhance corporate governance of investee firms. This chapter provides a theoretical overviewed and perspective to help identify and examine the major governance issues in the Chinese fund industry.

CHAPTER 3

CORPORATE GOVERNANCE IN CHINA

3.1 Introduction

As discussed in Chapter 2.2.4, with concentrated ownership, the fundamental agency problem is manifested between minority investors and controlling shareholders, and protecting minority shareholders' interests is key element to effective corporate governance. The state is the dominant shareholder in the majority of Chinese listed companies either through direct state ownership at both central and local government levels or indirect state ownership through shareholding in companies by SOEs and domestic organizations (Hu et al. 2010). Government as the dominant shareholder could also use their position to achieve some social imperative and political objectives, with detrimental impact on the interests of shareholders (Shleifer & Vishny 1997). Therefore, concentrated ownership coupled with the state as dominant shareholders introduces many complex corporate governance issues. Both external and internal governance mechanisms are needed to mitigate such governance issues.

This Chapter discusses Chinese corporate governance environment in terms of external and internal mechanisms. The role and efficacy of capital market development and legal infrastructure as the key external governance mechanisms in China are explored. This chapter also investigates in the Chinese context some key features of internal governance mechanisms such as the state as the dominant owner with a concentrated ownership, the function of supervisory board, and independence of directors.

3.2 External Corporate Governance Mechanisms

It is generally accepted that external governance mechanisms consist of corporate takeover market, financial market development, and the regulatory and legal system infrastructure. An active takeover market does not exist in China because of non-tradable share structure (Huyghebaert & Wang 2012). Market-driven merger and acquisition (M&A) are still rare (Rajagopalan and Zhang 2007). In this Section, the external governance mechanisms mainly including financial market development and legal infrastructure are examined.

3.2.1 China's capital market development and its relationship with corporate governance reforms

The relationship between corporate governance development and the development of China's financial system are complementary (Tam and Yu 2011). "The development of China's capital market is, to a large extent, determined by the quality of listed companies, which is closely linked with corporate governance" (Zhou 2004). Corporate governance is critically vital to enhance the credibility and confidence in company management, and is fundamental to the development of capital market. Tam and Yu (2011) stress that "well-functioning capital market and effective corporate governance at the firm level are widely accepted as mutually reinforcing". For instance, the securities market and its regulation play a crucial role in enhancing sound corporate governance practices, although such effects might be constrained by poor corporate governance at firm level (Haque et al. 2008).

Tam and Yu (2011) point out that some key criteria identified by (*The Financial Development Report 2009* 2009) for the necessary institutional and business environment for a country's financial development also belong to the set of essential internal and external governance mechanisms that are required for an effective corporate governance system. Those criteria include

- Capital account liberalisation
- Domestic financial sector liberalisation
- Extent of incentive-based compensation
- Efficacy of corporate boards
- Reliance on professional management
- Strength of auditing and reporting standards
- Protection of minority shareholders' interests
- Regulation of securities exchanges
- Property rights
- Judicial independence

Firms with good corporate governance can enhance its ability to access to finance or at a cheaper rate and better financial performance than those of firms with poor corporate governance (Black et al. 2006; Chugh et al. 2011; Drobetz et al. 2004; Klapper & Love 2004; Rezaei & Jalilmehr 2012), thus enhancing the development of capital market. Therefore, development of a country's capital market will help drive building a well-functioning and effective system of corporate governance (Tam and Yu 2011).

The Development of China's Capital Market

China's economic reform and development started in the late 1970s has generated remarkable economic results. Its gross domestic product has been growing at an average annual rate of over 9% for the last thirty years (China Statistics Yearbook), and total stock market capitalization surpassed RMB 24393.91 billion at the end of 2009. As shown in Table 2 and Figure 2, the stock market capitalization increased from 11.25% of nominal GDP (end of 1993) to 74.64% (end of 2009), and a big decline to 45.54% (end of 2011) due to the global financial crisis.

A few major reforms have been carried out over the last two decades which enhance the fundamental market structural conditions in China's capital markets. One key aspect of financial reform is to enhance the quality of listed companies. Several prominent milestones in the evolution of capital market are key to drive the evolution of corporate governance reforms in China. They include non-tradable share reform, improvement in the quality of listed companies, restructuring securities firms, strengthening institutional investors, further liberalizing the issuance procedures, improving the legal and regulatory frameworks². China has achieved great success in economic reform and opening up to the world markets.

The development of corporate governance in China and the development of other areas in the economic and regulatory environment are mutually reinforcing. As pointed out by Tam and Yu (2011), for instance, "the listing in recent years of major state-owned enterprises and banks in overseas stock exchanges has provided much needed impetus for ensuring governance and management changes that the Chinese authorities would find convenient to their advantage because foreign investors and regulators will demand compliance with higher international standards." With ever increasing number of state-owned enterprises listed in Hong Kong and on international stock exchanges, higher governance standards of those companies are required (He Huang & Orr 2007).

Chinese government has acted quite diligently in recent years to introduce measures to improve corporate governance practices. Poor corporate governance in China is the consequence of the malfunction of the stock market as well as the lack of market-based governance mechanisms (Zhang 2007).

² Xiaochuan Zhang (Deputy Division Director, Market Supervision Department, China Securities Regulatory Commission) speech, March 3rd 2009, "An introduction to the corporate governance development in China" OECD conference.

Figure 2: 1993-2009 Chinese Stock Market Capitalization (Percentage of GDP)

Source: CSRC.

Table 2: China Stock Markets.

	2008	2009	2010	2012
Number of listed companies (A and B Shares)	1625	1718	2063	2342
Total shares issued (billion shares)	2452	2616	3318	3610
Of which : Tradeable shares (billion shares)	1258	1976	2564	2885
Market capitalisation (billion yuan)	12137	24394	26542	21476
Of which: Tradeable shares capitalisation (billion yuan)	4521	15126	19311	16492
Valid number of shareholders (million)	104	120	134	141

Source: CSRC

Tam and Yu (2011) point out that the pace and quality of Chinese capital market development is a major challenge for corporate governance to evolve, and there is an urgent need to speed up China's financial development. One key element of the broader and deeper reform for China's financial system is to provide more varieties of financial products and services for companies and households to obtain better returns for their investments (Tam and Yu 2011). With national savings rate at over 50 per cent of GDP (Table 3), only a highly efficient financial system could turn such huge savings into more productive investment other than low yielding bank deposits (Tam and Yu, 2011).

Institutional investors could also play a crucial role in helping the steady growth of capital market. As discussed in Chapter 2.2.4, mutual fund in U.S. is the major investment channel for corporate and households and has increasing important role in the corporate governance of investee firms, whether the fund industry in China could play the similar role is still questionable given that the fund industry is still in early stage of its development.

Table 3: China's National Savings Rate

	National savings rate	Government	Corporations	Households
1995	39.4	4.6	15.8	19
1996	38	5.1	12.8	20.1
1997	38.3	5.3	13.7	19.3
1998	36.6	4.8	13.1	18.7
1999	34.9	5.2	12.9	16.7
2000	34.5	5.7	14	14.8
2001	34.2	6.7	13.3	14.2
2002	35.1	6.3	12.5	16.3
2003	37.3	8.1	13.5	15.8
2004	46.6	6.1	22	18.5
2005	48.2	6.4	20.4	21.5
2006	50.7	7	28.3	15.4

Source: Asian Development Bank

Importance of institutional investors in Chinese capital market

As discussed in Chapter 2.2.5., institutional investors could play a positive role not only in development of capital market but also in corporate governance of investee firms. A notable change of the Chinese capital market over recent years has been the emergence of various types of institutional investors, particularly FMC, which is beginning to constitute a significant proportion of Chinese stock market capitalization (AUM of fund industry account for 9.63% of market capitalization in 2010 from 4.38% in 2003) (WIND database). By encouraging institutional investors, particularly securities investment funds, to enter the capital market, China's regulatory authorities hold the expectation that they will enhance managerial accountability, raise corporate governance standards, and to promote a balanced and healthy development of the capital market (Kim, 2003).

As discussed in Chapter 2.2.5., the fund management industry is generally perceived to have longer investment horizon than individual investors, with an investment approach based on fundamental research in contrast to speculative behaviors. However, Chinese funds' investment period is still far shorter judging by the international comparison of turnover ratios as shown in Figure 3(Qi 2008). Chinese investors on average hold their stocks for less than four months, compared with the U.S. average of 17 months (Chen et al. 2005b).

Due to the lack of power of governance in investee firms as well as weak legal protection, non-state institutional investors and individual shareholders tend to focus on speculative activities (Kang et al. 2008).

Figure 3: International Comparison of Turnover Ratio of Managed Funds.

Source: QI 2008. Notes: SSE (Shanghai Stock Exchange); SZSE (Shenzhen Stock Exchange)

In China's context, as non-performing loans have been a major policy issue and an obstacle to the country's financial development and banking reform (Tam & Yu 2011), the fact that securities investment funds with no credit and insurance risks therefore may make the development of the fund industry particularly important and relevant to the development of Chinese capital market. Given the above reasons, institutional investors are expected by the Chinese government to help develop a more stable and healthy capital market environment.

Earlier studies suggest that institutional investors in China act passively and had a negligible role in investee's performance (Hu & Wu 2004; Li 2002). While Tam (2003) finds that some of China's institutional investors were engaged in monitoring investee's performance, Chao (2006) finds no evidence that clearly show causality between institutional investors' activism and firm performance.

However, recent studies document that institutional investors enhance firms' performance in China. Based on China's public-listed company data from 2000 to 2005, an empirical study by Yang and Wang (2008) finds that institutional investors have actively participated in corporate governance particular in improving ownership structure and the proportion of independent directors, and improving firm performance in the long term. They conclude that institutional investors have a significant impact on enhancing the corporate governance of investee firms and improving the firms' performance in the long term (Yang & Wang 2008).

Similar result achieved by Yuan, Xiao et al. (2008) showing that equity ownership by Chinese FMC has a positive effect on firm performance. They argue that FMC plays a significant role in monitoring controlling shareholders and their agents, therefore, agency problems are reduced and firm performance enhance in the long term.

Qi, Huang, & Wang (2011) find that mutual fund invest in listed companies with good corporate governance practices. For instance, listed companies with smaller board size, separation role of CEO and board chairman tend to have a higher ownership of mutual fund than those of firms with large board size and dual role of CEO and chairman. However, the proportion of independent director and number of board meetings has no relationship with the shareholding by mutual fund. It may suggest a negligible role of independent directors and board meeting in improving firm performance. Similar result by Shi, An, & Liu (2011) find that firms with larger mutual fund shareholding appear to have better performance than those with less mutual fund shareholding.

As discussed above, there may be two-way influences between intuitional investors' shareholding and corporate governance of investee firms. Intuitional investors are more capable of identifying those investees with good corporate governance. Then, companies who want to enhance their competitiveness in the equity market may want to improve their corporate governance.

This study focuses on corporate governance issues within China's FMC, and it is beyond the scope of this study to investigate FMC's impact on investee corporate governance. In any case, given the still immature stage of China's fund management industry and lack of shareholder activism, analysis of this subject would best be revisited in future when the development and market of FMC becomes more mature.

Given the significant role they can play in capital market development and the corporate governance of investee companies, institutional investors, and FMC in particular, how effective they have performed their role in a rapidly growing emerging economy such as China needs to be better understood. Corporate governance of institutional investors is also crucially vital in order for them to function effectively, efficiently and appropriately.

QFII

Qualified foreign financial institutions (QFII)³ have also been encouraged to invest in Chinese domestic exchanges since December 2002. Foreign ownership is generally expected to encourage the adoption of superior governance practices in areas such as information disclosure, internal checks and balances, and accounting standards (OECD 2002). Yoshikawa and Gedajlovic (2002) find that greater exposure to global capital markets including foreign ownership is positively associated with the quality of firms' investor relations practices, and firm performance. Tam et al. (2010) find that foreign financial institutions allowed to participate in China's domestic share market were unable to play a significant governance role as expected of their status as strategic investors. By April 2012, 129 foreign institutional investors had been granted QFII status and had been allocated quota totalling REM \$265.6 billion yuan⁴, of which 74.5% was reinvested in the stock market, 13.7% in bonds and 9.6% in bank deposits. QFII accounts for 1.09% of stock market capitalization.

QFII are expected to bring advanced investment methodology and skills and undertake long-term investment strategies, therefore could help develop a more stable and healthy stock market environment. It is also hoped that QFII's increasing significant shareholding in Chinese state-owned listed companies will enhance the governance standards of those

³ Qualified Foreign Institutional Investor was launched in 2002 in China to allow licensed foreign investors to buy and sell yuan-denominated "A" shares in China's stock exchanges. Chinese mainland stock exchanges were previously closed off to foreign investors due to China's capital controls which restrict the movement of assets in-and-out of the country (Wikipedia).

⁴ Report from CSRC website April 2012 on "QFII investment quota grant U.S. 5 trillion dollar" at http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201204/t20120403_208155.htm

companies (He Huang & Orr 2007). However, Tam et al. (2010) find that QFII have not yet been able to exert long-term impacts on the Chinese market. How the presence of foreign shareholding in FMC may affect board effectiveness and performance are examined in Chapter 7 and 8 respectively.

3.2.2 Legal regulations and institutional framework

Regulatory infrastructure and legal system provide a key and effective external mechanism in establishing good governance practices, building the capacity of institutions and individuals to implement apply and enforce those laws (APEC 2002). At the beginning of developing corporate governance development, Chinese government has adopted a top-down approach to setting up formal framework for publicly listed companies (Tam 1999). With the regulatory push, considerable progress has been made in creating many of the necessary conditions (Tam and Yu 2011). However, many of the formal and informal market and social institutions needed to be developed and functioning effectively for the corporate governance practices introduced under Anglo-American model to work well in China are missing (Tam 1999; Tam & Yu 2011).

CSRC was established in 1992 under the State Council to regulate China's securities and futures markets with an aim to ensure market participants operate legitimately and in orderly manner. CSRC stipulates a number of regulations and policies that provided key components of legal foundation for development of a modern corporate sector and capital market, which has a tremendous impact on corporate governance development in China.

Table 4 provides some key regulatory rules and framework for developing of corporate governance in China. For instance, '*China's Company Law*' was promulgated in 1993 and subsequently amended in 1999 and 2005. It aims to protect the legitimate rights and interests of companies, shareholders and creditors, promotes the restructuring of SOEs, and facilitates economic development (Qi 2008). It regulates the responsibilities, rights and obligations of corporate stakeholders including shareholders, board of directors, board of supervisors, and senior managers. A board of directors is required to establish for all limited liability companies, and "large" companies have to set up a separate board of supervisors, consisting of at least three independent supervisors. Shareholders are given the rights to appoint and remove directors and supervisors, and to determine their compensations.

Table 4: Law, Regulations and Administrative Guidelines Relating to Corporate Governance System Development and Practices

1992	China Securities Regulatory Commission (CSRC) established
1993	<i>Company Law of the People's Republic of China</i>
1998	<i>Securities Law of the People's Republic of China</i>
1998	<i>Shanghai Stock Exchange Listing Rules</i> (revised six times, latest revision 2008)
1998	State Bureau of Industry and Commerce Administration, <i>Administrative Rules for the Registration of the Legal Representative of Enterprise</i>
1999	<i>Accounting Law of the People's Republic of China</i>
2000	CSRC, <i>Opinions on Strengthening Work on Monitoring and Regulating Listed Companies</i>
2000	Establishment of State-owned Assets Supervisory and Administration Commission (SASAC)
2001	CSRC, <i>Implementing the System of Interview Discussion with Board Chairman of Listed Companies</i>
2001	CSRC, <i>Guidelines for the Establishment of the System of Independent Directors in Listed Companies</i> . (Independent directors to reach at least one third board membership in three years)
2002	CSRC and State Economic and Trade Commission, <i>Code of Corporate Governance for Listed Companies</i>
2002	CBRC, <i>Guidelines on Corporate Governance of Joint Stock Commercial Banks; Guidelines on Independent Directors and External Supervisors of Joint Stock Commercial Banks</i>
2004	Establishment of <i>Central Hui Jin</i> as Holding Company for China's Four State-owned Commercial Banks
2004	Small & Medium Enterprises Board, launched in Shenzhen Stock Exchange
2004	CSRC, <i>Regulations on Strengthening Protection of Shareholder's Rights of the General Public</i>
2004	SASAC, <i>Notice on the Publication of Central Enterprises Core Business (First Group)</i>
2004	SASAC, <i>Interim Methods for Confirmation of Enterprise State Capital Value Protection and Augmentation</i>
2005	<i>Revised Company Law</i> (Introduced proxy voting and cumulative voting system for election of board directors)
2005	CSRC, <i>Measures on the Administration of Split share Structure Reform of Listed Companies</i>
2005	CSRC, <i>Administrative Rules on Stock Incentives in Listed Companies (Trial)</i>
	Stocks or stock options to senior managers as incentives
2005	CSRC, <i>Guidelines for Investors Relations Work of Listed Companies</i>
2005	CBRC, <i>Guidelines for Boards of Directors Code of Conduct of Joint Stock Commercial Banks</i>
2006	Amendments to <i>Securities Law</i>
2006	CSRC, <i>Corporate Governance Code for Securities Investment Companies (Trial)</i>
2006	CSRC, <i>Administrative Rules for Takeovers of Listed Companies (Revised 2008)</i>
2007	<i>Property Rights Law of the People's Republic of China</i>
2007	CSRC, <i>Guidelines for Permission to Issue New Shares by Publicly Listed Companies</i>
2008	Ministry of Finance, CSRC, Audit Bureau, CBRC, CIRC, <i>Basic Regulations on Enterprise Internal Control</i>
2009	<i>Shenzhen Stock Exchange Growth Enterprise Market Listing Rules</i>
2009	SASAC, <i>Interim Method for Performance Appraisal of Responsible People of Central Enterprises</i>

Source: Tam and Yu (2011)

China's *Securities Law*, issued in December 1998 and enacted in July 1999, confirmed the importance of the capital markets and formalized its legal status in China for the first time. The article 166 states that CSRC is considered as the major authority to regulate and monitor the securities, IPO, M&A, disclosure information and others of public companies.

It regulates the issuance and trading of securities. The purpose of the law is to protect the rights and interests of investors, stimulate/boost the development of China's capital markets, safeguard public interests, and promote the growth of the socialist market economy. The amended Securities Law took effect on 2006 with some major changes as follows.

The Chinese *Securities Law* was amended in 2006 with an intention of protecting minority shareholders' interests, and balancing the power asymmetry between the dominate owners (usually is the state) and the minority shareholders (Tam and Yu 2011).

For instance, the newly added Article 47 states that senior officers including members on the board of director, supervisory boards, and top managers holding more than 5% of company's shareholding could not trade within 6 months from the date of purchase. It aims to limit senior officers using their inside information to trade to benefit themselves at the expense of minority shareholders. Another added Article 86 stipulates that an investor holding or jointly holding more than 5% shares of listed companies should report to CSRC their shareholdings status within 3 days when it happens. By acknowledging large shareholder's status, CSRC aims to mitigate insider trading. Article 87 and 134 regulate situations of M&A and litigation respectively to protect the interests of investors.

There are rules and regulatories directed specifically at developing corporate governance of listed companies in China. In 2002, CSRC issued China's first Code of Corporate Governance for Listed Companies which paid special attention to the protection of minority shareholders (as the Article 4 of general provision stated in *Code of Corporate Governance*). In addition, the general provision of the *Code of Corporate Governance* also promulgate that a sound board of directors is the prerequisite to good corporate governance, and is the core of the corporate governance, and shareholders are the major party of the corporate governance (Article 5 of *Code of Corporate Governance*).

Despite unified laws written by national institutions in China, legal enforcement and alternative informal mechanisms vary considerably in different provinces and regions in China (Allen et al. 2005; Chen et al. 2005a; Fan et al. 2007; Huyghebaert & Wang 2012). For instance, Zhang (2010) state that there are overall 900 legal regulations in China, but only

around 240 of them are being enforced. He argues that it is in an urgent need to enhance legal enforcement of existing written regulations. Tu (2012) and Shen (2008) point out that lack of legal enforcement is the key problem for China's legal system. It is generally accepted that external governance mechanisms including China's financial and legal systems as well as institutions are all underdeveloped (Allen et al. 2005; Hu et al. 2010).

External governance mechanisms in China are in general weak with poor effectiveness of legal enforcement and underdeveloped capital market, as well as ineffective negligible market for corporate control. Corporate governance reforms in China have relied on internal mechanisms with a particular focus on the responsibilities of directors and managers.

3.3 Internal Corporate Governance Mechanisms

In emerging economies with weak legal protection for shareholders and ineffective external governance mechanisms, internal governance mechanisms are expected to play a crucial role in protecting the interests of minority shareholder (Hu et al. 2010; Young et al. 2008). China imposes a two-tier board structure, consisting both board of directors and supervisory board, which combine features of the German, Japanese and the U.S. governance systems. Majority of Chinese listed companies have the state as dominant shareholder which raise additional governance issues. This Section examines some of the key internal governance mechanisms including ownership structure, supervisory board and board of directors.

3.3.1 Ownership structure

Share structure reform in China

Tam and Yu (2011) and Yang et al. (2011) argue that one of the main underlying problems for the development of corporate governance in China in publicly listed companies has been the dominant non-tradable shareholding by the state.

A range of familiar as well as China-specific problems in corporate governance practices and outcomes have emerged due to the large portion of non-tradable state shareholding in listed companies coupled with the widely acknowledged insider control problems in many of these companies (Tam and Yu 2011). This Section examines the evolution of privatization in Chinese publicly listed companies, and the effect and problems of state as dominant shareholder in those firms.

During the early stage of China's economic development and a centrally planned system, SOEs dominated the Chinese economy, and private enterprise were strictly prohibited. The state is the owner of the vast majority of economic entities, and commanded and controlled almost every aspects of the economy.

From 1984 to 1993, reform of China economic structure is initiated for the separation of government intervention from enterprise operation with a degree of caution, but it was later decreed that all medium and large sized SOE should be corporatized except for a few key strategic enterprises (Qi, 2008). Two stock exchanges were established to achieve that goal: Shanghai Stock Exchange (in 1990) and Shenzhen Stock Exchange (1991). The number of listed companies (1550 public listed companies) nearly doubled by 2007 compared to the year of 1999 when there were only 949 listed companies (Qi, 2008).

The China Securities Regulatory Commission (CSRC) was created in 1992 to be the main regulator of securities markets in China. The Securities Law also gives power to the CSRC to examine the listed firms over securities and corporate fraud.

The common practice of public listing of companies in China is that an SOE sets up a new company, and transfer a portion of its assets to the new company and becomes the majority shareholder. Various share ownership types are created, among which state shares, legal person shares and A shares⁵ are the most prominent. Shares are divided into tradable and non-tradable shares based on whether they can be traded on stock exchanges. State shares and legal person shares were non-tradable shares held by the shareholders before the companies went public and can only be transferred through the negotiation among designated parties. Shares are tradable shares which are those listed on the stock exchange and tradable by the public.

Legal person shares, unlike state shares, are held by domestic institutions such as other listed companies, state-private mixed companies and non-bank financial institutions (Qian & Wu 2000). Government-related institutions on average own 81.5% of total legal person shares over the period 1991-2001 (Delios & Wu 2005). As a result, there were a large number of shares overhung and non-tradable. Non tradable shares on stock exchange had been strongly criticized and viewed as the failure of the stock market to function effectively (Tao 2004).

⁵ There are different types of share class in China, including A share, B share and H share. A share refers to stocks that trade on the Shanghai and Shenzhen exchanges and denominated in renminbi. B share refers to shares of some Chinese companies are listed in Shanghai and Shenzhen, but traded in U.S. dollars. H shares are also Chinese companies, but these securities trade on the Hong Kong Stock.

Wu (2004) and Qiu and Yao (2009) argue that the split share structure (tradable and non-tradable) has affected negatively the development of stock market and the transformation of the Chinese economy. The split share structure is the main reason leading to the divergent wealth form listed firms by large shareholder because their shares are not allowed to be traded so they are indifferent to share price changes. CSRC in 2006 reports that there are 676 listed companies to have money appropriated by controlling shareholders totalling 96.7 billion Chinese Yuan, and 623 listed companies in 2003 to have money appropriated totalling 57.7 billion Chinese Yuan. Individual investors held extremely diffused shares so that they do not attend shareholder general meetings or exercise their voting rights to protect their interest (Chen et al. 2009a)". In addition, it is argued that an outside market for corporate control (e.g. takeover) has been precluded since the state and legal person shares occupy a majority portion of equity shares in most companies and they are non-tradable (Yang et al. 2011).

The conflict of interest between controlling and minority shareholders are exacerbated in China because of the presence of split share structure that non-tradable shares held by controlling shareholders and tradable shares held by minority shareholders (Zou et al. 2008).

Chinese government initiated the non-tradable share reform in 2005 to make non-tradeable shares tradable. It requires non-tradable shareholders negotiate with tradable shareholders to determine the compensation for tradable shareholders before non-tradable shares can be traded in the market. As Figure 4 shows, the proportion of negotiable stock accounts for about one third of market capitalization for most years until 2008, proportion of tradable shares among total stock market capitalization has increased significantly to 62% in 2009 from 37.25% in 2008, and increase slightly from 2010 to May 2012.

Since the non-tradable reform started in 2005, the proportion of tradable share among total stock market capitalization has been enhanced significantly over last several years. This share structure reform is significant not only for freeing the majority non-tradable shares in China's stock markets, but could also in time alleviate the dominant position of the state as owner of Chinese listed companies (Tam and Yu 2011). It is expected that the governance issues associated with dominant state ownership such as insider control and ineffective monitoring through a chain of distinct government agencies can be attenuated in time, as well as creating condition for an active market for corporate control through mergers and acquisitions (Tam and Yu 2011).

Cai et al.(2007) and Bortolotti Beltratti (2007) provide evidence that the non-tradable share reform has brought a statistically significant positive abnormal returns for listed firms.

Qiu and Yao (2009) also provide evidence that non-tradable reform has brought significant improvement in both corporate governance and firm performance, and enhancement in corporate governance of firms after non-tradable reform help improved firm's performance.

All though the non-tradable reform has increased the proportion of tradable shares in Chinese stock market capitalization significantly, the state is still the ultimate and in most cases the dominant shareholder for most of listed companies (Hovey 2006). For instance, the Chinese state as direct or indirect owner has for a considerable period of time held two thirds of issued shares over eighty per cent of the countries' listed companies (Shanghai Stock Exchange, 2006). Chinese state held approximately 83.1% of market capitalization in 2007 (OECD, 2011). The governance characteristics of concentrated state ownership in China are certainly worthwhile to investigate.

Concentrated state ownership in China

Comparing corporate governance in China with other OECD counties, Cheung et al. (2008) report that there is a weak relationship between the market valuation of listed firms and their corporate governance practices. Yang, et al. (2011) suggest the main reason for the ineffectiveness of corporate governance is the presence of the dominant state shareholding in listed firms. They suggest strong political connection between the governments and listed firms as well as lack of independent judicial system leads to inefficiency of corporate governance mechanisms.

Government owners could pursue their own agenda (e.g. maintaining employment levels) to achieve economic and political objectives, which are often different from shareholders' profit maximization, and may also contradict or be detrimental to the interests of minority shareholders (Jiang et al. 2008). In addition, SOE managers have weak and even sometimes adverse incentives to improve firm efficiency, because SOE managers as public employees cannot have private benefits of from increasing revenues or from nor reducing the firm's costs (Megginson 2005).

With concentrated ownership, controlling shareholder could gain personal benefits "through various forms of self-dealing transactions such as selling assets, goods and services to listed companies at high prices or transferring assets from listed companies to member firms under controlling shareholders' control at low prices (Wang & Xiao 2011)". In addition, controlling shareholders of many Chinese companies directly intervene in companies' operational business. For instance, they directly engage in staff appointments, business decision-making, or the implementation of new business initiatives. In some cases, they trade

with related parties to detriment to the interests of the company without fully disclosure (Qi 2008).

Tunnelling is often used to describe the transfer of resources away from firms for the benefits of controlling shareholders. It is generally accepted that tunnelling is more prevalent in emerging markets with weak legal system and ineffective corporate governance for minority shareholders. Granting the loans to majority shareholder and related party transactions are the major form of tunnelling in China (Liu & Lu 2007).

With the concentrated of state ownership in China, the major governance problems generally are the issue of state ownership, inside control, and the weak enforcement of law and regulations (Tam & Yu 2011). Most recent studies document a U-shaped relationship between government ownership and firm performance/valuation (Chen et al. 2009a; Tian & Estrin 2008).

Using a sample of 9594 firm-year observations between 1994 and 2004, Tian & Estrin (2008) find that detrimental effects of government shareholding initially decline as the state ownership stake increases, up to 25% shareholding, and increases thereafter. Therefore, they conclude that when the state is a large shareholder, firms could benefit from concentrated state ownership as state has the power to distort outcomes in favour of the firms that it owns. For instance, government may increase corporate value with a helping hand through tax rebates or government orders etc. Government ownership could be both detrimental and beneficial to corporate value.

In contrast, Chen et al. (2009) find the existence of an alignment effect, the larger the holding of the largest shareholder, the better firm's performance. Ma et al.(2010) also find that ownership concentration enhances Chinese firm performance. They point out that ownership concentration in Chinese firms is more powerful than any types of ownership in influencing firm performance. However, Huyghebaet & Wang (2012) find that increasing the government ownership in Chinese listed firms lead to higher the levels of expropriation of minority interests.

Liu & Lu (2007) point out that the major objective of developing equity market in China is to help SOEs to raise capital, and regulations are in favor of SOEs or the companies with close ties to the government. It could be therefore argued that the true relationship between state ownership in SOEs and firms' performance are hardly investigated as the state

may use their position to benefit SOEs which enhance firms' performance but detrimental to the competitive market such as access to financing or land.

As will be discussed in Chapter 4.4 of this thesis, the extent of shareholding by the state in FMC ownership may similarly exert a negative impact on board effectiveness. In practice, the fact that nearly 59.78% of FMC shareholding are controlled by state-owned financial institutions raises the question of how such concentrated state ownership may affect board effectiveness and FMC performance. These questions are examined in Chapters 6 and 7.

Chinese government may believe the presence of state ownership in publicly listed firms are important for the quality of firms or they want to use SOEs as device to implement their policies to achieve their goals. Over the last decade, a process of ownership reconcentration has brought many big SOEs to form central enterprises.

SASAC and State-owned Enterprises Governance

Central enterprises are wholly owned by the state. The State-owned Asset Supervision and Administration Commission (SASAC) was established in 2000 to be responsible for exercising the ownership rights on behalf of the state over state-owned and particularly the central enterprises (Tam & Yu 2011). Since 2002 the Chinese government has consolidated and merged the largest SOEs into central enterprise groups in certain "strategic" industries, and modern corporate governance mechanisms are to be imposed to those enterprises in order to exercise state ownership rights more effectively and to achieve better firm performance (TY 2011). Those central enterprises are industry leaders either by virtue of their size or their natural/regulatory monopoly position.

The number of central enterprises was 149 by July 2008, and 117 at the end of 2011 (SASAC website), but the total number of subsidiary companies and holding companies of those central enterprises under SASAC's supervision was about 10,000 (OECD 2009).

SASAC aims to reduce the number of central enterprises through restructuring and mergers between SOEs to develop the remaining ones to be more internationally competitive enterprises⁶. Ineffectual corporate governance practices of SOEs are unveiled when they operate in more sophisticated capital market like U.S. where better corporate governance is required. It was reported in 2010 that 25 out of a total of 284 Chinese firms listed in U.S.

⁶ News from "Newspapers for Young people in Beijing" on November 2007 <http://finance.qq.com/a/20071122/001012.htm>

stock market were sued by class action because of alleged violations of disclosed rules and regulations in their financial reports.

Figure 4: Negotiable Stock Capitalization/Total Stock Market Capitalization Ratio (%)

Source: CSRC; Note: Data for 2012 is 2012 May.

The state plays a very important role in Chinese economy, and mixed findings about the impact of state ownership on SOE performance provide further evidence that high levels of state ownership may yield different governance outcomes in contrast to firms with lower levels of state ownership. As shown in Chapter 6.4.1 of this thesis, the number of shareholders ranged from 1 to 6 among China's 61 FMC at the end of 2010, and Herfindahl index (HHI)⁷ is 0.428. The state on average own 59.78% of FMC shareholding. How such concentrated state ownership may affect FMC board effectiveness and performance will be investigated in this thesis.

3.3.2 Supervisory board

A listed company in China is required by law to have a dual board structure: board of directors and supervisory board (Section 4, 'China Company Law' 2005). The main roles of China's supervisory board are to examine the company's financial affairs, and to check the regulatory compliance of board of directors and senior managers ('China Company Law'

⁷ The Herfindahl index, also known as Herfindahl-Hirschman Index or HHI, is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. Formula is given in Appendix A, the higher HHI indicate higher concentration.

1994). Prior studies on the role of supervisory board suggest that Chinese supervisors are ineffective in performing their role (Dahya et al. 2003; Tam 1999; Tam & Hu 2006; Xi 2006). The latest amendments to China's Company Law in 2005 significantly strengthens the role of members of supervisory boards and gives them more rights to monitor. For instance, supervisory boards can now sue directors and senior managers who commit frauds. Supervisory boards are given right to raise questions on board meeting. Using data for the years of 2005 and 2006 data (before and after the new Corporate Law became effective), Ding et. al., (2010) examines the effects of both size and meeting frequency on total executive compensation. They found that a larger supervisory board leads to a lower level of pay-performance sensitivity, and there is an optimal range of meeting frequencies. They suggest the supervisory board can monitor better if it is empowered properly, and the new Corporate Law enhances supervisory board's monitoring role over executive compensation.

“A typical Chinese supervisory board consists of three mutually exclusive groups of supervisors, which consist of controlling supervisors (full-time employees of the largest shareholder of the listed company), executive supervisors (company employees) and outside supervisors.(Hu et al. 2010)”

The composition of supervisory board inherently makes supervisory boards less effective because of its weak independence from the company and its controlling shareholders (Dahya et al. 2003; Tam & Hu 2006).

3.3.3 Board composition and structure

With relatively weak position of minority shareholders under concentrated ownership, the board of directors is widely considered as the key internal corporate governance mechanisms to protect the interests of minority shareholders. Whether the board of directors has in practice played a crucial role in protecting the interests of minority shareholders is still widely debated. The function of the board of directors in FMC are similar to those in listed companies but with more complex responsibility to look after the interest of fund investors because of lack of direct representation of fund investors in FMC coupled with conflict of interests between FMC and fund investors. Therefore, issues affecting board of directors' effectiveness in listed companies are relevant and important for FMC. This sub-Section will discuss the function and role of board of directors and their effectiveness are explored.

The Board of Directors

The board of directors are accountable to shareholders under *The Code of Corporate Governance for Listed Companies in China* issued in 2001 by CSRC. Board of directors should treat all shareholders equally, and should protect the interests of various stakeholders in the listed companies. Similar to those of directors in other countries, as discussed in Chapter 2.1.4 of this thesis, the role of the board of directors is outlined as follows.

- “ calling and hosting the annual or special shareholder meetings and reporting to shareholders;
- executing resolutions passed by shareholders;
- making up the company’s operating and investment plans, debt and equity financing plans, and dividend policy;
- making proposals for merger, separation, and dissolution of the company;
- determining the firm’s internal organization;
- appointing or replacing top managers and setting their compensation.” (Huyghebaert & Wang 2012)

Because Chinese directors generally gain their power from the dominant shareholder, are appointed and removed by the dominant shareholders, it is therefore unrealistic to expect the board to discipline or punish the dominant shareholders, subsequently contributing to the ineffectiveness of the board of directors in the Chinese contexts (Rajagopalan & Zhang 2007). The state as the dominant owner in many Chinese listed companies may only exist on paper (Qi 2008). The absence of real governance representation for the state in some companies leads to the dominant position of insiders (normally insiders are senior executives) who populate the board of directors to exercise control in many situations. The “insider control” problem is usually considered as the major problem to enhancing the corporate governance of Chinese companies (Hu et al. 2010; Huyghebaert & Wang 2012; Ming et al. 2009). As a result, the protection of the interests of minority shareholders is weak.

Board size

In the literature, small boards are usually perceived as more effective in communication, coordination, decision making and financial performance (Jensen & Meckling 1976; Yermack 1996). Studies suggest that larger boards may have low individual motivation, and therefore less likely to actively participate in decision making (Wang & Deng 2006). Therefore, smaller boards may be more effective in protecting the interests of minority shareholders.

Most studies in the literature document that board size has no impact on firm performance in Chinese companies. For instance, using 1103 listed companies in 2004, Song et al. (2009) find no relationship between board size and firm performance. They suggest that Chinese firms on average choose the optimal board size. Similar result obtained by HouRen (2003) and Li (2009). Wang & Deng (2006) document that board size and CEO duality do not significantly affect the probability of default.

Using 1196 listed companies between 2000 to 2007, Liu (2009) documents that board size negatively affect firm performance, they suggest the communication problem may lead to the negative effect of board size. In a sample of 571 private Chinese listed companies in 2008, Wang (2012) documents that there is a positive relation between board size and firm performance in private listed firms. However, Li and Naughton (2007) provide evidence that board size only positively affect short-term returns. Whether board size has any impact on FMC performance will be tested in Chapter 7.

Independent directors

Independent directors are supposed to contribute to maximum firm value by providing expert skills and knowledge and monitoring management, thereby serving the best interests of shareholders (Fama 1980; Fama & Jensen 1983). It is also argued that independent directors will work in the best interests of shareholders to maintain their good reputation in society (Fama & Jensen, 1983). With principal-principal conflicts of interest, independent directors are especially important to be independent not only from the management but also from controlling shareholders to ensure independent board judgments and decisions toward maximize the value of the firm rather than those of controlling shareholders (Shleifer & Vishny 1997).

In other words, with concentrated ownership, independent directors have a particular responsibility to protect the interests of minority shareholders. Hence, it is generally believed that a well-functioning corporate governance system with independent directors that provides independent opinions should help to reduce principal–principal conflicts of interest in Chinese listed firms. However, managerial hegemony theory claims that the role of nonexecutive directors in strategic decision making is limited because of managerial domination (Westphal and Fredrickson 2001). Some studies stress that outside directors often lack industry-specific knowledge or expertise to implement their duties well (Baysinger and Hoskisson 1990; Estes 1980).

CSRC 2001 promulgates “Guideline on the Establishment of Independent Director System in Listed Companies” which requires all listed companies to have independent directors on the board and to reach at least one third of board memberships by 2003. The major role for independent directors is:

- review and express independent opinions on significant related - party transactions
- the nomination of directors and the appointment and dismissal of senior management officers, before these matters are submitted to board of directors for discussion
- review the determination of compensation or remuneration of directors and senior management officers
- vote on important managerial and financial decisions

Independent directors should not take any positions in the listed company other than independent directors according to Article 49 of *Code of Corporate Governance for Listed Companies*. They are prohibited from involving any business or other relationship with the companies or the dominant shareholders. Agency theorists held that being independence from management is vital for ID to function effectively (Fama 1980; Fama and Jensen 1983; Jensen 1993). In China, the independence of directors are always been questioned. For instance, HuyghebaertWang (2012) and ShanMcIver (2011) argue that independent directors are often selected by controlling shareholders due to the presence of high ownership concentration.

A survey conducted by Tam (1999) shows that “majority of independent directors were “former” officials (the precise nature of their employment relations with the government was complex and could often not be easily determined) in the ministries or departments that previously had a supervisory or administrative vis-a-vis the enterprise reform which the listed company was created”. Huyghebaert & Wang (2012) show that more than half of directors are appointed by the state in listed SOEs, and outside directors are often retired government officials, who are found to continue to act in the interests of the state rather than shareholders. Consequently, boards in China tend to lack independence and become rubber-stamp for the decisions made by the management and by controlling shareholders (Shan & McIver 2011).

The independent directors are more often termed by Chinese scholars “outside directors” who just have no official position in those companies. Kakabadse, et al. (2010) argue that independent directors could not perform their role effectively because of concentrated ownership structure and intervention of controlling shareholders. Thus, Chinese

boards are heavily dominated by insiders, including senior managers and representatives of dominant shareholders.

In addition, some directors do not exercise their duties and responsibilities adequately. For instance, they are frequently absent in board meetings, improper delegation of their duties to other, resulting in violating their fiduciary duty (Qi, 2008). Although CSRC has emphasized on the importance of the independent directors and defined the minimum number of ID each board should have, Rajagopalan and Zhang (2007) and Qi (2008) argue that there are shortage of qualified candidate to be the independent directors. In a sample of 300 largest Chinese publicly listed companies in 2007, HuTam (2012) found that 34% of independent directors in China possess expertise in one or more professional fields,

Kakabadse et al. (2010) state that establishment of independent directors with the aim of actively monitoring management in listed companies in China does not necessarily help to enhance corporate governance standards. He & Orr (2007) raise the concern that “how key decisions are made in companies in which the majority shareholder is still the government and the Communist Party plays a powerful if shifting role” .

Most studies in the literature document that larger proportion of independent directors enhance firm performance in Chinese listed companies (Ma 2008; Wang et al. 2008; Yang 2007b; Zhao & Zeng 2008). For instance, using 2729 firm-year observations between 2002-2004, Zhao & Zeng (2008) find that higher proportion of independent directors have positive impact on performance stability of Chinese listed companies. Similar result by Jiang (2007) showing that higher proportion of independent directors enhances firm performance in 374 listed companies on selected years of 2001, 2003 and 2005. Using a sample of ninety-six financially distressed companies and ninety six healthy companies, WangDeng (2006) find that the proportion of independent directors are negatively associated with the probability of distress. Whereas Shan & McIver (2011) documents that the degree of board independence have a significant positive impacts on performance only in larger companies. Given the complex governance issues of FMC (discussed in Chapter 5.2 of this thesis), board independence is vital to protect the fund investors. How board independence affect board effectiveness and FMC performance are the main questions to be examined in this thesis.

3.4 Conclusion

With concentrated ownership, a major conflict of interest arises between the firm's controlling shareholder and minority shareholders in Chinese listed firms. The principal-principal problem is more severe given that Chinese regulation and enforcement are still weak as well as the prevalent issue of insider control (Huyghebaert & Wang 2012). Therefore, how to protect the interests of minority shareholders is widely seen as the key issue for Chinese corporate governance.

It is generally accepted that in emerging markets like China, external governance mechanisms are weak as there is an absence of active M&A with ineffective law enforcement. The pace and quality of Chinese capital market development is a major challenge for the development of corporate governance, and there is an urgent need to speed up China's financial development. This is because the development of corporate governance and the development of capital market are mutually reinforcing. One key element of the broader and deeper reform for China's financial system is to provide more diverse varieties of financial products and services for companies and households to turn huge savings to obtain into more productive investment other than low yielding bank deposits (Tam and Yu 2011). The development of institutional investors is an urgent need.

There are increasing laws on paper in China, however, legal enforcement and alternative informal mechanisms vary considerably in different provinces and regions in China. It is generally accepted that external governance mechanisms including China's financial market and legal systems as well as institutions are all underdeveloped.

Therefore, internal corporate governance mechanisms are especially crucial in protecting the interests of fund investors. With the concentration of state ownership in China, it provides additional governance issues. There is as yet little evidence that supervisory board is effective. Therefore, board of director effectiveness is the key to protect the interests of minority shareholder. However, in China, due to the presence of controlling shareholder, board independence is compromised as controlling shareholder determines the appointment, compensation and tenure of directors. In addition, there is a general lack of qualified and experienced candidates for board members. Therefore, a better understanding of what influences board effectiveness is critical in enhancing the corporate governance of Chinese listed companies and FMC.

CHAPTER 4

FMC IN CHINA

4.1 Introduction

As discussed in Chapter 2.2.5, given the increasingly dominant position of institutional investors in equity market in many countries across the world, their role and responsibilities in corporate governance are important. As a major institutional investor, the fund industry has gained increasing attention. In order to implement their role in the capital market and in improving the corporate governance of investee firms, the quality of corporate governance of fund management companies themselves are critical for this important role to be realized.

A better understanding of the historical development and structure of the Chinese fund industry is important for analysing the governance of China's FMC. The purpose of this chapter is to examine the overall development and pertinent changes in the fund industry, the governance structure and governance issues of Chinese FMC, and to review the relevant literature of FMC governance in China. A comparison of the organizational form between Chinese FMC and U.S. mutual fund is outlined so as to better understand to what extent governance issues in U.S. mutual fund could be considered in the context of the Chinese fund industry, and how could the richer literature of corporate governance of U.S. mutual funds inform and be used in this study given that most of extant literature of corporate governance of mutual fund focuses on the U.S.

4.2 Background of Fund Industry

This Section examines the development and evolution of the Chinese fund industry. It also provides an outline of the current situation of fund industry worldwide, and discusses major forms of organization of FMC. A close looks at the differences of fund organizational structure between the corporate form in the U.S. and contractual form in China.

4.2.1 The definition of managed fund and classification of FMC

There are different terminologies for the principal players in the fund management industry among different countries such as the U.S. and China. Details of the key differences are listed in Table 5. 'Mutual fund' refers to U.S. open end fund (OEF). More explanations of the

difference of fund industry between U.S. and China in terms of organizational structure are provided later in this chapter.

Table 5: Fund Management Terminology in the U.S. and China.

	U.S.	China
OEF	OEF is called mutual fund in U.S., each mutual fund is independent entity from investment company	OEF is called securities investment fund in China, which includes both OEF and CEF. In China, OEF is not an independent legal corporate entity
Fund investors	Fund shareholders	Fund unit holders (who are not shareholder of FMC)
Who manages and invests fund assets	Investment adviser	Fund management company(FMC) - Fund managers
Custodian body	Custodian banks independent from Investment adviser	Custodian banks independent from FMC
Fund managers	Staff of Fund adviser outside of mutual fund	Fund Management department (within the FMC)

Table 6: Classification of Funds.

	How shares are bought	Sale price	Shares outstanding
CEF	Stock exchange	Market price	Fixed
OEF	Directly through the managed fund / bank / other financial institution	Net asset value	Varies

Source: ICI 2009, p172.

A mutual fund with its declared investment objectives pools sums of money from fund investors, and invest in financial assets. Fund investors could diversify their investments, and benefit from professional investment management at a reasonable cost (Reilly & Brown 2005). Similar to mutual fund in the U.S., an OEF in China is created by FMC with its own investment objectives, and fund managers from FMC pools money from many fund investors.

There are in general two types of funds based on whether their shares are redeemable or not, namely open-end fund (OEF) and closed-end fund (CEF)⁸. The major differences are listed in Table 6. Open-end funds issue “redeemable securities” which the fund investors can redeem their fund holding at current net asset value (NAV). The NAV is calculated by dividing the total market value of the fund’s assets, minus its liabilities, by the number of mutual fund shares outstanding (ICI 2009). On other other hand, CEF issues a fixed number

⁸ Investment company act of 1940, sec 5(80a-5)(a); SEC, “Policy Implications,” sec 39-40

of shares that are publicly traded on stock exchange at market-determined prices. With CEF, FMC has no obligation to redeem fund investors' shares. Investors usually buy and sell their shares through a broker, which is similar to trading the shares of publicly traded companies (ICI 2012). CEFs and OEFs are different in terms of their portfolio holdings, fee structures, and investment strategies. "The redemption mechanism is the institutional difference that gives rise to very different fund-management organizations." (Cherkes 2012).

As stated in Chapter 3.3.2 of this thesis, by 2010, OEF's AUM reached RMB 2.42 trillion yuan, which is 17.17 times of those of CEF. It could be argued that the governance issues are very different between OEF and CEF in the U.S. as they have different organizational forms. In China, a FMC can manufacture and manage both OEF and CEF, this thesis focuses on FMC governance issues on the whole. Because of the limited size of CEF and different investment style of CEF from OEF, this study will focus only on OEF.

4.2.2 Forms of fund management companies

Distinguished by the difference in the underlying organization structure and governance, two distinctive forms of fund management companies are identified: the corporate model (dominant in the U.S.) and the contractual model (prevalent in China, Japan, Germany, and the U.K.).

In the U.S., a mutual fund, under the corporate model, is an independent legal entity owned by the fund investors as shareholders with the capacity to enter into contract, to sue or to be sued (Wallison and Robert 2007, p1). Board of directors of the mutual fund is responsible for protecting investors' (who are the shareholders) assets and ensuring that the managers' behaviours complies with all laws and pre-established rule and terms⁹.

In contrast, Unit Trust (UT) under the contractual model in the U.K. has no board of directors but a trustee to monitor the fund as well as managers' behaviours. Unlike a mutual fund in the U.S., an UT is not an independent legal entity, and has no board of directors or no issue of voting securities to fund investors, but is a trustee to protect the interests of investors (Sin 1997; Warburton 2008). Similar to the role of directors, the trustee is responsible for protecting investors' interests and ensuring that the manager complies with all applicable laws and pre-established rules and terms (Warburton 2008).

⁹ Investment company act of 1940, sec 16 Board of Directors.

Different from board of directors under the contractual form, trustee relies more on rules (i.e. standard terms or rules) than discretion to ensure the fund manager's compliance with applicable laws and pre-established rules with little or no discretion (Warburton 2008). For instance, a trustee of a unit trust could only remove a fund manager if his/her wrongdoings breach the rules that are specified in the regulations. However, board of directors under the corporate form is given considerate discretionary authority in protecting shareholders' interest with substantial business judgments rather than following guidance or decision rules (U.S. *Investment Act of 1940*).

Therefore, the trustee has relatively limited authority to monitor fund managers' behaviours compared with the board of directors. Constructed in the contractual form in China, each fund is not a legal corporate entity to enter into contract. FMC is the firm manufacturing and marketing different types of funds including OEF and/or CEF, with one board of directors charged with the role of monitoring all fund managers' behaviors and safeguarding all fund investors' assets in a FMC (Chinese Securities Investment Fund Law 2004). Fund investors are not shareholders of FMC as they only invest in one or more funds rather than in the share capital of the company. A board of directors has been given similar discretionary authority in making decisions and protecting interests of investors like a board of directors under the corporate form in the U.S.

4.2.3 Comparison of corporate form of mutual fund and contractual form of Chinese FMC

As noted above, a mutual fund, under the corporate model, is an independent legal entity. Each mutual fund under this model enters into a contract with an independent investment adviser who manages the fund's portfolio according to the objectives and policies written in the fund's prospectus. The management fee, usually a percentage of assets under management will be charged by the independent investment adviser to the mutual fund. Apart from the investment adviser, a mutual fund also requires several service providers including principal underwriter, administrator, transfer agent, custodian and independent public accountant. The U.S. mutual fund organization structure is showed in Figure 5. Fund shareholders pay additional fees for other services such as legal and auditing services and custodian services which are not provided by the adviser.

Mutual fund is usually created by an investment adviser. While each fund has a board of directors, and all the executive officers are employees of the investment adviser. However, the

percentage of independent directors is required to be at least 40% in 1940. The scandals of the late 1990s and early 2000s in the U.S. prompted the U.S. Securities and Exchange Commission (SEC) to change corporate governance practices in 2004, in particular board composition. Board independence in U.S. fund industry has received increasing attention by the SEC, and is discussed in more details in Chapter 5.3.

A mutual fund complex is a family of mutual funds, which provides more diversified types of fund. A fund complex providing services as both adviser and administrator usually consists of numerous funds. But there are some cases where advisory investment and administration services are separated. According to ICI 2012, the percentage of fund assets managed by larger fund complexes has increased in the past decade. The share of assets managed by the largest 25 complexes increased to 73 per cent in 2011 from 68 percent in 2000 (Table 7). The mutual fund industry in the U.S. is highly concentrated. Baumol et al. (1990) points out that “The increase in the size of the typical complex over time may well have exacerbated the comparative disadvantages of a small organization”.

Table 7: Share of Assets at the Largest Mutual Fund Complexes.

	1990	1995	2000	2005	2010	2011
Largest 5 complexes	34	34	32	37	40	40
Largest 10 complexes	53	48	44	48	53	53
Largest 15 complexes	75	71	68	70	74	73

Source: 2012 Investment Company Fact Book, ICI

Three-quarters of fund complexes were independent fund advisers, followed by non-U.S. fund advisers (10%), insurance companies (5%), banks or thrifts (7%), and brokerage firms (3%),(ICI 2012).

Figure 5: Organization Structure of U.S. Mutual Funds.

Source: ICI “*Investment Company Fact Book*” 2009

In China, a FMC is established as a limited liabilities company according to ‘*China’s Company Law*’ and must also be approved by China’s securities regulator, the CSRC. Each FMC in the contractual form manages several OEFs and/or CEFs. Figure 6 is the typical structure for FMC which is represented in this case by China International Fund Management Co., Ltd. There is a unitary board of directors overseeing the performance of all funds within the FMC. Different from normal industrial companies, a compliance officer is required to be established in FMC by “Article 2 of *A management procedure of FMC*”, who is in charge of ensuring the operations of funds and FMC are in compliance with the relevant law and regulations as well as internal risk control. The compliance office must provide independent reports to CSRC and the board of directors. Within the office of the compliance officer, a department of Inspection and Auditing is also mandated by China’s regulatory authorities.

Figure 6 : FMC typical organization structure in China.

Source: China International Fund Management Co., Ltd.

Most of the functions associated with administration, distribution and investment adviser are performed by different departments within the FMC in the contractual form in China, in contrast to such services being provided by either external advisor or administrator under the corporate form in the U.S. Chinese FMC perform similar function to U.S. investment adviser or more exactly like a fund complex providing most of services needed to operating a fund. On average, each FMC manages 12 funds with different investment objectives in China.

It could be argued that the most distinct difference between U.S. and Chinese fund is the status of fund investors. In China, fund investors are only fund unit holder rather than FMC shareholders. Whereas in the U.S., fund investors are fund shareholders as each mutual fund is a separate legal entity separate from a fund complex or administrators. In subsequent chapters, how this difference in terms of organizational structure affect governance issues will be examined in Chapter 5.2.

4.2.4 The global fund landscape

Even though the fund industry in China has seen dramatic growth in the last decade, AUM of Chinese funds is relatively small compared to other countries. At the end of 2010, China's aggregate AUM of OEF is equivalent to U.S. \$36.5 billion, which is approximately 1/37 of the AUM in U.S. mutual fund (Table 9). The number of funds in China is 1/27 of those in U.S. (Table 9). Given China is the second largest economy in the world, the stable and healthy development of Chinese fund industry is critically important to keep up with the growth of the economy to provide an effective investment channel in the development of a competitive financial system.

Figure 7 shows the ratio of mutual fund AUM/GDP from selected countries during 2004-2010. U.S. has the highest mutual fund AUM/GDP ratio of all sample years, followed by France, and United Kingdom, indicating the fund industry is well developed in those developed countries. In contrast, the proportion of mutual fund AUM/GDP in Japan, China and India are much lower. There is a slight increase from 2004 to 2010 for Chinese FMC AUM/GDP ratio. More importantly, the high proportion of mutual fund AUM of GDP in developed countries such as U.S. indicates the growth potential of fund industry in China and other emerging economies.

Table 8: Worldwide Total Net Assets of Mutual Funds.

<i>Millions of U.S. dollars, year-end</i>							
	2004	2005	2006	2007	2008	2009	2010
World	\$ 16,152,911	\$ 17,757,360	\$ 21,808,884	\$ 26,132,316	\$ 18,920,012	\$ 22,952,849	\$ 24,698,642
Americas	8,780,593	10,840,205	11,470,491	13,423,909	10,581,943	12,585,819	13,586,869
Argentina	2,355	3,626	6,155	6,789	3,867	4,470	5,179
Brazil	220,586	302,927	418,771	615,365	479,321	783,970	980,448
Canada	413,772	490,518	566,298	698,397	416,031	565,156	636,947
Chile	12,588	13,969	17,700	24,444	17,587	34,227	38,243
Costa Rica	1,053	804	1,018	1,203	1,098	1,309	1,470
Mexico	35,157	47,253	62,614	75,428	60,435	70,659	98,094
Trinidad and Tobago	N/A	N/A	N/A	N/A	N/A	5,832	5,812
United States	8,095,082	9,981,108	10,397,935	12,002,283	9,603,604	11,120,196	11,820,677
Europe	5,640,425	6,002,310	7,803,877	8,934,860	6,231,116	7,545,535	7,902,835
Austria	103,709	109,002	128,236	138,709	93,269	99,628	94,670
Belgium	118,373	115,314	137,291	149,842	105,057	106,721	96,288
Bulgaria	N/A	N/A	N/A	N/A	226	256	302
Czech Republic	4,859	5,334	6,488	7,595	5,260	5,436	5,508
Denmark	64,796	75,187	95,601	104,083	65,182	83,024	89,800
Finland	37,658	45,415	67,804	81,136	48,750	66,131	71,210
France	1,370,954	1,362,671	1,769,258	1,989,690	1,591,082	1,805,641	1,617,176
Germany	295,997	296,787	340,325	372,072	237,986	317,543	333,713
Greece	43,106	32,011	27,604	29,807	12,189	12,434	8,627
Hungary	4,932	6,113	8,472	12,573	9,188	11,052	11,532
Ireland	467,620	546,242	855,011	951,371	720,486	860,515	1,013,549
Italy	511,733	450,514	452,798	419,687	263,588	279,474	234,313
Liechtenstein	12,543	13,970	17,315	25,103	20,489	30,329	35,387
Luxembourg	1,396,131	1,635,785	2,188,278	2,685,065	1,860,763	2,293,973	2,512,874
Netherlands	102,134	94,357	108,560	113,759	77,379	95,512	85,924
Norway	29,911	40,111	54,075	74,709	41,157	71,170	84,505
Poland	12,015	17,651	28,959	45,542	17,782	23,025	25,595
Portugal	30,514	28,801	31,214	29,732	13,572	15,808	11,004
Romania	72	109	247	390	326	1,134	1,713
Russia	1,347	2,417	5,659	7,175	2,026	3,182	3,917
Slovakia	2,171	3,031	3,168	4,762	3,841	4,222	4,349
Slovenia	N/A	N/A	2,486	4,219	2,067	2,610	2,663
Spain	317,538	316,864	367,918	396,534	270,983	269,611	216,915
Sweden	107,064		176,968	194,955	113,331	170,277	205,449

			119,103					
Switzerland	94,405	116,669	159,517	176,282	135,052	168,260	261,893	
Turkey	18,112	21,760	15,462	22,609	15,404	19,426	19,545	
United Kingdom	492,731	547,092	755,163	897,460	504,681	729,141	854,413	
Asia and Pacific	1,677,887	1,939,251	2,456,492	3,678,326	2,037,536	2,715,234	3,067,323	
Australia	635,073	700,068	864,234	1,192,988	841,133	1,198,838	1,455,850	
China	N/A	N/A	N/A	434,063	276,303	381,207	364,985	
Hong Kong	343,638	460,517	631,055	818,421	N/A	N/A	N/A	
India	32,846	40,546	58,219	108,582	62,805	130,284	111,421	
Japan	399,462	470,044	578,883	713,998	575,327	660,666	785,504	
Korea, Rep. of	177,417	198,994	251,930	329,979	221,992	264,573	266,495	
New Zealand	11,171	10,332	12,892	14,925	10,612	17,657	19,562	
Pakistan	N/A	N/A	2,164	4,956	1,985	2,224	2,290	
Philippines	952	1,449	1,544	2,090	1,263	1,488	2,184	
Taiwan	77,328	57,301	55,571	58,323	46,116	58,297	59,032	
Africa	54,006	65,594	78,026	95,221	69,417	106,261	141,615	
South Africa	54,006	65,594	78,026	95,221	69,417	106,261	141,615	

Note: Funds of funds are not included except for France, Italy, and Luxembourg. Data include home-domiciled funds, except for Hong Kong, Korea, and New Zealand, which include home- and foreign-domiciled funds. N/A = not available Source: 2011 Investment Company Fact Book, Investment Company Institute.

Table 9: Worldwide Number of Mutual Funds.

<i>Year-end</i>	2004	2005	2006	2007	2008	2009	2010
World	55,523	56,867	61,855	66,288	69,032	67,552	69,519
Americas	14,063	13,763	14,475	15,460	16,459	16,954	18,019
Argentina	186	200	223	241	253	252	254
Brazil	2,859	2,685	2,907	3,381	4,169	4,744	5,618
Canada	1,915	1,695	1,764	2,038	2,015	2,075	2,117
Chile	537	683	926	1,260	1,484	1,691	1,912
Costa Rica	115	110	100	93	85	64	68
Mexico	411	416	437	420	431	407	434
Trinidad and Tobago	N/A	N/A	N/A	N/A	N/A	36	35
United States	8,040	7,974	8,118	8,027	8,022	7,685	7,581
Europe	29,306	30,060	33,151	35,210	36,780	34,899	35,292
Austria	840	881	948	1,070	1,065	1,016	1,016
Belgium	1,281	1,391	1,549	1,655	1,828	1,845	1,797
Bulgaria	N/A	N/A	N/A	N/A	81	85	90
Czech Republic	53	51	52	66	76	78	80
Denmark	423	471	494	500	489	483	490
Finland	280	333	376	379	389	377	366
France	7,908	7,758	8,092	8,243	8,301	7,982	7,791
Germany	1,041	1,076	1,199	1,462	1,675	2,067	2,106
Greece	262	247	247	230	239	210	213
Hungary	97	91	161	212	270	264	276
Ireland	2,088	2,127	2,531	2,898	3,097	2,721	2,899
Italy	1,142	1,035	989	924	742	675	650
Liechtenstein	171	200	233	391	335	348	409
Luxembourg	6,855	7,222	7,919	8,782	9,351	9,017	9,353
Netherlands	542	515	473	450	458	N/A	N/A
Norway	406	419	524	511	530	487	507
Poland	130	150	157	188	210	208	214
Portugal	163	169	175	180	184	171	171
Romania	19	23	32	41	52	51	56
Russia	210	257	358	533	528	480	462
Slovakia	40	43	43	54	56	54	58
Slovenia	N/A	N/A	96	106	125	125	130
Spain	2,559	2,672	3,235	2,940	2,944	2,588	2,486
Sweden	461	464	474	477	508	506	504
Switzerland	385	510	609	567	572	509	653
Turkey	240	275	282	294	304	286	311
United Kingdom	1,710	1,680	1,903	2,057	2,371	2,266	2,204
Asia and Pacific	11,617	12,427	13,479	14,847	14,909	14,795	15,265
Australia	N/A	N/A	N/A	N/A	N/A	N/A	N/A
China	N/A	N/A	N/A	341	429	547	660
Hong Kong	1,013	1,009	1,099	1,162	N/A	N/A	N/A
India	394	445	468	555	551	590	658
Japan	2,552	2,640	2,753	2,997	3,333	3,656	3,905
Korea, Rep. of	6,636	7,279	8,030	8,609	9,384	8,703	8,687
New Zealand	553	563	613	623	643	702	700
Pakistan	N/A	N/A	31	64	83	96	125
Philippines	24	32	38	40	43	41	43
Taiwan	445	459	447	456	443	460	487
Africa	537	617	750	831	884	904	943

South Africa	537	617	750	831	884	904	943
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Note: Funds of funds are not included except for France, Italy, and Luxembourg. Data include home-domiciled funds, except for Hong Kong, Korea, and New Zealand, which include home- and foreign-domiciled funds. N/A = not available.
Source: 2011 Investment Company Fact Book, Investment Company Institute.

Figure 7: Mutual fund AUM/GDP ratio of selected countries from 2004 to 2010.

Source: Wind database.

4.3 The importance of funds in China

This Section provides some background on how Chinese fund are run. It discusses the financial environment in China, development and evolution of the Chinese fund industry, the regulatory environment for Chinese fund industry, custodian banks and distribution channel, importance and governance issues associated with fund fees. Literature on corporate governance of FMC in China is also reviewed.

4.3.1 Financial background in China

Although individual investors still account for the biggest proportion of share in China's stock market (51.3% at the end of 2008), securities investment funds (25.7% at the end of 2008) are growing in importance in China's stock market as shown in Figure 8. In fact, the large number of individual investors represents a potential market for future securities investment fund growth because of their high rate of savings and improving social safety net in China.

The government has introduced a series of new policies to build free basic education, expand health insurance coverage for all, and extend social safety nets to the rural people over the last 5-6 years (Wong 2010). For instance, as of 2008, around 40% of the labour force in China (total is 775 million workers) were covered by one of the three government sponsors and/or other mandatory pension arrangements (Impavido et al. 2009). Since 2009, pilot of Pension System was officially launched, and people who are exceeding 60 and registered in pension system could receive pension every month. By three years, the total of 0.38billion old people registered in this pension system, and over 100 million registered old people have received pension fund every month¹⁰.

With the expected increase in the number of people entering pension funds, receiving free education and having health insurance coverage, more people who are insured may seek alternative investment channels with expected higher returns than bank deposits. There might be increasing amount of investment into the securities market by direct investment (share) or additional indirect investment (securities investment fund). As shown in Figure 9 and Figure 10, China continues to rank as the world's highest saver with the vast majority of household wealth held in cash and/cash equivalents. The high saving rate in China also provides great opportunity for further financial investments. Thus, securities investment fund are expected to experience fast growth in the future (Z-Ben Adviser 2009).

¹⁰ News from Xin Hua on "Pension system is launched, there are overall 0.38 billion people registered to pension fund " at 1 July 2012, http://news.xinhuanet.com/fortune/2012-07/01/c_112329298.htm

Figure 8: Market Shares of Different Types of Investors in terms of AUM in China's Stock Market (at the end of 2007)

Source: Qi 2008.

Figure 9: Gross national saving rates in selected Asia Pacific economies (2008)

Figure 10: Percentage of Household Wealth Held in Cash in Selected Asia Pacific Economies (2008)

Figure 11: FMC AUM/Market cap ratio from 2001 to 2010 in China.

Source: WIND database

Figure 11 shows the ratio of FMC AUM of Total market capitalization and negotiable market capitalization¹¹. As fund could only invest in negotiable securities in Chinese stock market, therefore, changes in terms of the negotiable market is more relevant to show the trend over times. It shows that since the inception of China's fund industry in 2001, FMC accounts for a very small proportion of negotiable market capitalization, but the ratio of FMC AUM/Negotiable market capitalization experienced a sharp increase from 2001 to 2008 with some significant volatility, then hit a record of 44% in 2005 and 42% in 2008, but dropped to 17.7% in 2009 and 13.2% in 2010. That sharp changes within several years may be partly due to the short term investment focus on Chinese fund investors, and may also be due to the general influence of the rise and fall of Chinese stock market performance.

As pointed out by Zhang (2012), due to the absence of long term institutional investors, Chinese investors tend to have short-term focus and overreact to market anticipations. When market anticipates positively, Chinese investors usually react too optimistically, and vice versa. Due to the significant role that institutional investors could play in the development of capital market and corporate governance of investee firms as explained in Chapter 2.2.5, China should encourage institutional investors, such as securities fund, pension fund, life insurance fund, index fund to engage in more long term investment and enhance corporate governance of investee firms.

4.3.2 Development of fund industry in China

While close-end funds (CEF) were the earliest form of fund in China, open-end funds (OEF) had developed rapidly in the last decade. As Figure 12 shows, AUM of CEF was RMB 70 billion yuan compared to RMB 11.8 billion yuan of OEF at the end of 2001. OEF AUM has risen sharply since its inception and surpassed CEF AUM by 2004. Year 2007 saw a significant rise of OEF's AUM to RMB 694.11 billion representing a doubling in size within three years. By 2010 OEF's AUM reached 2.42 trillion yuan in contrast to the RMB 140.95 billion yuan of CEF.

¹¹ Negotiable securities is the securities which could freely buy, sold, and transfer.

Figure 12: 2001-2010 OEF&CEF Net Asset under Management in China (RMB Billion).

Source: WIND database

Table 10 indicates that the top 10 FMC manage 48% AUM of total industry assets compared to the bottom 10 with only 1.08% market share. In terms of fund AUM, the Chinese fund industry is highly concentrated and very similar to U.S., as discussed in Chapter 3.2.3 of this thesis. The largest 10 U.S. fund complexes own 53% of AUM in the U.S. fund industry at the end of 2011. Given the apparent high industry concentration across countries, it is therefore worthwhile to investigate whether scale economics exists in Chinese fund industry, the empirical part of this study in Chapters 7 and 8 also address this question.

Most fund unit holders in China are individuals who together account for 71.18% of AUM, whereas institutions held 28.82% by the end of 2009 (WIND database). In the U.S., household held 89% of mutual fund assets (ICI 2012).

Table 11 presents different types of funds in China's FMC at the end of 2010. Accounting for 40% of the number of Chinese funds, equity funds had more than 50% AUM of the Chinese fund industry. It was followed by hybrid funds, accounting for 29% AUM with 167 funds. The combined number of bond funds and money market funds is 224, equal to 26.52% of the total number of funds, indicating the small proportion of these two fund types. AUM of other funds account for 9.37% of total fund AUM. Other funds include balanced funds, preservation funds, QDII funds and closed end funds.

Table 10: Chinese Fund Industry Landscape (Market share, September 2011).

	Rank	Market share	AUM(RMB bn)
China AMC	1	9.15%	197.80
Harvest	2	6.35%	137.24
E-Fund	3	5.92%	127.99
Bosera	4	5.11%	110.52
Southern	5	5.04%	109.04
GF	6	4.54%	98.11
Dacheng	7	3.54%	76.62
Hua'an	8	3.12%	67.36
Yinhua	9	3.05%	66.01
Full Goal	10	2.96%	64.10
ICBC Credit Suisse	11	2.50%	54.15
China International	12	2.39%	51.61
China Universal	13	2.34%	50.56
Lion	14	2.32%	50.19
Peng hua	15	2.15%	46.51
Rong tong	16	1.93%	41.64
BoComm Schroders	17	1.92%	41.55
INVECO Great Wall	18	1.90%	41.10
Guotai	19	1.88%	40.61
CCB Principal	20	1.84%	39.77
Fortune SG	21	1.74%	37.54
Ubs Sdic	22	1.65%	35.70
Changsheng	23	1.63%	35.34
HFT	24	1.63%	35.20
AEGON-industrial	25	1.52%	32.97
Huashang	26	1.47%	31.83
China Merchants	27	1.46%	31.64
Great Wall	28	1.38%	29.89
China Post & Capital	29	1.38%	29.83
BOC	30	1.37%	29.53
Everbright Pramerica	31	1.15%	24.88
Manulife TEDA	32	1.12%	24.16
Changxin	33	0.82%	17.65
Franklin Templeton Sealand	34	0.79%	17.00
ABC-CA	35	0.76%	16.46
Huatai-PineBridge	36	0.68%	14.74
CITIC-Prudential	37	0.67%	14.38
GTJA Allianz	38	0.66%	14.30
Galaxy	39	0.65%	14.11
Wanjia	40	0.64%	13.91
Zhonghai	41	0.64%	13.87
Soochow	42	0.59%	12.79
SWS MU	43	0.55%	11.99

Morgan Stanley Huaxin	44	0.48%	10.41
HSBC Jintrust	45	0.44%	9.53
Orient	46	0.40%	8.74
First Trust	47	0.39%	8.45
Baoying	48	0.38%	8.32
Harfor	49	0.37%	8.03
Golden Eagle	50	0.34%	7.43
First State Cinda	51	0.30%	6.54
New China	52	0.30%	6.52
Tianhong	53	0.29%	6.35
Lambarda China	54	0.28%	6.11
Yimin	55	0.23%	5.01
Lord Abbett China	56	0.18%	3.79
China Nature	57	0.17%	3.70
Ping An UOB	58	0.15%	3.21
Minsheng Royal	59	0.10%	2.22
AXA SPDB	60	0.06%	1.40
KBC-Goldstate	61	0.05%	1.14
Fuanda	62	0.05%	1.06
BNY Mellon Western	63	0.05%	1.03
Zheshang	64	0.04%	0.93

Source: Z-Ben Advisors report 2011.

Table 11: Net Asset Value (NAV) and Size of China's Securities Investment Funds on 31/12/2010
(RMB Million).

Fund type¹²	Number of Funds	AUM (Million)	AUM (%)	Fund unit holding (Million)
Equity funds	327	12,816,355	50.12	12,558,647
Bond funds	155	1,411,140	5.52	1,329,579
Hybrid funds	167	7,414,517	29.00	6,826,471
Money market funds	69	1,532,771	5.99	1,532,771
Other funds	96	2,396,484	9.37	2,353,539
All	814	25,571,267	100	24,601,008

Source: WIND database

¹² Article 29, Section 4 in 'Operation and management procedures for securities investment funds' defines the types of funds. It stipulates that equity funds are the funds with more than 60% of its AUM invested in stocks; bond funds have more than 80% of its AUM invested in bonds; funds only investing in money market is defined as money market funds; mixed funds includes investments in stock, bond and/ or money market which are not within the above three definitions; others represent non-fixed income funds which CSRC promulgates as other type.

It is generally accepted that equity funds are usually associated with relatively higher returns and higher risks compared to other types of funds such as bond funds and monetary funds. Fund investors are increasingly drawn to equity funds to invest which involves more return and risk during the stock market bloom in 2006-2007(Bin, 2008). However, investment in equity fund declined significantly after the impacts of the global financial crisis due to uncertainties over the economy.

4.3.3 Evolution of the fund industry in China in terms of fund standardization

Three stages in the evolution of Chinese fund industry may be identified (Zhou 2008):

The first stage was from 1991 to 1997. From 1991 onward, a number of funds were created to invest in securities and real estate by raising capital from the public but a large portion of their investments were invested in illiquid real estate. A total of 78 closed-end funds were established, with a total fund size of approximately US \$ 794 million by the end of 1996 (Qi 2008). Although these old funds developed and expanded rapidly in early years, they were found to have many problems in their operations. For instance, there was a lack of effective monitoring agencies and regulations in terms of their establishment, management and oversight of the assets of the fund, resulting in the poor protection of the interests of investors (He 2003, Yang 2007). Other major problems of China's fund industry were the problem of single fund model (only closed-end funds), small size of fund, narrow investment (most investment in illiquid real estate), and big differences between funds in their investment returns (He 2003; Yang 2007a; Zhou 2008).

The second stage was from 1997 to 2004. In November 1997, the "*Provisional Measures on Administration of Securities Investment Funds*" was promulgated by CSRC to regulate the FMC development (Qi 2008). CSRC replaced the People's Bank of China as the major regulator of FMC (Zhou 2008). In an attempt to standardize all the old funds, most of the old funds were required to be restructured; consolidated, relisted and meanwhile new funds were created and become listed in the stock exchange (He 2003).

Up to 2001, a total of 14 new fund management companies were approved by CSRC with 48 closed-end funds and RMB 81.7billion of assets under management (Yang 2007; Zhou 2008). In 2001, the first open-end fund was established based on the Open-end

Securities Investment Funds Pilot Schemes (Yang 2007; Zhou 2008). Since then open-end funds developed rapidly, and there were a total of 59 open-end funds with RMB 81.6 billion of assets under management by the end of 2004 (Zhou 2008). Notable milestones have been achieved during this stage including the introduction of the monitoring system for the fund management industry (CSRC, sub-institutions from CSRC and stock exchange), formation of relatively professional fund management companies, and funds becoming an important force of institutional investors in securities market (Zhou 2008).

The third stage is from 2004 onward. In 2004, '*Securities Investment Fund Law*' was promulgated by CSRC to regulate the rights and responsibilities of all parties, with a detailed set of provisions in terms of information disclosing, fund operations, securities investment activities and trading, investment objectives, requirements from prospectus, variations of contracts and etc. in protecting the rights of investors in the securities markets. Others major regulations related to the development of FMC are listed in Table 12. Table 13 outlines major product developments in China's fund industry.

Key developments in China's fund industry

When CEF emerged in China in 1991, they operated with low efficiency due to lack of experience, regulations and irregularly trading behaviours. CSRC cleaned up or restructured the "old funds" since 1998. OEF become the mainstream products since 2002, and at end of 2006, many types of fund products in mature markets were introduced in China as listed in Table 13, providing more choices for investors' needs and keeping pace with international markets.

Table 12: Major Regulations over FMC in China.

Year	Regulation Title
1997	Management Procedures for FMC
1999	FMC Management Procedures - Guidelines on information disclosure for FMC
2001	Notice about the Application and Establishment Procedures of FMC
2002	A Guidance and Advice for FMC Internal Control
2003	Notice about Performance Compensation in FMC
2004	China Fund Law
2004	FMC Distribution Procedures
2004	The Appointment Procedures for the Senior Officers of FMC
2006	Guidelines on other Content and Format of Compliance Director's Report in FMC
2006	Regulations about the Management of FMC Compliance Officer
2006	Code of Corporate Governance for FMC

2007	Guidance on Internal Control for the Distribution Organizations of FMC
2008	Guidance for Fair Trading System for FMC
2008	The Appointment Procedures for the Senior Officers of FMC
2009	Management Procedures for Distribution Fees of OEF
2010	Models for FMC Information Disclosure
2011	Revised version of Guidance for Fair Trading System for FMC
2012	"Fund and Institutions Regulatory and Surveillance Task" system launched to monitor trading activities
2012	Revised version of China Fund Law

Source: CSRC.

Table 13: Major product development in China's fund management industry.

1991	close-end fund launched
1998	close-end fund launched (restructured and listed in stock exchange)
2001	open-end fund launched
2002	bond fund and index fund launched
2003	umbrella fund, principal-guaranteed fund, and money market fund launched
2004	convertible bond fund, listed open-end fund, and exchange traded fund launched
2005	mid/short-term bond fund launched
2006	QDII fund launched
2007	open-end fund QDII; first new style CEF
2008	first certificate to manage assets of a specific client
2009	first permission to manage the assets for multiple specific clients
2010	allow for margin trading and short selling
2011	first RQFII (RMB Qualified Foreign Institutional Investors)
2012	first arbitrage private fund

Source: CSRC website.

Table 14: Samples of Publicly Reported Scandals in Chinese FMC.

Year	FMC	Alleged nature of scandals
2003	Shantou Shun Jin Asset Management	Insider trading
2007	China International Fund Management	Insider trading
2007	Anxin Trust & Investment	Information disclosure
2009	Rong Tong	Insider trading
2010	Great Wall	Insider trading
2010	INVESCO Great Wall	Insider trading, Market timing strategy and Internal control problem.
2011	Southeast Securities	Insider trading
2011	Everbright Pramerica	Insider trading
2011	Great Wall	Insider trading
2011	Franklin Templeton Sealand	Insider trading
2012	Investchina Xinyatai Investment Management	Market timing strategy

Source: CSRC

There are four major categories of breaches in Chinese fund industry reported by CSRC over the last decade including insider trading, market timing strategy, problems of internal control and fail to disclose appropriately (Table 14).

Insider trading is the most prevalent problem in Chinese fund industry. “Lao Shu Cang” is one type of insider trading, and is generally considered as the most common form of inside trading in China. “Lao Shu Cang” refers to one gains unpublished trading information through the position and take advantage of this information to trade. For instance, famous “Jian Tang¹³” event. Tangjian is an assistant to fund manager of Morgan Stanley Huaxin Co. He purchased stock using his own account before he invested fund assets so that stock price rose, he stood to make significant private profit.

Article 18 and 43 of “*Chinese Fund Law*” (2004) stipulates that fund managers should not participate in activities which damage fund assets and the interests of fund unit holders. Article 79 of Securities Law stipulates that if the activities of officers from FMC or custodian damage fund assets and the interests of fund unit holders, officers should compensate the damage; if it is serious, the qualification licence of fund officer is required to be cancelled; if it is charged as a crime, the wrong doer will be criminally responsible. This regulation did not specify the penalty clearly. In 2009, Article 180 of “Criminal Law” was revised and stipulates that fund managers who participate in “Lao Shu Cang” may compensate 1 to 5 times of the damages as a penalty depending on the situation, and the wrong doer may be sentenced up to 10 years in prison as penalty. It is hoped that the severe penalty will help curb the prevalent practice of “Lao Shu Cang” in China.

INVESCO Great Wall (IGW) is a FMC in China and was reported by CSRC in 2010 to have committed a series of problems such as insider trading, market timing strategy and internal control. Internal control is the major issue in terms of supervision and management of fund managers, IGW compliance officer cannot fulfill their responsibility, IGW did not manage stocks according to its constitution, IGW investment trading system is unsound. Those problems breached “Regulations about the Management of FMC Compliance Officer” 2006, “A Guidance and Advice for FMC Internal Control” 2002, and “The Appointment Procedures for the Senior Officers of FMC” 2004.

Other scandals reported by Chinese media included issues on “Transferring” and “Due diligence”. The transferring refers to fund managers/senior officers deliberately benefit the

¹³ News of “A penalty decision from CSRC (Jian Tang)” (reported on 21 April 2008) on http://news.xinhuanet.com/fortune/2008-04/21/content_8022512.htm

interests of other party but damage the interests of fund unit holders. For instance, in the notorious “Fanghe Han” event¹⁴. Fanghe Han received RMB 4 million to manipulate stock prices with Yonglin Yuan (Ex- Chairman of Shanghai Haixin Group). He was sentenced to 18 years in prison for collusion and breaching the law on manipulation of stock price.

The “Due diligence” issue refers to fund managers who did not operate fund assets in compliance with the regulations required by law such as overpurchasing certain stocks and trading later than regulation allows. As stipulated in Article 9 of “*Chinese Fund Law*” and Article 25 of “*Trust Law*”, fund managers should act in good faith, prudence and diligence. FMC should monitor and train fund managers to minimize the damages from these breaches. For instance, five funds under Hua An FMC, Southern FMC, ABN AMRO TEDA, did not trade according to regulations leading to overall RMB 2.2million losses of fund assets¹⁵.

HeSun (2009) point out that the value of AUM that funds are required to be reported periodically is normally manipulated by senior managers in FMC. If there is a big rise in stock price on fund investment portfolio, pressure for redemption of fund unit share is high on that day. Therefore, FMC hide part of the gains by undervaluing its fund AUM(He & Sun 2009). CSRC in 2008 promulgates the valuation methods of fund assets in “*Further Regulating the Operations of Securities Investment Funds*” to mitigate those manipulative practices. However, fund AUM are still frequently undervalued just in other forms (He & Sun 2009).

Those frequent scandals including manager’s self-serving behaviours and poor internal control damages the interests of investors, how to enhance the corporate governance of those FMC is vital to protect the interests of fund investors.

4.3.4 Supervision of fund industry in China

The problem of insider trading is the most prevalent and serious problem in Chinese fund industry. In recent years, CSRC has promulgated a number of rules and regulations to

¹⁴ News of “Ex-CEO of Hau An fund management company charged 18 years of prison” reported by JRJ.com on 26 September 2007, on <http://fund.jrj.com.cn/2007/09/000002730384.shtml>.

¹⁵ News of “Delaying in executing convertible bonds” by Yahoo Caijing on 26 September 2007, on <http://fund.jrj.com.cn/2007/09/000002730384.shtml>

mitigate the problem of insider trading associated with the problem of internal control, unusual trading monitoring system¹⁶ to enhance the corporate governance of those FMC.

Article 26 of the revised version of “*Guidance of management for the fund management companies*” in 2009 stipulates that FMC should implement sound communication management system and to enhance management of all types of communication tools. For instance, FMC should record all conversations through fixed phone. Communication devices of fund traders’ such as mobile phones and laptops should be kept centrally daily during office hours. Other types of instant communication tools such as MSN and QQ should to be monitored during the entire trading process. All records should be kept for five years.

In response to this policy, several FMC report that they have established sound Fair Trade system in their companies. For instance, CCB Principal Asset Management Co., Ltd report¹⁷ installed “Fair Trade Module” to mitigate the problem of insider trading. If different funds purchase the same securities exceeding certain amount at the same time, this system will automatically transfer to Fair Trade Module to operate. They suggest this system will strictly prohibit transferring between different parties either directly or indirectly through third party.

Morgan Stanley Huaxin Ji Fund Management Co., Ltd.report¹⁸ that sound control system in terms of research quality, audit of stock storage, investment decisions, fund managers permissions, trading, and afterwards checks and balances to ensure effective risk prevention and compliance in the process of from research to investment, and then to trade have been established. They also implement the entire records of staff’s fixed phone, emails, and other communication means ect to record the entire process and backup monitoring, to ensure there are records for this whole process.

According to interview of Zhifeng Xu¹⁹ Vice-president of CSRC, in general the number of cases related to insider trading against formal investigation cases is increasing over recent years although more efforts have been implement to curb this problem. For instance, he said the percentage of cases related to insider trading accounting for all CSRC formal investigation

¹⁶News of “CSRC introduce measures to prevent the problem of “Lao Shu Cang” from four aspects ” reported by Caijing, at 25 September 2007 on(http://news.xinhuanet.com/newscenter/2007-09/25/content_6791292.htm)

¹⁷ News of “A report of the second quarter of Equity securities investment funds of CCB Principal Asset Management Co., Ltd”, reported by Sina Finance on 18 July 2012 on <http://finance.sina.com.cn/stock/t/20120718/070612593975.shtml>

¹⁸ News of “Morgan Stanley Huaxin Ji Fund Management Co., Ltd deny the insider trading and stock price manipulation”, report by Caijing on 17 January 2012 on <http://finance.caijing.com.cn/2012-01-17/111624042.html>

¹⁹ News of “Insider trading subvert the foundation of the stock market” on CSRC website on 25 May 2012, http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201205/t20120525_210592.htm

cases are 38%、56%、71%、61% from 2008 to 2011, and among this, the proportion of cases relating to insider trading out of transferring the cases to police are 15%、42%、50% and 80% from 2008 to 2011.

It may suggest even the relevant rules and regulations are well-written, whether they could be enforced effectively is hard to measure. Even FMC report that they have implemented relevant systems and modules to prevent and mitigate the problem of insider trading, however, CSRC report there are three “Lao Shu Cang” event happened in the first 11 month of 2011.

Earlier 2012, CSRC have recruited and trained more than 200 officials with relevant background, and stationed in Shanghai, Beijing, Hangzhou, Shenzhen, and other major regions to carry out inspection work in terms of insider trading²⁰. It is said that this is the largest regulatory action from CSRC. CSRC put effort to enhance the internal control of FMC to protect the interests of investors; however, it is yet to see the outcome of those regulatory actions.

CSRC revised “China Fund Law” in July 2012. Several key amended articles are identified which is important to enhance the corporate governance of FMC. They include:

Article 19: if senior officers of FMC want to purchase/sell securities, they must report to FMC first, and should not have any conflict of interests to fund investors.

Article 19 senior officers of FMC should avoid using their position to benefit themselves which may detriment the interests of investors.

Article 23(a): FMC should establish good corporate governance, and to clarify the function of shareholders committee, board of directors, supervisory board, and senior managers, to ensure FMC is operated independently from major shareholders.
(b)FMC could implement stock compensation system, to establish long term compensation scheme for senior managers.

Article 23(a) is to constrain and clarify senior executives powers to mitigate the problem of insider control where dominant executives take advantages of their power and position to intervene in company’s daily operations outside their authority. Article

²⁰ News of “Regulatory storm: CSRC send 200 people to investigate the problem of insider trading at national level”, reported by Sohu on 9 July 2012 on <http://stock.sohu.com/20120709/n347621248.shtml>.

23(b) is to align the interests of senior managers and fund managers to the interests of FMC and fund investors to avoid self-serving behaviors.

Article 25: FMC shareholder, especially dominant shareholders, should not infringe on the rights of other shareholder and board of directors to intervene in the daily operational activities.

Article 26: if FMC breaches FMC constitution, code of corporate governance, internal control and/or risk management policies, leading to the detriment for interests of fund investors, the two major penalties are associated with senior officers are:

(a) Limitations should be imposed on dividends distribution, and on payments of remuneration and provision of other benefits to directors, supervisors and senior managers.

(b) Replace board of directors, members on supervisory board, senior managers, or restrict their rights.

These articles are just example to indicate that CSRC has identified the more frequent problems and put in places measures to enhance the corporate governance of FMC to protect the interests of investors.

Significant progress has been made in terms of imposing punishment for breaches. The revised “*China’s Fund Law (2012)*” clarifies the penalty for breaches which was ambiguous in the original version. For instance, Article 26 as discussed above clearly aligns the misconduct to those officers who are directly in charge of those tasks.

As Association of Investment Fund was established in Beijing in July 2012, in the hope that professional association could enhance competition, stimulate innovations, and promote better corporate governance of FMC²¹.

CSRC has identified some of the weaknesses and failures of corporate governance in the fund industry. It institutes increasing regulations and rules in fund industry to enhance FMC corporate governance. However, whether these rules and regulations could be enforced effectively is hard to ascertain precisely. Thus, internal corporate governance is critically

²¹ News of “The association of investment fund is established in Beijing at July 2012” on CSRC websites on 7 June 2012 on http://www.csrc.gov.cn/pub/newsite/bgt/xwdd/201206/t20120607_211192.htm.

important to protect the interests of fund investors, and the central mechanism is board effectiveness.

4.3.5 Custodian banks and distribution channel for funds in China

According to Article 29 Chapter 3 of “*Chinese Fund Law*”, the function of a custodian bank is to provide a true, accurate and complete report to CSRC to detail the investment and operation of a fund. Custodian bank should report to CSRC immediately if they notice any violations that FMC may breach the law, regulations or clauses in the fund contract (Article 30 Chapter 3 of “*Chinese Fund Law*”). Like custodians in the U.S., the role of custodian in China is usually taken up by major Chinese banks such as China’s Construction Bank, Industrial and Commercial Banks of China, Bank of China, Agricultural Banks. Custodian banks are required by law to be independent from FMC.

Table 15 shows that the NAV and number of managed funds in Chinese custodian banks at the end of 2009, and it is reported by CSRC that there are 18 custodian banks in August 2012 (CSRC website). The first 5 banks managed RMB 2155.507 billion at the end of 2009, accounting for 91.21% all AUM of mutual funds. Custodian banks for China’s fund industry have a highly concentrated structure. “*Management Procedure for the Qualifications of Custodian Bank of Securities Investment Funds*” stipulates that applicants seeking to become a custodian for a fund must be a commercial bank which continually has net assets of more than RMB 2 billion in the last three financial years. This regulation excludes trusts, securities companies or other types of financial institutions or smaller banks. There are overall 14 banks as custodian bank for FMC in China at the end of 2009. The overall assets under custodian supervision by 18 custodian banks are 1.415 billion by 2011 from 0.375 billion in 2009, which growth rate at 277.17%²². The report stress that custodian industry could help reduce transaction costs and solve the problem of information asymmetry in Chinese fund industry.

However, whether China’s fund custodian industry could play its roles is controversial. First, custodian banks normally charge 0.25% of AUM directly from the fund assets the custodian supervises (Zhou 2008). Because custodian fee charged by custodian banks is directly related to the proportion of fund AUM, custodian bank has ban incentive to encourage the expansion of the fund AUM rather than focusing on monitoring FMC. Even if

²² A report on the ‘development of China’s custodian industry in 2011’ written by 11 custodian banks on September 2012. . http://product.dangdang.com/main/product.aspx?product_id=22905488

they find some violations occurred to FMC, custodian banks are less likely to report to CSRC as their profits could be affected if FMC reputation is damaged (Xi 2011). Therefore, there is a question whether the compensation of custodian banks which are aligned with FMC rather than with fund investors could curb the custodian's willingness to monitor. However, research and data in this area are scarce.

In addition, most of FMC shareholders are financial institutions such as banks, investment companies, trust, insurance companies ect. Custodian banks are more likely to have some relationships rather than custodianship with FMC through FMC dominant shareholders or FMC themselves which could jeopardize custodian banks' supervision. Those relationships could lead to conflict of interests, related party transactions, or others among those associated organizations (Xi 2011).

Table 15: The NAV and Quantity Number of Managed Funds in Custodian Bank of China 31.12.2009.
(RMB)

No.	Custodian Bank	NAV (Million)	Number of funds	Market Share (%)
1	Industrial and Commercial Bank of China	756,684	159	29.36
2	China Construction Bank	627,863	159	23.02
3	Bank of China	422,009	86	17.29
4	Agricultural Bank of China	327,016	72	13.19
5	Bank of Communications	194,765	45	8.35
6	China Everbright Bank	52,534	11	2.24
7	China Merchants Bank	47,848	22	1.94
8	Industrial Bank	45,824	12	1.46
9	SPD Bank	33,635	9	1.28
10	China Mingsheng Banking	23,321	7	0.96
11	Huaxia Bank	9,931	6	0.45
12	China Citic Bank	10,546	4	0.38
13	Postal Savings Bank of China	1,478	1	0.06
14	Shenzhen Development Bank	432	1	0.02
Total		2,553,886	594	100

Source: Wind database

In terms of distribution channel of fund products, there are direct distribution and indirect distribution. Direct distribution is through FMC's own website or counters in different locations. Indirect distribution is primarily through banks and securities companies. In China, banks are the predominant distribution channel for funds. a number of issues in distribution channel for Chinese fund industry can be identified. First, bank as the traditional financial services provider in China has a wide coverage so that potential fund investors or

existing fund investors can easily access to fund products (Chen 2011b). However, bank staff generally lacks detailed knowledge of fund products so that fund investors or potential investors could not be fully informed about the merits and weaknesses of fund products. Second, FMC usually have no contact details of fund investors so FMC could not provide further information to them²³.

The four state-owned commercial banks are currently the most popular sites in broadcasting fund products, and these banks will choose quality FMC or those FMC pay them the best fees to work with. Banks promote different types of financial products, smaller or young FMC may find it hard to find distribution channel or face relatively more expensive distribution fees. For instance, if the FMC is also a subsidiary of the commercial bank, the commercial bank will clearly be more inclined to sell funds from its own subsidiary first. Even if a major bank acts as a distributor, it is the local (provincial or city) branches that are the actual distributor; it is also rare for all local branches of a national bank to exert the same level of efforts and promotion for a FMC's fund product²⁴.

4.3.6 Fund Fees

Fund investors seek to maximize their fund returns. Thus, minimizing fees and expenditures is one of the keys to achieving superior returns; whereas fund fees enrich FMC and are the major income source of FMC and its managers (Kong and Tang 2008; He 2005). The findings of both Chapter 7 and Chapter 8 of this thesis indicate that the level of fees charged by a FMC significantly reduces FMC performance affirms this argument. Therefore, there is an inherent conflict of interests between FMC and fund investors because of the fee setting, and fees charged by FMC to fund investors are important for investors, FMC, and policy makers. With the characteristics of the corporate model of U.S. mutual fund where each fund is an independent entity, most of extant literature use fees at the fund level as proxy of board effectiveness (Kong and Tang 2008; Ferris and Yan 2007). Given the generally accepted central position the board of directors has in China's fund industry as discussed in Chapter 5.3 and following existing relevant literature, this study uses FMC total expense ratio (TER) as a measure of board effectiveness in China to investigate how key governance variables impact on board effectiveness in the contractual form of FMC in China (Chapter 7).

²³ Interview notes with a FMC general manager from First State –Cindy Fund Management Company on 7 June 2012.

²⁴ Interview notes with an independent director of a joint venture FMC from First State –Cindy Fund Management Company on 10 July 2011.

There are different types of fees²⁵ charged to fund investors, which are somewhat similar in the U.S. and China. In the U.S., there is a strict disclosure requirement relating to fund fees. TER is required by law to be included in the report for investors in the U.S. However, in China there is no relevant regulation to require FMC to report them. Chinese fund investors may or may not be fully aware and understand the effect of those expenses upon fund returns.

Table 16 shows that equity funds occupy the largest proportion of AUM of China's fund industry, followed by mixed fund. In 2010, overall AUM of equity fund and mixed fund was RMB 2023 billion accounting for 84% of total AUM of the Chinese fund industry. It could be argued that managing equity, mixed and other non-fixed income funds normally requires greater input and more active efforts, perhaps higher skills, and more time by fund managers in their investment strategies than bonds and money market funds.

Mixed funds on average charge the highest TER from 2005 to 2010 followed by equity fund (Table 16). It is worthwhile to note that the year of 2008 witnessed the highest TER for non-fixed income funds such as equity, mixed and other funds although there was a significant drop in AUM except for bond funds. This could be due to the fact that up-front fee charges on the huge inflow of investment into managed funds prior to the global finance crisis, redemption volume however rapidly rose following the crisis and AUM dropped.

Compare the fund TER between U.S. and China, U.S. has seen a declining trend over the past two decades since 1990 (Table 17). TER of equity funds in 2010 was less than half of TER in Chinese equity or mixed fund. As reported by ICI (2011), the steep decline in fees in U.S. mutual fund can be attributed to the growth of mutual fund sales through employer-sponsored retirement plans. Its loads²⁶ for purchases of fund shares are often waived through such retirement plans. U.S. has more intense competition in the fund industry which could drive down cost and fees. The big gap of TER between Chinese and U.S. fund may signal the presence of greater agency costs and deserves better understanding and investigation.

²⁵ According to Article 34 of China's "A management procedure of FMC operation" in 2004 stipulates that fees could be charged to fund investors, including management fees, custodian fees, disclosure fees, fees for hiring accountant and lawyer, fees for holding the meeting for fund investors, trading fees, and other fees regulated in relevant regulation and FMC-investor contact.

²⁶ The fund investor pays the load to compensate the service of a sales intermediary (broker, financial planner, investment advisor, etc.). (ICI 2012)

Table 16: Average fund total expense ratio 2005-2010 in China.

	2005	2006	2007	2008	2009	2010
Equity (%)	1.45	1.34	2.26	3.52	2.43	2.45
Mixed (%)	1.91	1.65	2.86	3.94	2.82	2.72
Bond (%)	1.19	2.68	1.6	1.32	2.46	-
Money market (%)	0.93	1.95	0.91	0.5	1.74	1.84
Others (%)	1.72	1.37	2.62	4.94	2.29	2.46

Source: Wind database

Table 17: Asset-weighted fund total expense ratio on selected year in the U.S.

	1990	1995	2000	2005	2008	2011
Equity funds (%)	0.99	1.06	0.99	0.91	0.83	0.79
Hybrid funds (%)	1.02	0.97	0.89	0.8	0.77	0.8
Bond funds (%)	0.88	0.84	0.76	0.69	0.61	0.62

Note: total expense ratios are measured as asset-weighted averages.

Source: Investment Company Institute and Lipper, ICI 2012.

Several factors affect total expense ratio. First, expense ratios often vary inversely with fund assets, simply because of the way of the ratio is calculated. Certain fund costs – such as transfer agency fees, accounting and audit fees, and directors’ fees – are more or less fixed in dollar terms regardless of fund size. In principle, when the value of fund assets rises, these fixed costs become smaller relative to those assets (ICI 2012), thus, a fund’s total expense ratio should be reduced. However, as shown in Figure 12, AUM of 2007 reached the record level of RMB 3039.33 billion, which is more than 4 times the size of AUM in 2006, and TER on average actually rose to 2.26% (2007) from 1.34 (2006), and then even going up to 3.52% in 2008 and stayed high during the years of 2009 to 2010 despite a sharp drop of AUM in 2008 and fluctuations of AUM between 2008 and 2010. It seems that fund expenses have not been pushed down by economies of scale and competition within the fund industry in China, there has been relatively high fees and expenses charged by FMC to fund investors regardless of the changes in AUM. This may suggest that significant agency costs exist in Chinese fund industry. How to protect the interest of fund investors are therefore vital to the healthy development of fund industry.

As listed above, in 2001, CSRC stipulates that the management fee must be charged on a fixed rate over assets under management (AUM), which is paid directly from the fund’s assets and calculated as a percentage of the net assets in the portfolio, as compensation for the contractual investment advice and contractual administrative services provided to the fund by FMC.

Wang (2009) argues that the current “management fee” payment system may motivate FMC to focus on fund AUM rather than fund performance, which may be detrimental to the

interests of fund investors. Using TER as a proxy for board effectiveness, this study will test what specific internal governance mechanisms enhance board effectiveness.

4.4 Literature on Chinese Corporate governance of FMC

Most studies on China's FMC focus on individual fund performance and fee structure. An empirical study by Gao and Wang (2005) on the relation between individual fund characteristics and fee levels find that fund/FMC size and number of funds within FMC has no impact on fund fee levels. They find the higher the fund turnover rate, the more diversified in their portfolio and the older the fund will lead to higher fee level (Gao & Wang 2005). Similar results shows that fund size and the age of fund have no relation with fund fees but fund types and their fund investment strategies have an impact (Xia & Tang 2009).

Some descriptive comparative studies have compared the fee level in China and the U.S (Luo 2008). Luo (2008) investigates the existing problems related to fund fees charged by Chinese FMC such as simple and excessive management fees rate compared to those in the U.S. An empirical study by Zeng et al. (2005) focuses on the relation between fund fee and fund performance. They provide evidence that better performed funds are negatively related to fund fee level, whereas underperformed funds have positive relation to fund fees.

Xu and Deng (2004) offer little empirical evidence other than giving a brief introduction on the basic composition of the expenses and rate level of the securities investment fund, analyzing the characteristics of the fund rate level.

At present, studies on China's FMC and its corporate governance are scant. He (2003) argues the interests and objectives of fund investors and FMC shareholders are the same in the long term, but different and contradictory in the short term. For instance, he notes that managers may engage in irregularities such as over allocation to support share prices in order to maximize profit in the short term. Such behavior is detrimental to the interests of fund investors and may even violate the law. Ji (2010) find that FMC with the presence of foreign shareholding outperform those of companies without foreign shareholding. She also finds that there is a presence of economies of scale in fund industry in China. Yin et. al. (Yin et al. 2011) document that incentive and restraint mechanism of management compensation has no impact on the performance of equity funds.

Some earlier studies provide only theoretical analysis as there is a lack of data for their studies since open-end fund only started since 2001 in China. For instance, Ou and Sun (2001)

offers a comparative study on the corporate governance of FMC in China and U.S.; Yu (2002) investigates the role and functions of board of directors in FMC (Yu 2002); Meng (2003) explain the theory of corporate governance FMC from both internal and external corporate governance mechanisms (Meng 2003). Zhou (2008) stresses the need for better corporate governance by introducing more use of incentive-based compensation.

The limited studies on China's FMC corporate governance have tended to be based on conjecture and not empirically tested. This thesis will fill a gap in the literature by providing analytical model and empirical tests to investigate corporate governance of FMC. Thus, examining the effectiveness of FMC governance will enhance better understanding for improving their corporate governance. FMC with strong governance will gain greater ability to implement their expected functions in the capital markets and in the corporate governance of investee firms.

4.5 Conclusion

There is an increasing anticipation for China's fund industry to function not only as important investment channel but more importantly as a shareholder of investee firms to enhance corporate governance of those investee firms. Given China's lack of long term investment perspective in the capital market and generally poor performance in corporate governance of publicly listed companies, there is an urgent need to develop a well-functioning fund industry. Unlike mutual funds in the form of corporate model, fund investors under the contractual form of FMC in China have different status. This Chapter examines the differences between these two major organization forms of fund management companies in order to better understand the governance issues associated with them.

Even though Chinese funds have a very short history for over a decade, and they have developed quite rapidly. In China, fund investors are not shareholders of FMC and there is lack of direct representation for fund investors in FMC governance. This issue is aggravated by the presence of conflict of interests between fund investors and FMC shareholders. Regulations have been put in place to protect the interests of fund investors. The ever present agency problems are evidenced by constant media and official reports of scandals such as frequent incidences of insider trading, tunnelling, and market timing strategies.

The newly amended "*Chinese Fund Law*" (2012) identifies several key governance issues in Chinese fund industry including dominant shareholders' daily unauthorised

interventions in operations, frequent insider trading activities, lack of incentive based compensation system for senior managers, and ambiguity of penalty for breaking the law and regulation. Custodian banks as one of the major supervision body may also lack motivation to work in the best interests of fund investors given the conflict of interest between custodian bank and fund investors, as well as the possible complex relationship between custodian bank and FMC.

Fund expenses and fees are the major income source for FMC, which can reduce fund returns for fund investors. FMC fees are a key element in the quest for protection of fund investors. Even though the magnitude of AUM has risen significantly over the last decade, fund fee has showed an increasing trend. That may suggest significant agency problems in Chinese fund industry. This thesis investigates what internal governance settings could enhance FMC governance and performance so the agency costs are mitigated and interests of investors are better protected.

CHAPTER 5

THEORETICAL ANALYSIS AND HYPOTHESES DEVELOPMENT

5.1 Introduction

Under the contractual form of FMC in China, fund investors are not shareholders of FMC, as distinct from the corporate form of mutual fund in the U.S. where fund investors are also fund shareholders (see Chapter 4.2.3.). There is a conflict of interests between FMC and fund investors as fund fees are the major income source for FMC which reduce fund returns for fund investors. The complex structure of FMC provides additional governance issues compared to publicly listed companies. The generally weak external governance mechanisms make the internal governance mechanisms particularly important and relevant in China's fund industry. Both in the literature and in practice, the board of directors is considered as the central governance mechanism to protect the interest of fund investors.

The first major research question for this study is to investigate what specific governance setting could enhance board effectiveness. The second research question of this study examines how the totality of corporate governance quality affects FMC performance, and the relation between the specific governance mechanisms and FMC performance. The extant literature on U.S. mutual fund focuses on how board composition and characterises influence board effectiveness. This study also considers the impact on board effectiveness and FMC performance from shareholder profile and composition, but will also incorporate unique characterises of supervisory board, and the role of compensation committee.

This chapter starts with an analysis of the key governance issues under the contractual form of fund companies in China to better understand the problems and challenges facing the Chinese fund industry. The relevant literature relating to the dissertation's two major research questions is reviewed, followed by hypothesis development for testing in the empirical part of the thesis in Chapter 7 and Chapter 8.

5.2 Major governance issues of Chinese FMC

As discussed in Chapter 4.3.6, the profit maximization motive of FMC is realized primarily by increasing the size of assets under management (AUM) so that greater amount of fees can be earned. It is generally accepted that the remuneration of senior managers especially incentive payments in the Chinese fund industry are commonly based on the total AUM a FMC manages. The interests of FMC shareholders and senior managers, who could all be considered as “insiders”, in this important respect, are aligned.

On the other hand, fund investors seek the highest possible returns on their investment after fees and expenses. As discussed in Chapter 4.3.6, the change of fund AUM which is used to calculate fund returns has no impact on fund TER suggesting that there is a misalignment of interests between fund investors and FMC performance. Therefore, it could be argued that immediate personal benefits of FMC insiders are aligned with fees FMC charge but not directly linked to FMC performance.

As a result, there is a conflict of interests between fund investors and FMC because of contrary objectives regarding fees that FMC charge, leading to agency problems. This study adopts agency perspective as the main theoretical underpinning to examine the agency problem between fund investors and FMC.

Under the corporate form of mutual funds in the U.S., fee setting is generally regarded by the extant literature as the most transparent manifestation of the conflicts of interests between the fund investors and the fund management company (fund advisors) (Ferris & Yan 2007; Kong & Tang 2008; Tufano & Sevick 1997). Fee settings as important a governance issue under the contractual form of FMC in China as in U.S. mutual fund because of similar conflict of interests between FMC and Chinese fund investors. However, unlike U.S. fund investors who are also fund shareholders, Chinese fund investors are only fund unit holders due to the different structure of U.S. mutual fund and Chinese FMC as detailed in Chapter 4.2.3.

The governance issues of a Chinese FMC (as shown in Figure 13) shows there is a lack of direct representation for fund investors in FMC governance. If fund investors are not satisfied with FMC management or performance, they could really only exit and leave the fund, which incurs costs. In principle, a general meeting for fund investors can be called but it can only be convened when more than 10% of fund investors call for a meeting and 50% of fund investors attend the meeting (Article 72 and 75, *Chinese Fund Law*, October 2003).

Under the revised *China's Fund Law* (2012), a fund investors meeting could be held with more than 1/3 of fund investors attending the meeting. If insufficient attendances lead to a failure to convene a meeting, fund investors could call for another one within 6 months, but must have more than 1/5 of fund investors attending the meeting.

Figure 13: Governance Structures in Chinese FMC.

In practice, however, it is rare for investors to call and hold such a meeting because of their dispersed fund unit holding. Fund investors activism in FMC has been rare in China. It is only recently that a lawsuit by a couple of fund investors brought against “China Southern Fund (CSF)” for failing to distribute dividends as required by the terms of the fund prospectus. The prospectus of China Southern Fund stipulates that the proportion of dividend distribution should not be below 90% of available-for-distribution profits. In fact, with RMB 9.735 billion yuan profits in 2007, CSF should have distributed 0.6958 yuan per unit of fund as required by the contract to fund investors. However, CSF has never distributed dividends. A regulation of “A guide for profit distribution of fund dividends” issued by the CSRC (2009) states that fund contract and prospectus should stipulate that the date to distribute dividends should not exceed 15 days from the date of calculation of profits (which is the end of financial year and is 31 December in China). However, it does not mandate FMC to distribute dividend under this circumstance.

CSF reinvests the profits (which should have been distributed as dividends) in the fund without notice and approval by fund investors. However, CSRC did not punish CSF but claim that those fund investors activism will “enhance monitoring” on fund industry. Fund investors failed this case even though CSRC praises those fund investors who take an active role to sue CSF, saying that those investors have made distinguished contribution to the issue of dividends distribution²⁷. According to WIND, there are overall 16 OEF that should have distributed dividend in 2006 and 2007 but did not do so.

Even though CSF fund investors failed to obtain compensation from or impose any penalty to CSF, they did generate attention on this issue to the Chinese fund industry and supervisory authority about dividends. For instance, Franklin Templeton Sealand Fund Management Co, Ltd paid dividends to its fund investors for the year of 2007 in April 2009 which should have been paid in 2007²⁸. China AMC amends the clause in the contract for funds relating to “dividend”. They change the “date of distribution” to the “date of reinvesting the dividends” to avoid further payment obligations relating to dividend²⁹.

Chinese fund investors are more vulnerable to expropriation than fund investors in U.S. Whereas fund shareholders/investors in the U.S. have specific voting rights such as electing directors and approving material changes in terms of a fund’s contract with its investment adviser, fund investors in China have no means nor direct representation to monitor fund managers’ behaviours other than the fact that the board is entrusted by law to undertake the monitoring role on behalf of fund investors.

The misalignment of interests between FMC and fund investors coupled with fund investor’s lack of direct representation in Chinese FMC governance makes fund investors vulnerable to expropriation by FMC and fund managers. This was evidenced by frequently reported scandals such as insider trading or market trading strategies as discussed in 4.3.3. In addition, FMC are better positioned to exploit opportunities to charge excessive fees in order to maximize their pecuniary interests at the expense of fund investors. Recent reports unveil that 56 Chinese equity funds have experienced dramatically decrease in their AUM but the

²⁷ News of “The first case about dividend distribution: China Southern Fund breach the contract, did not distribute the dividends, but fund investors lose the lawsuit” reported on 14 March 2012 from www.ce.cn

²⁸ News of “Franklin Templeton Sealand Fund Management co, Ltd makeup dividends” reported by Wangyi Caijing on 15 April 2009 at <http://money.163.com/09/0415/08/56U5V21H0025304V.html>

²⁹ News of “China AMC co, Ltd revised clause about dividends distribution”, reported by Wangyi Caijing on 15 April 2009 about <http://money.163.com/09/0415/09/56U99J8S00251LDT.html>

management fees for those funds have risen over the previous financial year³⁰. It is commonly accepted that both external and internal governance mechanisms are needed to reduce agency costs. Appropriate law, effective enforcement mechanisms and market competitive conditions (competitive capital market, industry concentration, conditions of entry, investor mobility) are widely regarded as essential external governance mechanisms for a well-functioning mutual fund industry. As discussed in Chapter 3.2, China's FMC organisation form and the institutional and regulatory environment are at early stages of development compared to the more advanced economy such as the U.S. (Tam & Yu 2011). It is well documented that emerging economies like China do not have well developed external governance mechanisms, such as the necessary market and social institutions, well-designed law and efficient law enforcement (Kakabadse et al. 2010; Tam 1999)

Weak legal enforcement in China leaves much room for FMC shareholders and fund managers to exploit fund investors' rights and interest. Ineffective external governance mechanisms therefore make internal governance mechanisms particularly important in protecting the interests of fund investors (Xi 2011). Studies on U.S. mutual funds provide ample evidence that internal corporate governance plays a crucial role in protecting the interests of fund investors (Adams et al. 2010; Chou et al. 2007; Ferris & Yan 2009; Gompers et al. 2001; Wallison & Litan 2007; Wellman & Zhou 2007). There are however relatively few studies on corporate governance of FMC in emerging economies like China where the fund management industry has only gradually gained importance in the financial system.

As discussed in Chapter 4.4., the current limited studies on China's FMC focus primarily on the relationship between the types of fund (by investment objectives) and their financial performance (Ding & Wermers 2005; Gao & Wang 2005; Xia & Tang 2009). Studies by Chinese researchers (He 2003; Zhou 2008) on FMC corporate governance in China have tended to be descriptive and not empirically tested.

This study aims to contribute to the literature by providing an empirical analysis of how governance mechanisms affect board effectiveness and fund performance; it is the first systematic study on the corporate governance of Chinese FMC. It aims to shed light on the corporate governance of fund companies under the contractual form in China.

³⁰ News of "AUM of 56 Funds decreases but their management fees are increasing" reported on 10 April 2012 from <http://finance.qq.com/a/20120410/001075.htm>.

5.3 Literature on board effectiveness

Commonly regarded as the central internal governance mechanisms, the board of directors is charged with the responsibility to protect the interests of shareholders. Most studies of the U.S. fund industry show that superior board performance is expected to lead to reduction in fund fees, and improvement in fund performance (Ferris & Yan 2007; Khorana & Servaes 2004; Kong & Tang 2008; Meschke 2007; Tufano & Sevick 1997).

In China, the role of the board of directors is similar to that of board of directors in U.S. mutual funds including management fees with fund investors, and budget in financial reports; monitoring of fund management and enforcing legal compliance; initiation of a new fund. Board of directors is expected to evaluate and monitor the performance of fund management to reduce compliance violations to a minimum. Compared to board of directors in the corporate form of mutual fund in U.S., board of directors under the contractual form in China are in principle primarily responsible for protecting the interests of fund investors rather than FMC shareholders who are also their employers.

The FMC board is required by law to represent first and foremost the interests of fund investors. The CSRC has placed the board of directors in a central position to protect the interests of fund investors and assets managed by FMC. However, in China, it is the FMC shareholders who ultimately determine the appointment and compensation of directors although their decisions are required to be submitted to CSRC for approval (Article 45, *'Corporate Governance Code for FMC'*). With widespread ownership concentration in Chinese FMC, most board members and especially the positions of CEO or chairman are likely to be appointed by the controlling shareholders.

The question therefore arises whether these insiders could genuinely represent the interests of fund investors rather than the FMC shareholders especially when there is a conflict of interests between fund investors and FMC shareholders. In most cases, the ultimate controlling shareholder in China's fund industry is the state, but the state's dual role as owner and regulator raises agency problem of how to motivate and monitor bureaucrats to maximise the interests of fund investors in selecting, disciplining, and motivating management. Therefore, whether the FMC board can perform its role effectively in these circumstances is critical.

The role of board independence has received heightened attention after every recent global or regional financial crisis. This is particularly the case in the fund industry. For instance, SEC requires at least 75% of a mutual fund's directors to be independent and also mandating chairman independence (Article 1 (a) (7), '*Investment Company Governance*', U.S., 2004). By the end of 2009, independent directors comprised at least three-quarters of board membership in almost 90 per cent of fund companies (ICI 2011). These changes demonstrate the significant role of independent directors is expected to play in the U.S. fund industry.

But in China where there is a lack of qualified independent directors, their role and their independence have been questioned all the time (Kakabadse et al. 2010; Yuan & Yuan 2007). Whether independent directors could perform their assigned functions to represent the interests of fund investors is clearly critical to the governance development for the industry.

Given the complex and potentially pivotal corporate governance issues in Chinese FMC, how to improve FMC board effectiveness is critically important in China, and a better understanding of what makes board of directors effective is vital to addressing some major governance issues faced by the burgeoning fund industry in China. This study extends the literature by identifying and examining the efficacy of key governance mechanisms in the development of an effective and well-functioning board in the contractual form of FMC organization in an emerging transition economy.

The first major research question of this study is as follows:

(1) How may specific internal governance mechanisms impact on board effectiveness in Chinese FMC?

As discussed in Chapter 4.3.6, FMC total expense ratio (TER) is employed as a proxy of board effectiveness to examine how governance settings impact on board effectiveness in the contractual form of FMC in China where each board of directors oversees all the funds underneath the fund companies (Chapter 7). The impact of each of the internal mechanisms in theoretical terms is discussed in the following Section.

5.4Hypotheses development: governance mechanisms and board effectiveness

This Section discusses the development of the major hypotheses relating to the first key research question of this thesis. It addresses the issue of which type of governance characteristics matters most in the governance of FMC in enhancing board effectiveness for fund investors in China.

Most of the extant studies in the literature focus on the impact of board composition and characteristic on board effectiveness in the U.S. context (Adams et al. 2010; Ding & Wermers 2009; Ferris & Yan 2007; Khorana et al. 2007a; Khorana et al. 2007b; Kong & Tang 2008; Meschke 2007). This dissertation extends the conventional analytical approach by including an analysis of the impact on board effectiveness from governance variables such as FMC ownership identities, structure, and concentration, the presence of remuneration committee and the supervisory board.

FMC shareholding structure

Given the high concentration of ownership, board effectiveness is subject to the influence of shareholders as they have the capacity to influence the appointment and compensation of directors although their decisions are nominally subject to CSRC approval (Article 45, '*Corporate Governance Code for FMC*'). Therefore, whether certain types of shareholding characteristics and structure could improve or impair board effectiveness for the protection the interests of fund investors will be a key issue to be investigated in this study.

As discussed in Chapter 3.3.1., state-owned companies are often considered to be associated with slow growth and low performance (Pedersen & Thomsen 2003; Shleifer 1998). It is often argued that state ownership harms firm performance in Chinese firms (Li et al. 2009; Nee et al. 2007; Yiu & Lu 2005).

In the context of FMC ownership, it could be argued that the extent of shareholding by the state may similarly exert a negative impact on board effectiveness. Whereas the CSRC requires major shareholder of FMC to have financial industry background (Article 12 (3), Chapter 2 of '*Chinese Fund Law*', 2004), in practice, nearly 59.78% of FMC shareholding are state-owned financial institutions. Accordingly, in this study we will examine whether the

level of ownership stake of state-owned financial institutions in FMC affects board effectiveness. Hypothesis 1 is formulated:

Hypothesis 1: Shareholding by state-owned financial institutions in FMC diminishes board effectiveness.

As noted in Chapter 3.3.1, many studies on Asia and China reveal that dominant controlling shareholder frequently expropriates the interests of minority shareholders (Claessens et al. 1999; Hu et al. 2010). Empirical studies also find that controlling shareholder in China often engages in related party transactions, market manipulations, and even falsifications of financial statements, thus harming the interests of minority shareholders (Bai et al. 2004; Hu et al. 2010; Yiu & Lu 2005) .

A controlling shareholder³¹ of Chinese FMC on average holds nearly 47% of total shareholding. Board effectiveness can be influenced by controlling shareholders as they can exert influence on director appointment and compensation. Listed companies are subject to more rigorous corporate governance mandates and are generally expected to exhibit higher governance standards. We therefore test whether publicly listed companies as the controlling shareholders could enhance FMC board effectiveness. Based on the above analytical perspective, Hypothesis 2 is formulated.

Hypothesis 2: A listed company as the controlling shareholder of FMC enhances board effectiveness.

As discussed in Chapter 3.2.2, increasing the presence of foreign institutions as shareholder is expected to enhance the governance standards of public listed companies. Since the ‘*Rules on the Establishment of Joint Venture Fund Management Companies*’ came into effect in July 2002, there have been 28 joint venture FMC established (out of 61 FMC) by the end of 2010 (WIND). It has been argued that foreign ownership in FMC has brought to Chinese FMC product diversification, increased competition, improved compliance and

³¹This study defines a controlling shareholder as the shareholder with the largest shareholding which is at least 2% greater than the second largest shareholder. The 2% difference is used as China’s regulation only allows majority shareholding for domestic companies and there are many companies with the largest shareholder holding at 51% and the second shareholder holding 49%. This is particular common for FMC with foreign companies participates. Article 8 of “Rules on the Establishment of Joint Venture Fund Management Companies” promulgates that the aggregate foreign direct and indirect shareholding should not exceed 49% of FMC. It indicates that CSRC may try to control the power of foreign companies on the FMC.

management efficiency, and has facilitated good international practices, and improved the international competitiveness of domestic FMC (Qi 2008). Foreign shareholding in Chinese FMC varies from 16.5% to 49%. Accordingly, Hypothesis 3 is formed:

Hypothesis 3: The presence of foreign shareholding in FMC enhances board effectiveness.

The law and finance literature argues that quality of legal protection for shareholder and ownership concentration are inversely related, that is, they are substitutes (Burkart & Panunzi 2006; La Porta et al. 1999). However, in terms of Chinese FMC where shareholders are not fund investors, the relation between concentrated ownership and fund investor protection deserves better understanding and investigation.

As Table 21 indicates, the number of shareholders in FMC varies from 1 to 6 in China (WIND). For instance, “Huaxia” and “Zhongxin” both have only one shareholder with 100% shareholding. Most FMC have state-owned financial institutions as the controlling shareholder. A high level of control by the controlling shareholders may be more likely to lead to a reduction in the power and effectiveness of the board of directors (Sanchez-Marin et al. 2011). It could be argued that a more dispersed shareholding in FMC should in principle be expected to positively impact on board effectiveness. Herfindahl index (HHI)³² will be used in this study to measure ownership concentration in FMC. Hypothesis 4 is formulated:

Hypothesis 4: Higher ownership concentration diminishes board effectiveness.

Board Characteristics and composition

As discussed in Chapter 3.3.3, a substantial body of work in the literature views the board of directors as the center of corporate governance architecture. The board of directors is also expected under Chinese law to play a critical role in the effective corporate governance of FMC. Having the optimal board composition is generally considered important for the board to perform effectively (Bange & Mazzeo 2004).

Superior board governance performance is expected to lead to reduction in fund fees, and improved fund performance (Ferris & Yan 2007; Khorana & Servaes 2004; Kong & Tang 2008; Meschke 2007; Tufano & Sevick 1997). Board of directors is considered as a central

³² Herfindahl index (HHI) is defined in Chapter 3.3.1.

internal mechanism to protect the interests of investors in mutual fund by both regulators and researchers. Using agency theory as the dominant theoretical paradigm, the extant literature has focused mainly on mutual fund in the U.S. in investigating which type of board as an internal governance mechanism can improve board effectiveness.

Tufano and Sevick (1997) show that lower fees are charged by funds with smaller board, a greater fraction of independent directors, and whose board members sit on a larger fraction of the fund sponsor's other boards. They also find evidence that independent directors with relatively higher compensation approve higher fees charged to fund investors. Using director data and 2689 U.S. domestic equity mutual funds, Ding and Wermers (2009) confirm Tufano and Sevick's findings of 1995, 1999, and 2002. Similar result is found for closed-end funds by Del Guercio, Dann and Partch (2003) that small boards that are dominated by independent directors charge lower fees.

However, Ferris and Yan (2007) find that neither chairman independence nor independent directors is related to the probability of fund scandals or fund expense ratio, which challenges the usefulness of SEC recent regulations towards corporate governance of FMC. They also provide evidence that other governance factors such as multiple directorships, board size and unexplained independent director compensation are positively related to fund expense ratios. Kong and Tang (2008) find that a unitary board of small size, rather than independent boards contributes more to the benefits of fund investors.

Studies on U.S. mutual funds document that funds with larger board charge higher fees (Ferris & Yan 2007; Gao & Wang 2005; Kong & Tang 2008; Tufano & Sevick 1997). They argue that a large number of directors on the board pose a challenge in terms of coordination and using them effectively and having any kind of meaningful individual participation.

Studies investigating mutual fund under the corporate form find that the independence of the board of directors enhances its monitoring effectiveness (Mayers & Smith 1986; Weisbach 1988). Tufano and Sevick (1997) provide empirical evidence that funds with a higher percentage of independent directors charge lower fees. The relation between the fraction of independent directors and fund fees is also found to vary over time (Meschke 2007). Kong and Tang (2008), however, find that board independence is not beneficial to fund investors as FMC with higher board independence tends to charge higher fees.

In theory, independent directors are expected to contribute expertise and greater objectivity that reduces managerial entrenchment and expropriation to protect the best

interests of investors, thereby decreasing managerial opportunism and lowering fund fee level (Kong and Tang 2008). In China, fund investors are not FMC shareholders as FMC are organized in contractual form. Independent directors in China are formally charged with the mandatory responsibility to safeguard fund investors' wealth and to protect their interests. On the basis of the existing literature, Hypotheses 5 and 6 are therefore formulated.

Hypothesis 5: Smaller FMC board size enhances board effectiveness.

Hypothesis 6: Higher proportion of independent directors enhances board effectiveness.

In corporate governance literature, it is sometimes argued that a feature of good corporate governance is having diversity in the board and senior management, because it could potentially impact positively on shareholder value and firm performance (Bantel & Jackson 1989; Carter et al. 2003; Murray 1989; Weippert 2002). For instance, female in top management positions is found to enhance board effectiveness because of the management diversity (Singh & Vinnicombe 2004; Smith et al. 2004; Srinidhi et al. 2011). Nielsen & Huse (2010) found that gender diversity in the board encourages cognitive conflict which results in more effective decision making.

In a sample of U.S. listed firms from 2001-2007, Srinidhi et al. (2011) document a positive relation between the presence of female directors and firm performance. Their result suggests gender diversity on corporate boards may enhance board effectiveness. Muller-Kahle & Lewellyn (2011) however find that board with gender diversity is negatively associated with subprime lending. As a different group from the dominant "old boys" network, women are considered to be more independent than male board members (Brennan & McCafferty 1997).

To the best of our knowledge, the relationship between management diversity (female representation) and FMC/mutual fund board effectiveness has not been investigated in prior studies. Accordingly, Hypotheses 7 and 8 are formulated.

Hypothesis 7: A female CEO/ board chair enhances board effectiveness.

Hypothesis 8: Board with gender diversity enhances board effectiveness.

Other key governance variables

A well designed executive remuneration scheme plays a significant role in attracting and maintaining quality managers, and provides incentives to perform their duties in alignment with the best interests of shareholders (Anderson & Bizjak 2003; Conyon 1997). Whether FMC with remuneration committee could be managed in a more efficient way so that their fee level can be lower than those FMC without remuneration committee will be examined in this study. Based on the above theoretical perspective, Hypothesis 9 is given.

Hypothesis 9: The presence of remuneration committee enhances board effectiveness.

As discussed in Chapter 3.3.2., most studies in the literature show that the presence of supervisor board has no effective role in Chinese public listed companies. For Chinese FMC, there has been no study on the impact of supervisors. In China, supervisors in FMC are required to play the same role as those in public companies. We therefore expect supervisors are also ineffective in FMC, Hypothesis 10 is formulated.

Hypothesis 10: Increasing the number of supervisors does not enhance board effectiveness.

Table 18: List of Hypothesis to test relationship between specific internal corporate governance mechanisms and board effectiveness in Chinese FMC.

<i>Hypothesis 1: Shareholding by state-owned financial institutions in FMC diminishes board effectiveness.</i>
<i>Hypothesis 2: A listed company as the controlling shareholder of FMC enhances board effectiveness.</i>
<i>Hypothesis 3: The presence of foreign shareholding in FMC enhances board effectiveness.</i>
<i>Hypothesis 4: Higher ownership concentration diminishes board effectiveness.</i>
<i>Hypothesis 5: Smaller FMC board size enhances board effectiveness.</i>
<i>Hypothesis 6: Higher proportion of independent directors enhances board effectiveness.</i>
<i>Hypothesis 7: A female CEO/ board chair enhances board effectiveness.</i>
<i>Hypothesis 8: Board with gender diversity enhances board effectiveness.</i>
<i>Hypothesis 9: The presence of remuneration committee enhances board effectiveness.</i>
<i>Hypothesis 10: Increasing the number of supervisors does not enhance board effectiveness.</i>

5.5 Literature on FMC performance and corporate governance

In principle, enhancing performance is vital to attract and retain the interests of investors, and FMC should be willing to enhance their performance to attract investors in order to increase their AUM so that more income could be earned. Empirical finding in Chapter 8 shows there is no relation between AUM/TER and performance, as fund investors pursue maximization of fund performance whereas FMC wants to charge more fees or enlarge AUM so more fees

could be charged. Therefore, a misalignment of interests arises between FMC shareholders and fund investors.

In two interviews with fund senior managers of Chinese FMC by the author of this thesis, the interviewees point out that it is only possible to increase a fund performance when fund AUM is relatively small because of investment strategies and skills. In addition, a fund with star performance (top five among all funds) could have positive effect on FMC AUM as the reputation of FMC could be enhanced by its star fund. However, other funds within the same family may not have increased returns; therefore, overall FMC performance is slightly changed. Empirical studies find that fund performance does not persist in China. For instance, in a sample of 122 OEF from 1 January 2009 to 31 December 2010 and using four performance measures, Niu (2012) find that except for index funds, all other types of OEF including equity, bond, and mixed funds previous year performance has no relationship with future performance. This result is supported by GuoZhang (2012) showing that quarterly performance of 44 Chinese OEF in 2006 to 2008 did not persist.

Feng (2009) finds that if fund's current performance is better than the last investment period, it could induce an AUM outflow as fund investors redeem their investment to collect the gains. This result is consistent with findings by Li (2003), Liu (2004) and Lu et al. (2007). Feng (2009) explains that because of the absence of persistent performance in China, fund investors normally disregard fund's historical performance but their buying decisions are primarily influenced by the recommendation of staff of the bank selling the fund product. Given the fluctuations in fund performance, investors usually redeem the funds to reap the gains when fund performance is seen as good. Therefore, the motivation for FMC to raise FMC overall performance is not as strong as compared to the maximisation of the AUM of FMC.

It could be argued that the immediate personal benefits of FMC insiders are thus aligned as far as fees income is concerned but is not directly linked to FMC performance. Examining how FMC performance may be enhanced by the quality of corporate governance therefore provides further clues to addressing the governance issues inherent in the fund industry. As discussed, fees are a major income source for FMC, thus FMC insiders (shareholders and senior managers) want to maximum this income. However, those fees enrich FMC but harm FMC performance which is the major return for fund investors' investment.

The current literature provides empirical evidence that fund governance plays an important role in mutual fund performance (Chou et al. 2007; Cremers et al. 2009; Wellman

& Zhou 2007). Better fund governance may bring fees more in line with performance (Gil-Bazo & Ruiz-Verdú 2009). Chou, Ng et al. (2007) find that fund with better governance standards tend to invest in corporations with good corporate governance mechanism.

It should be noted that this study investigates the impact of governance profile on board effectiveness and performance at the FMC level rather than at the fund level, taking into account the contractual nature of Chinese FMC as also funds within the FMC operate under the same set of governance mechanisms.

To what extent overall corporate governance quality may impact on FMC performance in China is unknown. This study aims to make a contribution to the literature by examining how the overall quality of FMC governance and various governance mechanisms affect FMC performance under the contractual form of fund industry in China where institutional and regulatory environment is quite different from those of funds in the U.S. If higher quality of corporate governance could lower fund expense ratio and enhance fund performance, then it is useful and valuable for fund investors to take governance rating into account when deciding on their investments. Fund investors could use this information to invest in funds managed by the FMC with good governance or avoiding FMC with poor governance. FMC are more likely to improve their corporate governance ratings to attract more investors, which in return could enhance their performance. Therefore, examining the link between quality of corporate governance and FMC performance is critical.

It is generally accepted that some governance mechanisms may likely be more effective than others. Chinese fund industry is no exception. Board is widely regarded as the central internal governance mechanisms playing a vital role in Chinese fund industry; however, other internal governance mechanisms may also works effective in FMC. As the central internal governance mechanism, board may perform better if other internal governance mechanisms function well. It is therefore worthwhile to identify which mechanisms work and those that are not in enhancing the effectiveness of corporate governance in FMC. The relationship between specified governance mechanisms and FMC performance is therefore further investigated.

As a form of robustness test, this thesis also uses *total expense ratio as a proxy of board effectiveness* to examine the relation between this key governance mechanism (board performance) and FMC performance.

The second major research question in this thesis is:

- (2) How does the overall quality of FMC corporate governance affect FMC performance?
What are the relationships between specific internal governance mechanisms and FMC performance?***

There are four measures of FMC performance in this study: continuous monthly returns (MPF), objective-adjusted performance (OAPF), Modigliani and Modigliani performance (M2PF) and Jensen's alpha (JENSENPF) as explained in details in Chapter 6.6.5. Taking the perspective of fund investors, FMC performance is about returns to their investment. Thus, FMC performance under these measures is essentially derived from various methods for aggregating the performance of funds managed by a FMC.

5.6 Hypotheses development: governance mechanisms and performance

It is widely accepted that given the right institutional conditions the quality of corporate governance can enhance firm performance in conventional firms (Duggal & Millar 1999; Hermalin & Weisbach 1991; Jackling & Johl 2009). Improving FMC performance is important for a transition economy as those financial institutions form an important aspect of a reforming economy's path to financial development. It is therefore important to examine whether the quality of corporate governance could impact on firm performance in Chinese fund industry when there is an immature capital market, weak legal enforcement and poor external institutional conditions. The empirical analysis and evidence of this study may provide useful insights for instituting measures to better protect the interests of fund investors. The hypotheses are developed as follows.

Studies on the governance of U.S. mutual funds show that the quality of governance, as measured by governance ratings, plays a significant role in attracting fund investors. However, there is little empirical research on the role of corporate governance quality measured by those governance ratings in assessing fund performance (Chou et al. 2007; Ertugrul & Hegde 2009; Wellman & Zhou 2007).

If higher quality of corporate governance could lower fund expense ratio and enhance fund performance, then it is useful and valuable for fund investors to take governance rating into account when deciding on their investments. In the Chinese context, fund investors could

use this information to invest in FMC with good governance or avoiding FMC with poor governance. FMC are more likely to improve their corporate governance to attract more investors, which in return could enhance their performance. Therefore, examining the link between the quality of corporate governance and FMC performance will provide important evidence.

A series of studies in the literature have attempted to investigate the overall quality of a firm's governance in conventional companies including La Porta, Lopez de Silanes et al. (1998), Gompers, Ishii et al. (2001), Gompers, Ishii et al. (2001) and Bebchuk et al. (2009). Most of them suggest that better corporate governance enhances firm performance.

There are relatively scant studies on how better governance quality may affect fund performance in the fund industry. Using Morningstar's rating of board directors quality, Lai et al. (2010) examine 461 U.S. equity funds over 2001-2007 showing that good quality board are more responsive to adopt strategic change when performance is poor. Factors considered in measuring the board quality rating in the Morningstar include the nature of past board actions, board independence, director ownership stake, and the quality of board oversight. Wellman and Zhou (2007) document that the quality of fund governance is positively correlated to fund performance. Chou, Ng et al. (2007) show that a fund with better corporate governance ratings tends to invest in firms with strong corporate governance.

The literature on governance rating and fund performance suggests that fund investors ought to make their fund selection based not only on the fund's past performance, but also fund governance. There has been no study on the Chinese fund industry to provide insight of the efficacy of FMC governance and its ramifications for FMC performance. This study fills a gap in the literature by examining how the overall quality of corporate governance as measured by governance ratings may affect FMC performance. Hypothesis 11 is formulated:

Hypothesis 11: Good governance enhances FMC performance.

The Corporate Governance Index (CGI) constructed by the China Centre for Institutional Investors (CCII at Nanjing University) is used as a proxy for overall quality of corporate governance and is applied to examine its impact on FMC performance in China. There are 7 provisions in the construction of the index including shareholders, board of directors, board independence, supervisory board, investment committee, superior officers and fund manager. For each category, it contains diversified variables underneath in terms of

age, sex, education background, position, years of experience, professional background. CGI aims to measure the overall quality of corporate governance in Chinese FMC.

In addition to investigating the link between the overall quality of governance and performance of FMC, this dissertation will also examine the relationship between identified governance mechanisms and FMC performance. It identifies for the Chinese context key internal governance mechanisms from various perspectives including shareholder identity and structure, board of directors, remuneration committee, and supervisory board.

Internal governance mechanisms

Most of the extant studies investigate what types of board composition and characteristics affect fund performance in the U.S. context (Adams et al. 2010; Ding & Wermers 2009; Ferris & Yan 2007; Khorana et al. 2007a; Khorana et al. 2007b; Kong & Tang 2008; Meschke 2007). This dissertation extends the conventional analytical approach by including an analysis of the potential performance impact of FMC ownership structure and concentration, presence of remuneration committee and Chinese supervisory board. It contributes to the studies of the corporate governance of the fund industry with new perspective and evidence.

Shareholder identity and concentration

It is often argued that state ownership harms firm performance in Chinese firms (Li et al. 2009; Nee et al. 2007; Yiu & Lu 2005). Most of the controlling shareholder for Chinese FMC is state-owned financial institutions. Accordingly, in this study we will examine whether the level of ownership stake by state-owned financial institutions in FMC affects FMC performance. Hypothesis 12 is formulated:

Hypothesis 12: Shareholding by state-owned financial institutions in FMC damages FMC performance.

As discussed in Chapter 3, with highly concentrated ownership, controlling shareholder can influence internal governance mechanisms such as the appointment of directors and supervisors' choice (Hu et al. 2010). As already discussed in Section 4 of this Chapter, a controlling shareholder of Chinese FMC on average holds nearly 47% of total shareholding. And listed companies are usually subject to more rigorous corporate governance mandates and are generally expected to exhibit higher governance standards. It is therefore important to understand better how controlling shareholder affect firm performance. Hypothesis 13 is formulated:

Hypothesis 13: A listed company as the controlling shareholder of FMC enhances FMC performance.

A dummy variable will be used to test the effect of the presence of foreign equity ownership in FMC on FMC performance (See hypothesis 14). In the context that Chinese FMC shareholders are not fund investors, how concentrated ownership of FMC may affect performance deserves greater understanding and investigation. Hypothesis 14 and 15 are formulated:

Hypothesis 14: The presence of foreign shareholding in FMC enhances FMC performance.

Hypothesis 15: Higher ownership concentration damages FMC performance.

Board characteristics and composition

Using Morningstar Stewardship Grades, both Wellman and Zhou (2007) and Lai, Tiwari et al. (2010) document that the quality of the board is the most important factor among all possible governance factors to explain mutual fund performance. The impact of board composition and characteristic on fund performance is the most researched area.

For instance, Ding and Wermers (2009) provide evidence that larger board composed of larger proportion of independent directors are related to better fund performance. Kong and Tang (2008) show however that none of the governance structures is significantly related to performance when continuous monthly returns (MPF) is used to measure performance, whereas fund with larger boards and boards with more than 75% independent directors actually underperform their peers when using objective-adjusted performance. By contrast, in a sample of 5957 U.S. mutual funds in 2002-2004, Meschke (2007) show that board independence affects fund performance negatively. Using 1406 U.S. equity and bond funds in 2005, Khorana, Servaes et al. (2007a) find that the size of the board, the degree of board independence, and board member compensation exhibit no statistical significance in explaining abnormal performance. Adams, Mansi et al. (2010) find an inverse relation between board size and fund performance but find no evidence that director time constraint such as retirement status, number of funds overseen with the fund family complex, outside directorships, and board of directors tenure are related to fund performance. Ferris and Yan (2007) find that neither chairman nor board independence is related to fund scandals nor fund

performance. However, existing studies provide ambiguous results regarding whether and how composition and profile of board of directors could enhance FMC performance.

Literature has shown that having diversity in the board and senior management could potentially impact positively on firm performance (Bantel & Jackson 1989; Carter et al. 2003; Murray 1989; Weippert 2002). This study examines how board size, independence, gender diversity affect FMC performance under China's contractual form (see Hypotheses 16-19).

Hypothesis 16: Smaller FMC board size enhances FMC performance.

Hypothesis 17: Higher proportion of independent directors enhances FMC performance.

Hypothesis 18: A female CEO/ board chair enhances FMC performance.

Hypothesis 19: Board with gender diversity enhances FMC performance.

Executive remuneration and supervisory board

Due to the acute shortage of qualified fund managers in China, fund managers turnover rate is therefore particularly important given managers turnover rate is on average 48% in 2000-2010 (Zou 2011). In 2011, the average tenure for fund managers in 62 FMC was only 2.56 years (Wind database). Song (2012) points out that high turnover rate of fund managers signals the importance for the introduction of performance-based compensation.

It could be argued that one desirable feature of good corporate governance for China's fund industry is to identify skilled managers, and set up the right incentives to motivate and encourage managers to retain their service so they would work longer and better than those FMC having poorer corporate governance practices. A remuneration committee can play an important role to align the interests of shareholders and those of senior managers and fund investors to better protect the interests of investors given fund investors are not shareholders and there is a conflict of interest between FMC shareholders and fund investors. Whether FMC with remuneration committee could enhance performance in contrast to those FMC without remuneration committee will be examined in this study (see Hypothesis 20). In China, supervisors of FMC are also required to play the same role as those in China's public companies. Hypotheses 20 and 21 are formulated:

Hypothesis 20: The presence of remuneration committee enhances FMC performance.

Hypothesis 21: Increasing the number of supervisors does not enhance FMC performance.

Table 19: List of Hypothesis to test the relation between internal governance mechanisms and FMC performance.

<i>Hypothesis 11: Good governance enhances FMC performance.</i>
<i>Hypothesis 12: Shareholding by state-owned financial institutions in FMC damages FMC performance.</i>
<i>Hypothesis 13: A listed company as the controlling shareholder of FMC enhances FMC performance.</i>
<i>Hypothesis 14: The presence of foreign shareholding in FMC enhances FMC performance.</i>
<i>Hypothesis 15: Higher ownership concentration damages FMC performance.</i>
<i>Hypothesis 16: Smaller FMC board size enhances FMC performance.</i>
<i>Hypothesis 17: Higher proportion of independent directors enhances FMC performance.</i>
<i>Hypothesis 18: A female CEO/ board chair enhances FMC performance.</i>
<i>Hypothesis 19: Board with gender diversity enhances FMC performance.</i>
<i>Hypothesis 20: The presence of remuneration committee enhances FMC performance.</i>
<i>Hypothesis 21: Increasing the number of supervisors does not enhance FMC performance.</i>

5.7 Conclusion

Under the contractual form of FMC in China, fund investors are not shareholders of FMC, which is different from the corporate form of mutual fund in the U.S. where fund investors are fund shareholders. A conflict of interests arises between FMC and fund investors as fund fees are the major income source for FMC which reduced fund returns for investors. Lack of direct representation for fund investors coupled with conflict of interests between FMC and fund investors gives rise to complex governance issues in Chinese FMC. The board of directors is placed as the key internal governance mechanism to protect the interests of fund investors. The first major research question of this thesis is therefore to examine how board effectiveness may be enhanced under highly concentrated ownership in China's FMC where the controlling shareholder usually has a dominant position.

Given the situation of a misalignment of interests between fund investors and FMC, FMC performance is a key to attract fund investors and protect their interests. Therefore, two major research questions are formulated to be tested empirically in this study:

- How may specific internal corporate governance mechanisms impact on board effectiveness in Chinese FMC? (Chapter 7)
- How does the overall quality of FMC corporate governance affect FMC performance? What are the relationships between specific internal governance mechanisms and FMC performance? (Chapter 8)

Internal corporate governance mechanisms including shareholder profile and characteristics, board structure and characteristics, size of supervisory board and the presence of remuneration committee are applied to investigate the relationship between corporate governance and board effectiveness and FMC financial performance. Corporate governance rating is applied to examine the relationship between quality of FMC corporate governance and FMC performance.

With prevalent concentrated ownership in Chinese FMC, most of the board members especially the position of CEO or chairman are more likely to be appointed by the controlling shareholders. The question therefore arises whether these insiders could represent the interests of fund investors rather than FMC shareholders especially when there is a conflict of interests between fund investors and FMC shareholders. The controlling shareholder in China's fund industry is, in most cases, ultimately the state, but the state's dual role as owner and regulator raises another problem of how to motivate and monitor government appointed insiders to maximise the interests of fund investors in selecting, disciplining, and motivating senior management.

The role of board independence in mutual fund in the West has received heightened attention. But in China where there is a lack of qualified independent directors, their role as well as their independence has been questioned all the time. Therefore, whether independent directors could perform their assigned functions to represent the interests of investors in fund industry is poorly documented by empirical evidence and worthwhile to investigate.

Given the complex and intense corporate governance issues in Chinese FMC, how to improve FMC board effectiveness and increase FMC performance is critically important in China, and a better understanding of what makes governance mechanisms' effective is vital to addressing some major governance issues faced by the burgeoning fund industry in China. This study contributes to the literature by examining how governance mechanisms matter in the development of an effective and well-functioning board in FMC.

CHAPTER 6

METHODOLOGY

6.1 Introduction

To investigate the relationship between internal governance mechanisms and board effectiveness as well as FMC performance, this chapter describes the data set and discuss the methodology used in this thesis. Four estimation models employed in this study are discussed: pooled ordinary least square (OLS) estimation, random effect (RM) specification, Bootstrap method, and Generalized Method of Moments (GMM).

6.2 Sample

Our sample comprises 288 firm-year observations covering 58 FMC over 5 years from 2006 to 2010 (Table 20). Our sample FMC own more than 98% of all open-end funds (OEF) funds, managing more than 95% of AUM in fund industry (WIND database) and accounting for 58 of the 61 FMC in China. We exclude three newly established FMC between 2008 to 2010 to eliminate the young FMC in the sample as a three-year track record is generally considered necessary for performance assessment. We further exclude CEF because of their relatively small size and difference in operations and fund management style from OEF. We use the year of 2006 as the start point because OEF only started in China in 2001 and there has been a lack of comprehensive data and specific regulations prior to 2006. Indeed, ‘*China’s Fund Law*’ as the major regulation for the fund industry only came into effect in 2004.

Article 29, Section 4 of CSRC’s ‘*Operation and management procedures to securities investment funds*’ defines several types of funds. It defines that equity funds as a fund with more than 60% of its AUM invested in stocks; bond funds will have more than 80% of its AUM invested in bonds; funds investing only in money market is defined as money market funds; mixed funds include investments in stocks, bonds and/ or money market and are not within the above three definitions; others include represent non-fixed income funds.

6.3 Data Sources

Data are collected from three primary data sources. First is the WIND database, which provides information on fund performance, fund flows and fund characteristics such as

fund/FMC AUM, total fund fees, and fund investment objectives. The second data source is the fund prospectus. It offers useful information on FMC governance including the identity and composition of shareholders, board characteristics, and other governance information. When fund prospectus does not provide full information about governance, we check fund's financial report. "Jian An Jin Xin Database" is the third data source for this study, where we collect fund performance data including fund's continuous monthly returns, Jensen's alpha and M2PF.

Table 20: Summary Description of Sample Data on China's Fund Industry

Fund type	2005			2006			2007			2008			2009			2010		
	Funds No	AUM (b)	% of Total AUM	Funds No	AUM (b)	% of Total AUM	Funds No	AUM (b)	% of Total AUM	Funds No	AUM (b)	% of Total AUM	Funds No	AUM (b)	% of Total AUM	Funds No	AUM (b)	% of Total AUM
Equity	61	52	12%	104	293.18	36%	127	1570.68	48%	308	695.47	37%	308	1325.21	49%	327	1281.64	53%
Bond	13	24	5%	20	17.40	2%	29	63.50	2%	147	191.09	10%	98	82.51	3%	155	141.11	6%
Mixed	86	116	26%	110	291.94	36%	122	1176.52	36%	165	542.02	29%	165	793.18	30%	167	741.45	31%
Money Market	30	187	42%	49	79.49	10%	51	111.05	3%	69	350.07	18%	69	259.53	10%	69	153.28	6%
Others*	28	70	16%	30	133.81	16%	36	330.39	10%	85	129.44	7%	85	217.69	8%	36	98.70	4%
Total	218	449	100%	313	815.82	100%	365	3252.12	100%	509	1900.21	100%	725	2678.12	100%	754	2426.03	100%
Sample Funds No	Not in the sample			292	763.61	93.60%	358	3128.75	96.20%	478	1797.47	96.42%	672	2551.90	95.29%	691	2333.79	96.59%
FMC No	47			56			58			60			61			63		
Sample FMC No	Not in the sample			56			58			58			58			58		

Notes: We exclude from our sample three newly established FMC between 2008 to 2010 to eliminate the young FMC in the sample as a three year track record is generally considered necessary for performance assessment. Others* include balanced funds, preservation funds, QDII funds and closed end funds. We further exclude CEF and passive index funds because of their relatively small size and different of operations and fund management style from OEF. We use "Plot Box" to identify outliers and replace them using mean-value.

6.4 Descriptive statistics on FMC governance structure

6.4.1 Shareholders composition and concentration

The number of shareholders ranges from 1 to 6 among China's 61 FMC at the end of 2010 (Table 21). Most FMC have 3 shareholders. The majority shareholder of FMC are in general state-financial institutions as CSRC has explicitly requires China's financial institutions to be major shareholders according to Article 13.3 Section 2 "*Chinese Fund Law*", which stipulates that the major shareholder of a FMC must participate in securities operation, consulting for securities investment, trust asset management, or other financial assets management.

This study defines a controlling shareholder as the shareholder with the largest shareholding which is at least 2% greater than the second largest shareholder. A 2% difference is used as China's regulations only restrict majority shareholding greater than 50% to domestic companies and there are many companies with the largest shareholder holding at 51% and the second shareholder holding 49%. This is particular common for FMC with foreign companies as equity partner. Article 8 of "*Rules on the establishment of Joint Venture Fund Management Companies*" limits the aggregate foreign direct and indirect shareholding to below 49% of FMC. It indicates that CSRC tries to control the power of foreign companies in FMC.

Table 21: Numbers of Shareholders in China's 61 FMC (2010).

Number of shareholders in a FMC	Number of FMC
1	2
2	17
3	25
4	12
5	4
6	1

Source: FMC financial reports

Table 22 indicates that the top 10 FMC in terms of AUM on average account for 50% of total industry AUM compared to the bottom 10 with only 1.5% from 2005 to 2010. In terms of industry concentration, Chinese FMC are highly concentrated. In examining the shareholding structure of Chinese FMC in this study, three types of major shareholders are

identified: state-owned financial institutions (average 58.34% shareholding), state-owned non-financial institutions (average 21.64% shareholding), and foreign companies (average 20% shareholding) (WIND database).

Table 22: 2005-2010 FMC Market Concentration (RMB Billion).

Market Concentration	2005	2006	2007	2008	2009	2010
Top 10 FMC AUM	258.3	474.63	1342.8	974.93	1187.48	1157.5
(Their proportion of overall industry AUM (%))	(57.27)	(58.18)	(42.98)	(51.55)	(49.14)	(48.00)
Bottom 10 FMC AUM	1.14	8.33	1.35	28.16	42.76	44.8
(Their proportion of overall industry AUM (%))	(0.25)	(1.02)	(1.00)	(1.49)	(1.77)	(2.00)

Source: compiled based on WIND Database

6.4.2 Board composition and characteristic

There are 202 independent directors among 527 board of directors in the sample of 58 FMC, the proportion of independent director ranges from 33.3% to 60% at the end of 2010. Among all independent directors, 39.11% of them are academics and scholars from universities or research institutions, followed by retirees (15.35%), lawyers (11.88%), financial professionals (11.88%), and accountants (4.95%) (Table 23).

Table 23: Composition of Independent directors in Chinese FMC (2010).

Independent Directors	Board Size	ID	ID %	FMC	
				FMC No.	FMC %
FMC with 3 Independent Directors	9	3	33.33	18	30
	8	3	37.5	5	8.33
	7	3	42.86	15	25
	5	3	60	1	1.67
Subtotal (Overall ID In FMC with 3 ID)	312	117	37.5	39	65
FMC with 4 Independent Directors	12	4	33.33	1	1.67
	11	4	36.36	9	15
	10	4	40	1	1.67
	9	4	44.44	9	15
Subtotal	202	80	33.33	20	33.33
FMC with 5 Independent Directors	13	5	38.46	1	1.67
Subtotal	13	5	38.46	1	1.67
Total	527	202	100	60	100

Source: FMC financial reports.

Table 24: FMC Description of Independent Directors Background (2010).

Background/Affiliation	ID No.	ID %
Universities and Research Institutions	79	39.11
Retirees	31	15.35
Law Firms	24	11.88
Financial Institutions	24	11.88
Accounting Firms	10	4.95
Business	6	2.97
Other Institutions	28	13.86
Totals	202	100

Source: FMC financial reports.

Table 24 indicates that academics and scholars are popular as independent directors in China. However, while they have specialist knowledge, their usual lack of industrial experiences and operational background may pose challenges for them to contribute to the board. According to Article 45, “*Corporate governance Code for Chinese FMC*” the first set of independence directors on the board are nominated by shareholders, and further appointment of independence directors may be nominated by independence directors, with the specific nomination subject to FMC constitution, making it hard to ensure board independence.

6.5 Panel data analysis

This Section reviews different estimations to be applied in Chapter 7 and 8. From traditional Pooled OLS to more complicated GMM, the strengths and weakness are outlined below.

6.5.1 Pooled OLS with panel data

Existing literature mainly uses OLS estimation to examine the relation between board characteristics and mutual fund fees (Ferris & Yan 2007; Kong & Tang 2008; Meschke 2007), and between governance mechanisms and fund performance (Adams et al. 2010; Cremers et al. 2009; Khorana et al. 2007a; Kuhnen 2009).

We follow prior studies and adopt pooled OLS estimation as robustness test in this thesis, which is written as

$$Y_{i,t} = \alpha + \beta X_{i,t} + \varepsilon_{i,t} \quad (4.1)$$

Where $Y_{i,t}$ is the dependent variable, $X_{i,t}$ is the independent variable matrix, α is intercept, and $\varepsilon_{i,t}$ is the idiosyncratic error term.

As the nature of sample in this study is panel data, pooled OLS is often not an appropriate estimation to use as it ignores the correlations of same FMC over time. However, this correlation over time is eliminated using more sophisticated GLS (generalized least square) method in Random Effect Model (REM) (Wooldridge 2009).

6.5.2 Random effects estimation with panel data (applied in Chapter 7 and 8)

Because of the nature of panel data set, we adopt Random Effect Model (REM) rather than Pooled OLS as main tests. Some of the key explanatory variables (governance variables) are constant over time in the analysis of the impact of governance variables on FMC performance. REM is generally accepted as more appropriate than Fixed Effects Model because REM allows for the inclusion of time-invariant variables (Muller-Kahle & Lewellyn 2011; Wooldridge 2009; Zhou 2001). For instance, key governance variables including board size, board independence and shareholder structure do not change frequently over a period of 5 years, within-firm variations for these variables are therefore limited. In addition, all estimations reported in this study use heteroskedastic robust standard errors, which is used to minimise heterogeneity among FMC, and correct heterogeneity and influential observations (Arellano 2003 ; Wooldridge 2009).

RE model is an expanded model of pooled-OLS (4.1) and is written as

$$Y_{i,t} = \beta X_{i,t} + \varepsilon_{i,t} \quad (4.2)$$

Where $Y_{i,t}$ is the dependent variable, $X_{i,t}$ is the independent variable matrix, and $\gamma_{i,t}$ is the composite error term as $Y_{i,t} = \alpha_i + u_i$. Because α_i is the composite error in each time period, thus $\gamma_{i,t}$ are serially correlated across time. By ignoring correlation issue, pooled OLS standard errors are biased by under/over estimating the true variability of the coefficient estimates. Generalized least squares estimation is therefore used in the analysis of RE models to solve this serial correlation problem (Petersen 2009).

Wooldridge (2009) and Arellano (2003) discuss that heteroskedastic robust standard errors `vce (robust)` is equivalent to specifying `vce (cluster panelvar)`, where the `panelvar` is the variable used to identify the panels. It could be used to control for heteroskedasticity, within-panel serial correlation in the idiosyncratic errors and influential or extreme observations. Therefore, robust-cluster analysis is applied to all the models in this study to minimise the heterogeneity among FMC, correct heterogeneity and influential observations.

6.5.3 Bootstrap methods for panel data (applied in Chapter 7 and 8)

If the sample size is not large enough, the asymptotic behaviour of the statistics could lead to a poor approximation of the true one (Wooldridge 2009). Therefore, estimates using standard econometric approach, i.e. mean and standard deviation, are biased. Bootstrap could provide a solution that the mean and standard deviation be estimated with minimal bias (Cremers et al. 2009). Bootstrapping is a statistical method to estimate the sample distribution of an estimator by using the sampling with replacement from the original sample (Shao & Tu 1995).

This study has 288 year firm observations, which may be considered as small sample size. We then use bootstrap method as robustness test to examine whether results from REM are robust to those from bootstrap methods.

6.5.4 Generalized Method of Moments (applied in Chapter 8)

There are factors influencing firm performance that are hard to capture and measure (Pindado & De Miguel Hidalgo 2001). The result will be biased if we ignore heterogeneity. Generalized Method of Moments (GMM) can be used to eliminate unobservable heterogeneity (using panel data methodology) and to control for potential endogeneity (using instruments) (Arellano & Bond 1991).

Arellano and Bond (1991) estimator formed “moment condition” using lagged-levels of the dependent variable and the predetermined variables with first-differences of the disturbances. They show how to construct estimators based on moment equations constructed from further lagged levels of dependent variable and the first-difference errors. In the case of nonidentically distributed disturbances, they use a two-step GMM estimator to estimate the covariance matrix of the moment conditions using the first-step residuals.

As Arellano-Bond (1991) methodology departs from a fixed effects formulation but the model is estimated in first differences and, therefore, the fixed effects are removed from the estimation. As key governance variables in this study are nearly time-invariant, Arellano-Bond (1991) is inappropriate to use.

Blundell and Bond (1998) show that difference GMM performs poorly when dependent variable(y) appear to be a random walk because untransformed lags (lagged -levels) are weak instruments for transformed variables. Therefore, their suggested solution is to transform the instruments to make them exogenous to the fixed effect instead of transforming the regressors. They propose another estimator - system GMM- with one equation in levels (with lagged first differences as instruments) and one equation in first differences (with lagged level as instruments). This approach will introduce more instruments, and also improve efficiency dramatically. The time invariant variables are dropped from the equation in first difference (as expected) but they are still present in the equation in level. In the case of the Blundell-Bond system estimator, we could actually include time-invariant variables in the estimation.

As some of the key repressors in this thesis are nearly time-invariant (fixed effects) in this study that will be removed from Arellano-Bond (1991) estimation because their model is estimated in first differences. Therefore, we use Blundell-Bond (1998) estimation and two steps estimation to correct the standard errors (two step system GMM) and will be used in this study.

The dynamic panel-data model Blundell-Bond (1998) :

$$Y_{i,t} = \sum_{j=1}^p \alpha_j y_{i,t-j} + X_{i,t} \beta_1 + w_{i,t} \beta_2 + \gamma_i + \varepsilon_{i,t}$$

Where the α_j are p parameters to be estimated,

$X_{i,t}$ is a $1 \times K_1$ vector of strictly exogenous covariates,

β_1 is a $K_1 \times 1$ vector of parameters to be estimated,

$w_{i,t}$ is a $1 \times K_1$ vector of predetermined or endogenous covariates,

β_2 is a $K_2 \times 1$ vector of parameters to be estimated,

γ_i are the panel-level effects, $\varepsilon_{i,t}$ are i.i.d over the whole sample with variance σ_ε^2 .

6.6 Regression models

6.6.1 Transforming variables and Issue of normality

We first use “Box Plot” to identify outliers for all main variables and replace them using mean-value. Then, we look at the best forms of main variables. A normal distributed residuals is vital for the t-test to be valid, and a common cause of non-normally distributed residuals is non-normally distributed outcome/or predictor variables (Chen et al. 2003; Wooldridge 2009). Chen (2003) point out that in order to have valid t-tests in regression results, variables are expected transformed to a form with the smallest Chi-square. The transformed variables will have a more normal distribution.

Table 25 reports main variables with the chi-square value of identity and best form. The best form with the smallest chi-square will be applied. Most of variables use their original form except taking natural logarithm of Herfindahl index (HHI), NOSUPERVISOR and TOTALTER, and use $1/(ID^2)$ for ID (independent directors) .

Table 25: Transforming variables.

	Formula	Chi2(2)
TSTATESH	identity	7.35
HHI	identity	4.19
BODSIZE	identity	2.48
ID	identity	42.42
	1/square	36.63
FEMALEBOD	identity	3.45
SUPERVIORNO	identity	56.35
	log	13.88
MPF	identity	28.1
OAPF	identity	2.35
M2PF	identity	17.68
JENSENPF	identity	14.64
TOTALTER	identity	44.11
	log	20.47
AWTER	identity	13.46

Notes: formula with the smallest Chi2(2) is the best form to use. For brevity, we only report the chi2(2) value for identity and the best form of the variable.

6.6.2 Endogeneity

It could be argued that both FMC governance structure and TER/performance may be jointly and endogenously determined by the same set of underlying variables. For instance, Tufano and Sevick (1997) point out that fund adviser who seek higher fees could be more likely to select boards that are less effective. There are 44 incidences of Chinese FMC changing their shareholding structure over the sample periods from 2006 to 2010. Among these, 14 of them have changed their block shareholder, and 15 FMC changing whose shareholding once, but 29 FMC change more than once. It could be argued that FMC total fee level and governance mechanisms may influence each other simultaneously or may be the same set of underlying variables affects fund fee level and FMC shareholding structure and other FMC governance mechanisms. For instance, FMC with lower total fee level may choose to adopt stricter corporate governance mechanisms, signalling their higher performance potential and willingness to comply with better corporate governance, which may in return reduce costs and expenses for FMC. In addition, FMC with higher performance may choose to adopt stricter corporate governance mechanisms, signalling their higher performance potential in future and willingness to comply with better corporate governance, which may in return enhance FMC performance.

Current year FMC TER/performance might thus be simultaneously determined with current-year governance variables. To mitigate the above-mentioned endogeneity problems, we therefore use one-year lagged FMC governance variables in all models. It could also be valuable to use lagged FMC governance variables as current governance mechanisms are more likely to influence future performance than the immediate current year's.

6.6.3 Model for testing FMC board effectiveness and governance variables

As discussed in Chapter 4.3.6., FMC total expense ratio (TER) is employed as a proxy of FMC board effectiveness to investigate the impact of various governance mechanisms on board effectiveness. As discussed, this study investigates the impact of governance profile on board effectiveness at the FMC level rather than at the fund level, taking into account the contractual nature of Chinese FMC as funds within the FMC operate under the same set of governance mechanisms.

To examine the relationship between FMC total fee level and governance variables, we apply the following panel-data regression model.

$$TER_{i,t} = \alpha + \beta \sum_j CG_{j,t-1}^i + \gamma CV_{i,t} + \varepsilon_{i,t} \quad (1)$$

Dependent variables: total expense ratio (TER)

Two measures of FMC TER are adopted in this study. The first measure for FMC TER is total expense ratio (TOTALTER), calculated by total expenses of FMC as a fraction of its asset under management (AUM) at the end of the year. Funds managed within the same FMC shares overall costs and expenditures such as professional training, nurturing knowledge and information sharing, and direction and guidance from investment strategy committee. These activities and associated costs contribute to enhance fund managers' skills that can be reflected in better productivity and lower costs. In addition, supervision over managerial opportunism of senior managers will also reduce overall unnecessary costs and agency costs. Therefore, all such fees and expenses are included in the calculation of TER.

The second measure for FMC TER is asset-weighted individual fund expense ratio in a FMC (AWTER), covering equity, mixed, and other non-fixed income funds². Fixed income funds such as bond funds and money market funds are excluded from measurement of AWER because of their different investment style from equity, mixed and other non-fixed income funds with significantly dissimilar cost structure and their relatively small size. It could be argued that managing equity, mixed and other non-fixed income funds normally requires greater and more active efforts, perhaps higher skills, and more time and effort by fund managers in their investment strategies than bonds and money market funds. Therefore, equity, mixed and other non-fixed income funds are more likely to exhibit the quality of governance of a FMC.

Key independent variables

Governance factors includes total state-owned financial shareholding (SHSTATEFIN), a listed company as controlling shareholder dummy (CSHLISTED), foreign ownership dummy (SHFOREIGN), ownership concentration (HHI), percentage of independent directors (ID), female member on board (FEMSENOIRBOD), female senior dummy (BOARDFEMALE), remuneration committee dummy (REMUNERACOMM), number of members on

supervisory board (NOSUPERVISOR). Detailed explanation of variables are given in Appendix A.

Control variables

Literature suggests that fund expenses are affected by fund characteristics. The existing literature finds that fund age, fund size, lag performance, fund turnover rate all affect fund TER (Ferris & Yan 2007; Gao & Wang 2005; Kong & Tang 2008; Tufano & Sevick 1997).

Economies of scale. In the U.S. context, Tufano and Sevick (1997) suggest that economies of scale can exist both at the fund level and the sponsor level. Larger funds may have lower costs over their research and selling efforts. Kong and Tan (2008) point out that fund in larger fund families tend to charge lower fees because of economies of scale and more bargaining power with other service providers. Ferris and Yan (2007) find that larger funds or funds in a larger families charge significantly lower fees. We therefore include in this study the natural logarithm of total net asset value for a FMC to control for possible economies of scale.

FMC age. Tufano and Sevick (1997) suggest that younger fund may have less experience and high start-up costs, and thus higher fees. However, Ferris and Yan (2007) find that younger fund charges lower fees, suggesting that younger funds might be subsidized by the sponsor, and lower fees will be charged. We include FMC age as a control variable.

Lagged FMC performance. Ferris and Yan (2007) document a negative relation between fund expense ratios and lagged fund performance. Fund with higher fees may have higher performance. We therefore include lagged FMC performance as control variable.

Fund turnover rate. All else being equal, investors usually prefer funds with low turnover ratios. The transaction costs associated with turnover are passed on to investors (Bogle 1994). The extant literature exhibits mixed results in regard to the relationship between a fund's turnover ratio and performance. FMC turnover rate is included to control for costs of transaction.

We also include the year as dummy variables to control the year effect on dependent variables. Appendix A provides the detailed explanation of variables.

6.6.4 Model for testing overall quality of FMC governance and governance variables

The proxy for the overall quality of FMC corporate governance is CGI over 2007-2009 (MCG0709) from CCII. We examine the impact of the quality of corporate governance on FMC performances using the following model:

$$\begin{aligned} \text{PERFORMANCE}_{i,t} = & \alpha + \beta_1 \text{CGI}_{i,t-1} + \beta_2 \text{AGE}_{i,t} + \beta_3 \text{SIZE}_{i,t} + \beta_4 \text{TURNOVER}_{i,t} \\ & + \beta_5 \text{FMCTER}_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (2)$$

Two FMC performance measures are used: FMC annual continuous monthly returns (MPF) and risk-adjusted performance (Modigliani and Modigliani: M2PF) in model (2). As discussed, this study investigates the impact of governance profile on performance at the FMC level rather than at the fund level. FMC performance measure is calculated by sum of asset-weighted fund performance measure under the same FMC.

FMC annual continuous monthly returns (MPF)

The monthly returns is calculated by taking the change in a fund's net asset value in a particular month, divided by the fund's net asset value at the beginning of the month, assuming the reinvestment of all income and capital-gains distributions. FMC raw returns is the asset-weighted of all funds in FMC compounding monthly raw returns. Detailed of FMC performance measures are given in Appendix A. Annual continuous monthly returns is widely used as a measure of fund performance by previous studies both in the U.S. mutual fund and Chinese fund industry (Cremers et al. 2009; Ferris & Yan 2007; Khorana, Servaes & Wedge 2007; Kong & Tang 2008; Kuhnen 2009; Yang 2007).

M2PF

Modigliani and Modigliani (1997) propose a “Modigliani measure risk-adjusted performance” which they believe that the average investor would find it easier to understand. It expresses performance as follows:

$$M2_{it} = \frac{\sigma_{mt}}{\sigma_{it}}(\bar{R}_{it} - R_{ft}) - \bar{R}_{mt} + R_{ft}$$

Where σ_{mt} is standard deviation of market index, “Shanghai composite index” is adopted;

σ_{it} is fund i’s standard deviation, $\bar{R}_{it} - R_{ft}$ is fund’s average excess returns, R_{ft} is “China 7 Day Repo Rates”. FMC M2 performance (M2PF) is the asset-weighted of all funds’ M2PF.

M2PF measures a fund’s performance relative to the market in percentage terms, which considers all risks including both systematic and unsystematic risks a fund confronts (Yang 2007a). In Chinese context, M2PF is widely used to compare the returns with the bank saving rate to evaluate fund investors’ investment returns, and M2PF is publicly available from database such as WIND and “Ji An Jin Xin”.

6.6.5 Model for identified internal governance mechanisms and FMC performance

To examine the relation between corporate governance quality in terms of the identified specific governance mechanisms and FMC performance, the following model is employed:

$$PERFORMANC E_{i,t} = \alpha + \beta \sum_j CG_{j,t-1}^i + \gamma CV_{i,t} + \varepsilon_{i,t} \quad (3)$$

There are four measures of FMC performance: continuous monthly returns, objective-adjusted performance (OAPF), M2PF and Jensen’s alpha. FMC raw returns and M2PF have been explained in previous session. FMC performance measure is calculated by asset-weighted fund performance measure under the same FMC. Four performance measures from different perspective are used to provide more robust test outcomes. Detailed explanation of variables is given in Appendix A.

Objective-adjusted annual return (OAPF)

Objective-adjusted annual returns is computed as the difference between a fund’s annual return and the median returns of all funds within the same objective and divided by the cross-

sectional standard deviation of a fund's returns within same investment objectives³³. FMC OAPF is the asset-weighted of all funds OAPF under a FMC.

As funds in the same investment objective is affected similarly by the changes of economic and market condition, OAPF therefore presents the returns of each fund relative to the funds in the same category. This measure is also widely used by the relevant studies (Ajay 1996; Ferris & Yan 2007; Khorana, Servaes & Wedge 2007; Kong & Tang 2008).

Jensen's alpha

Jensen's alpha is written as

$$\alpha_{it} = R_{it} - [R_{ft} + \beta_i(R_{mt} - R_{ft})]$$

Where R_{it} is fund i's returns for time period t; R_{ft} is returns for risk-free assets during time period t, R_{ft} uses "China 7 Day Repo Rates"; β_i is beta coefficient for fund I; and R_{mt} is market returns during the same time period. FMC Jensen performance is the asset-weighted of all funds Jensen's returns. Risk-adjusted returns (Jensen's alpha) are also widely used by previous studies (Adams et al. 2010; Shu et al. 2002). In this study, the calculation of FMC Jensen's alpha includes only equity and mixed funds under a FMC to make FMC performance comparable as equity and mixed funds have similar level of risk which substantially differ from other types of funds such as money market and index funds. AUM of overall equity and mixed funds between 2006 to 2010 accounts for more than 77% of overall AUM in the sample.

Key independent variables

Governance factors includes total state-owned financial shareholding (SHSTATEFIN), a listed company as controlling shareholder dummy (CSHLISTED), foreign ownership dummy (SHFOREIGN), ownership concentration (HHI), precentage of independent directors (ID), female member on board (FEMSENOIRBOD), female senior dummy (BOARDFEMALE), remmuneration committee dummy (REMUNERACOMM), number of members on

³³ As shown in Table 20: Summary Description of Sample Data on China's Fund Industry, the sample is divided into five types of funds in Chinese fund industry including equity, bond, mixed, money market and others. The definitions of those funds are discussed in Chapter 6.2.

supervisory board (NOSUPERVISOR). Detailed explanation of variables is given in Appendix A.

Control variables

Prior studies suggest that fund belonging to larger families perform better (Chen et al. 2004). Webster (2002) find that market adjusted returns deteriorate as the fund get older. Using 16316 open-end actively managed equity mutual funds in 27 countries over 1999 - 2007, Ferreira, Keswani, Miguel, & Ramos (2011) find that fund age is negatively related to fund performance in the sample of non-U.S. funds, but this relation is statistically insignificant in the sample of U.S. funds. Droms, William and Walker (1996) find that turnover ratio is negatively related to performance. Ippolito (1989) , Peterson et al. (2001) and Droms and Walker (2001) document that no statistically significant relationship between turnover and performance.

This study includes FMC AUM, age, and turnover rate as control variable. The year dummy variable is also included to control the year effect on dependent variables. Lagged performance is included in the GMM model of the robustness tests to control the effects from past performance on current year performance. We also include the year as dummy variables to control the year effect on dependent variables.

6.7 Conclusion

This chapter describes the data set and methodology to be used for empirically testing the hypotheses in this thesis. Four estimations including pooled OLS estimation, RM specification, Bootstrap method, and GMM to be used in Chapter 7 and 8 are discussed. As some of the key governance variables are time-invariant, REM are adopted as the main test to investigate how governance mechanisms affect FMC TER (Chapter 7), how overall quality of governance mechanisms affect FMC performance (Chapter 8) and how do specific governance mechanisms affect FMC performance (Chapter 8). When sample size is not large, the asymptotic behaviour of statistics could lead to poor approximation of the true one (Wooldridge 2009). Bootstrap method is used as robustness check in Chapter 7 and 8. GMM

is also used to deal with endogeneity problem and dynamic panel data to examine the appropriateness of REM in Chapter 8.

CHAPTER 7

IMPACT OF GOVERNANCE MECHANISMS ON BOARD EFFECTIVENESS

7.1 Introduction

Board effectiveness is particularly important in the Chinese fund industry as investors are not shareholders and there is a lack of direct governance representation of fund investors. The board of directors is required by law to put the interests of investors ahead of FMC shareholders who control directors' appointment, compensation, and tenure in China. Therefore, how to ensure and enhance board effectiveness is vital to the healthy and stable development of the fund industry. This chapter aims to investigate how governance settings influence board effectiveness in Chinese FMC. By using FMC total expense ratio (TER) as proxy for board effectiveness, our tests examine the impact of the identity and composition of shareholders and the board, presence of remuneration committee, and size of supervisory board on FMC board effectiveness.

This chapter presents firstly a summary of descriptive statistics of the full sample. The relevant literature review and theoretical analysis of the relation between governance variables and board effectiveness are provided in Chapter 4. Chapter 5 discusses the methodology and data for this chapter, which starts with an analysis of the relevance of governance variables with univariate analysis-correlation between main variables. Regression models including OLS, RE, Bootstrap and GMM are adopted to explore the relations between governance variables and FMC performance.

7.2 Statistics summary

Table 26 presents descriptive statistics of the variables in the sample. Included are the mean, standard deviation, minimum, and maximum values for the variables of FMC performance measures, governance characteristics, and FMC characteristics except dummy variables.

Panel A in Table 26 contains a description of FMC fee measurements. FMC total TER (TOTALTER) is on average 2.52% with a maximum value of 8.58% and a minimum value of

0.391%. The mean value for asset-weighted TER (AWTER) is 1.93% arranging from 0.46 to 5.28.

Panel B provides descriptive information on FMC shareholder and board of directors characteristic. The total shareholding of state-owned financial institutions in FMC is on average 59.78%. HHI is 42.8%, affirming the concentrated nature of FMC ownership. The average board size has 8.6 members with 42% being independent directors, but there is a substantial cross-sectional variation among FMC, with a range from 4 to 13 members in the board and from 33% to 80% being independent directors. On average, there is 0.98 female on FMC board with a range from 0 to 3, with 8.3% of FMC having female as top executive (CEO or board chair). Overall, 33.33% of FMC has a listed company as controlling shareholders, 38.19% has set up a remuneration committee, and 54.86% are partnering with foreign shareholders.

The average FMC age is about 5 years, and FMC AUM is on average of RMB 144.5 billion yuan, with an average of 11.5 funds managed by each FMC (WIND database).

Table 26: Descriptive statistics of main variables.

Summary statistics of main variables				
	Mean	Std. Dev.	Min	Max
Panel A: Board of directors effectiveness measurements				
FMC total expense ratio (%) (TOTALTER)	2.52	1.177	0.391	8.578
Asset weighted FMC total expense ratio (%) (AWTER)	1.93	1.313	0.46	5.278
Panel B: Shareholder and Board of directors characteristics				
HHI	0.428	0.144	0.1	1
Total state-financial institutions shareholding (%) (TSTATESH)	59.781	17.98	10	100
Board size (BODSIZE)	8.622	1.729	4	13
Independent directors Percentage (*100)	42.025	10.196	33.33	80
Number of female on the board (FEMALEBOD)	0.983	0.953	0	3
Number of Supervisors (SUPERVIORNO)	3.724	1.453	1	8
Panel C: FMC characteristics and Control variables				
FMC age (FMCAGE)	5.7	3.056	1	13
FMC AUM(billion) (AUM)	144.5	83.283	1	288
FMC turnover rate /1000 (TURNOVER)	0.106	0.05	0.003	0.239
Jensen performance	0.332	0.386	-0.585	1.5
Panel D: Dummy variables				
	Number	Proportion of total number		
Listed controlling shareholder (LISTEDCONTROL)	96	33.33%		
Foreign companies' shareholding (FOREIGNSH)	158	54.86%		
Senoir female (FEMSENOIRBOD)	28	9.72%		
Remuneration Committee (REMUNERATION)	110	38.19%		
JENSENPF	144	50%		

Notes: our sample comprises 288 firm-year observations covering over 95% of all AUM in Chinese fund industry over 2006 - 2010. The definition and measurement of above variables are presented in Appendix A. We use “Box Plot” to identify outliers and replace them using mean-value.

7.3 Results and discussion

7.3.1 Correlation analysis

To investigate the relations between governance variables and FMC performance, we start our analysis with the examination of the Pearson correlation test to understand the approximate relations among main variables, and then explore these relations using panel-data regression models in the subsequent section.

Table 27 reports the Pearson correlations of main variables showing the correlations of governance variables and board effective measurements: TOTALTER and AWTER.

Table 27: Correlations of main variables

	TOTALTER	AWTER
TOTALTER	1.000	
AWTER	-0.5927*	1.000
TSTATESH	-0.100	-0.072
HHI	-0.049	-0.104
BODSIZE	-0.041	-0.036
IDNEWFORMPERCENT	-0.043	-0.054
FEMALEBOD	-0.004	0.056
SUPERVIORNO	-0.013	-0.022

Total state-owned financial shareholding (TSTATESH) has a negative relation with the TER measures of TOTALTER and AWTER, suggesting increasing shareholding by state in FMC reduces TER. This negative relation is contrary to the Hypothesis 1 that postulates state shareholding FMC damages FMC board effectiveness. There is negative relation between ownership concentration (HHI) and TER measures, suggesting highly concentrated ownership enhances board effectiveness. BODSIZE affects both TOTALTER and AWTER negatively, which is inconsistent with Hypothesis 5 that postulates smaller size enhances board effectiveness. Both measures of TER is found to negatively correlate with percentage of

independent directors (ID), suggesting higher board independence enhances board effectiveness. Number of members on supervisory board (SUPERVIORNO) is found to affect FMC TER negatively, indicating that increasing number of supervisors on the supervisory board will enhance board effectiveness.

The Pearson correlation results provide some insights into the linkage between FMC TER measures and key governance variables. While correlations between governance variables and FMC TER are not statistically significant, most variables have the predicted signs with TER. It should be noted that univariate analysis only considers the relations of two variables, and FMC TER measures may be influenced not only by governance variables but also by other variables such as FMC age or size. We further investigate these relations between governance variables and performance measures through regression models where we could incorporate governance variables in one model, and other variables are controlled.

7.3.2 Random effects (RE) estimation

Regression models used to investigate the relation between governance variables and FMC TER are discussed in Chapter 5. The description of variables is given in Chapter 4.

$$TER_{i,t} = \alpha + \beta \sum_j CG_{j,t-1}^i + \gamma CV_{i,t} + \varepsilon_{i,t} \quad (1)$$

Table 28 reports the results of RE estimation. Two FMC TER measures: TOTALTER and AWTER. The results of two regressions are presented in Model 1 and Model 2 respectively.

Hypothesis 1 investigates the association between state financial institutions in FMC ownership and FMC board effectiveness. The coefficients for the level of shareholding by state-financial institutions have inconsistent signs, and those relations are statistically insignificant. The result suggests that shareholding from state-owned financial institutions has no significant impact on board effectiveness. As discussed in Chapter 5.4, most findings of the current literature document that state ownership normally plays no discernible impact on firm performance in China. Similarly, it could be argued that those state-owned financial institutions as FMC shareholders play no role in FMC management. It may be because the state as the ultimate owner of FMC has several tiers in between, which limits the power or

interests of the state to intervene in the governance of FMC. In addition, it is generally accepted that Chinese fund industry is subject to an extra regime of financial regulations compared to other types of Chinese companies, therefore, state interventions in FMC governance and management may be less apparent and direct.

Hypothesis 2 predicts that a listed company as the controlling shareholder of FMC enhances board effectiveness. Our result provides strong support for *Hypothesis 2*, the coefficients for dummy variable of a FMC with a listed controlling shareholder for the two models are statistically significant with the predicted sign. It suggests that a FMC with a listed controlling shareholder reduces FMC TER compared with those whose controlling shareholder which are not listed. For instance, the presence of a listed company as controlling shareholder of FMC on average lowers FMC TOTALTER by 12%, which is significant and important given the mean of TOTALTER is 2.5% and this result is significant at 5% confidence level. It could be explained that FMC with a listed company as the controlling shareholder exhibits higher governance standards which will therefore enhance board effectiveness. With an average of 48.7% shareholdings by the controlling shareholder, a listed company as the controlling shareholder in Chinese FMC could provide a powerful driver in enhancing board effectiveness and will thus reduce FMC fees and expenditures they charge.

Hypothesis 3 predicts that the presence of foreign shareholding in FMC enhances board effectiveness. Results from both models testing against Hypothesis 3 show that both coefficients of foreign shareholding dummy variable in FMC are positive, and Model 1 shows this to be significant at 5% level. The results indicate that presence of foreign shareholder increases FMC TER. Therefore, *Hypothesis 3* is rejected. The finding may be due to the higher set up and running costs because of the adoption of foreign operational and remuneration standards in FMC with the presence of foreign shareholders compared to FMC with only domestic companies as FMC shareholders. Foreign invested FMC may incur costs such as higher pay for employees, higher compensation and cost for foreign directors to attend meetings, more expensive hardware and software for operations imported from foreign sources, etc. For instance, in 2010, 38% of FMC had remuneration committee; most of them have foreign presence in their ownership.

Table 28: RE estimation of the impact of lagged value of governance variables on FMC TER.

VARIABLES	Model 1	Model 2
	LOG(TOTALTER)	AWTER
	REM	REM
TSTATESH	-0.001 [-0.57]	0.001 [0.33]
LISTEDCONTROL	-0.12** [-2.17]	-0.22** [-1.96]
FOREIGNSH	0.11** [2.31]	0.14 [1.30]
HHI	-0.18 [-1.19]	-0.25 [-0.96]
BODSIZE	0.019 [0.94]	0.047 [1.64]
ID	-0.033 [-0.68]	-0.089 [-1.30]
FEMSENOIRBOD	-0.12* [-1.70]	-0.18 [-1.06]
FEMALEBOD	0.13 [1.63]	0.032 [0.63]
REMUNERATION	-0.091* [-1.83]	-0.0013 [-0.012]
SUPERVIORNO	-0.013 [-0.69]	-0.0049 [-0.17]
LOGFMCSIZE	-0.041 [-1.64]	-0.03 [-1.62]
FMCAGE	0.021* [1.81]	0.036 [0.51]
LAGJENSENPF	0.016 [0.33]	-0.089 [-1.15]
JENSENPF(DV)	-0.19*** [-3.07]	-0.32*** [-2.91]
TURNOVER	0.00072*** [6.76]	0.0011** [2.25]
Year Dummies	Yes	Yes
Constant	-3.81*** [-16.1]	0.44 [0.92]
Observations	288	288
Number of fmc	58	58

Notes: t-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1. As explained in Chapter 6.6.1, original form of most variables are applied except for using log of TOTALTER, HHI, supervisory, and AUM. LAGJENSENPF represents the previous year's performance. JENSENPF(DV) is dummy variable to represent the higher FMC performance group by its mean. Variance inflation factor (VIF) is used to evaluate multi-collinearity among the key variables. We find no evidence of a collinearity problem in our main governance and control variables (see Table 29)

Table 29: Multicollinearity Test.

TSTATESH	1.38
LISTEDCONTROL	1.54
FOREIGNSH	1.69
HHI	1.77
BODSIZE	2.17
ID	1.85
FEMALEBOD	1.39
FEMSENOIRBOD	1.58
REMUNERATION	1.2
SUPERVIORNO	1.38

Hypothesis 4 predicts that higher ownership concentration diminishes board effectiveness. Both models show that the coefficients for shareholding concentration are negative, but statistically insignificant. This result suggests that concentrated shareholdings, even when the majority shareholders tend to be state-owned financial institutions, makes no difference in board effectiveness. It could be argued because of the highly concentrated nature of shareholding in the Chinese fund industry, (with the number of shareholders from 1 to 6 as shown in Chapter 5.4), shareholders are likely to have common interests, which is to increase the AUM so that the major income (fees FMC charge) could be increased. Therefore, there is no difference between one shareholder or several shareholders in terms of shareholding's impact on board effectiveness.

Hypothesis 5 predicts that smaller FMC board size enhance board effectiveness. We did not find evidence for hypothesis 5 as both models find board size affects FMC TER positively but this relation is insignificant at all levels. The evidence on China FMC therefore shows that the size of board has no impact on board effectiveness, which is consistent with previous discussion that board size in general is ineffective in Chinese listed companies as discussed in Chapter 3.3.3. This result is inconsistent with findings by Kong and Tang (2008) that smaller board in the U.S. mutual fund has a lower total expense ratio, and Tufano and Sevick (1997), Ferris and Yan (2007) who shows that funds in U.S. with smaller boards charge lower management fees.

Hypothesis 6 predicts that higher proportion of independent directors enhance board effectiveness. All models shows that there is negative relation between board independence and FMC TER but all of the coefficients are statistically insignificant. As Kakabadse, Yang et al. (2010) points out non-executive directors in China is primarily driven by legislation rather

than the result of market development. Because of China's lack of well-functioning financial markets (e.g. a well-defined legal system, efficient regulatory agencies, and rigorous law enforcement), and with its concentrated ownership, a weak investor protection environment and shortage of qualified independent directors in China, it is unlikely that independent directors will play an effective role in monitoring and control. Although there is a range of board size from 4 to 13 and big variation from 33% to 80% of board independence among China's FMC, we find that neither board size nor board independence is associated with FMC board effectiveness.

This result is consistent with Ferris and Yan (2007) who find no relation between the percentage of independent directors on board and fund expense ratio, but contrary to the findings of Tufano and Sevick (1997) that the proportion of board independence is negatively related to fund expenses ratio in the U.S. context.

Hypothesis 7 predicts that a presence of female senior executive (CEO/ board chair) enhance board effectiveness. Results from the models provide evidence for *Hypothesis 7* as both models show that the coefficients for the FEMSENOIRBOD dummy variable are negative and Model 1 shows this to be statistically significant at 5% level. We could argue that female as the top executives in a FMC may contribute a different perspective and approach to the male dominated board environment, thus enabling them (female CEO or Chairman) to enhance productivity and reduces total fee level for fund investors.

Hypothesis 8 predicts that board with gender diversity enhance board effectiveness. The coefficients of FEMALEBOD from both models are positive, and this relation is statistically significant at 10% level in Model 1. There is therefore modest evidence that increasing the number of females on the board diminishes FMC board effectiveness. Most female directors are appointed to be independent directors. The result may suggest that appointing female on the board only for gender diversity or "guanxi" has little to do with enhancing board effectiveness; in fact it can increase the costs for fund investors.

Hypothesis 9 predicts the presence of remuneration committee enhance board effectiveness. Results of models show that a FMC with remuneration committee lowers FMC fees, which is statistically significantly at 10% level in Model 1. It suggests that the presence of remuneration committee could enhance board effectiveness and reduce FMC TER. The results show that FMC with the presence of remuneration committee significantly enhances board performance than those FMC without setting up remuneration committee. Remuneration committee institute more rational incentive system to better align the interests

of board members and senior management to those of fund investors, and help motivate and review senior management performance more effectively. The establishment of remuneration committee is particularly important in Chinese FMC given the complex relationship between FMC shareholders and fund investors as its presence can help better align of interests between senior officers in FMC and fund investors enhance board effectiveness.

Hypothesis 10 predicts that increasing the number of supervisors does not enhance board effectiveness. All models show that an increase in the number of supervisors on supervisory board reduces FMC TER, but this relation is statistically insignificant at all levels. It affirms the general expectation that supervisors are ineffective in terms of reducing overall fee level.

For control variables, we find no evidence of economies of scale in the Chinese fund industry. But there is reasonable evidence to support that older FMC charge higher TER. It could be argued that older FMC may charge higher for their established reputation.

We find financial performance from previous year has no impact on current year FMC TER. When we divide FMC performance by its mean to higher/lower performance groups, both models provide strong evidence that FMC within higher performance group charge significantly lower fees, and is statistically significant at 1% level. The result suggests either charging higher fees dramatically affect FMC performance or FMC with better performance have a lower costs compared to lower performing FMC. Consistent with findings by Gao and Wang (2005), we find strong evidence that higher FMC turnover rate leads to higher fee level in Chinese FMC, and this relation is significant at 1% level.

7.4 Robustness test

Our empirical results are robust to the use of alternative regression methods including Bootstrap regressions and Pooled OLS. As we have relatively small sample size (288 firm-year observations), we use Bootstrap regression first to test the robustness of our findings from REM. Most of the current relevant studies in the literature use OLS to examine the relationship between governance variables and fund expense in the U.S. (Ferris and Yan 2007; Meschke 2007; Kong and Tang 2008). We therefore use Pooled OLS to examine whether the relations found in the U.S. also exist in Chinese FMC.

7.4.1 Bootstrap methods for panel data

Results from Bootstrap method shown in Table 30 are highly consistent with findings in the preceding Sections of this Chapter. In fact, Models 3 and 4 confirm prior findings especially for the presence of remuneration committee and foreign shareholding in more significant ways than REM. For instance, Table 30 provides strong evidence as both models show that the coefficient for the presence of foreign ownership on board effectiveness is positive and statistically significant. Results from Bootstrap methods also show that FMC with a remuneration committee enhances board effectiveness, and is statistically significant.

7.4.2 Pooled OLS methods for panel data

Table 31 reports Pooled OLS estimations to test the robustness of the results from the RE Model estimations. Pooled OLS model yields consistent results with RE estimations in a less statistically significant way but affirms the findings in previous section.

Table 30: Robustness test: Bootstrap method of the impact of lagged value of governance variables on FMC TER.

VARIABLES	Model 3	Model 4
	LOGTOTALTER	AWTER
	Bootstrap	Bootstrap
TSTATESH	-0.001 [-0.92]	-0.001 [-0.49]
LISTEDCONTROL	-0.11** [-2.18]	-0.12** [-1.97]
FOREIGNSH	0.10** [2.43]	0.10* [1.82]
HHI	-0.18 [-1.00]	-0.17 [-0.74]
BODSIZE	0.012 [0.78]	0.018 [0.82]
ID	-0.034 [-0.53]	-0.031 [-0.51]
FEMSENOIRBOD	-0.0026 [-0.11]	-0.0017 [-0.049]
FEMALEBOD	-0.12 [-1.63]	-0.13 [-1.18]
REMUNERATION	-0.087** [-1.97]	-0.092* [-1.77]
SUPERVIORNO	-0.041 [-0.63]	-0.04 [-0.39]
FMCAUM	-0.042* [-1.85]	-0.041* [-1.75]
FMCAGE	-0.18*** [-2.96]	-0.19*** [-3.14]
LJENSENPF	0.027 [0.64]	0.016 [0.34]
I.JENSENPF	-0.018** [-1.97]	-0.020* [-1.67]
TURNOVER	0.001*** [4.08]	0.001*** [5.34]
Year Dummies	Yes	Yes
Constant	-3.86*** [-16.0]	-3.81*** [-14.2]
Observations	279	279
R-squared	0.43	
Number of fmc		58

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1

Table 31: Robustness test: OLS estimation of the impact of lagged value of governance variables on FMC TER.

VARIABLES	Model 5	Model 6
	TOTALTER	AWTER
	OLS	OLS
TSTATESH	-0.00076 [-0.74]	0.001 [0.69]
LISTEDCONTROL	-0.12** [-2.25]	-0.24*** [-3.02]
FOREIGNSH	0.12*** [2.74]	0.13 [1.44]
HHI	-0.21 [-1.24]	-0.29 [-1.17]
BODSIZE	0.019 [1.03]	0.051** [2.13]
IDNEWFORMPERCENT	-0.036 [-0.94]	-0.091 [-1.55]
FEMSENOIRBOD	-0.14** [-2.03]	-0.23** [-2.19]
FEMALEBOD	0.0004 [0.018]	0.035 [0.76]
REMUNERATION	-0.095** [-2.13]	-0.023* [-1.87]
SUPERVIORNO	-0.014 [-0.92]	-0.011 [-0.35]
FMCSIZE	-0.043* [-1.96]	0.056 [0.88]
FMCAGE	0.022** [2.13]	-0.032 [-1.42]
LJENSENPF	0.025 [0.58]	-0.08 [-1.15]
I.JENSENPF	-0.18*** [-2.88]	-0.30** [-2.32]
TURNOVER	0.00077*** [7.70]	0.0012** [2.33]
Year Dummies	Yes	Yes
Constant	-3.80*** [-17.0]	0.33 [0.62]
Observations	288	288
R-squared	0.43	0.82
Number of FMC	58	58

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1

7.5 Conclusion

The development of a well-functioning financial system is critical for a large, rapidly growing economy still undergoing economic reform with a dominant state-owned sector in the economy. The growth of the fund management industry is an important part of China's financial development. The contractual form of FMC organisation in China presents a variety of governance issues in addition to the conventional agency problems associated with modern corporations. However, research on how fund management companies are governed is scant. This chapter presents an analysis of the effectiveness of the board of director as the key internal governance mechanism of Chinese FMC in ameliorating the misalignment of the interests between FMC and its fund investors.

The literature on fund management industry in the West has traditionally concentrated more on fund performance than governance. There are relatively limited studies on board effectiveness of mutual funds in the U.S., and very little is known about board performance of FMC in China. This chapter represents a first systematic study on the corporate governance challenges confronting the fledging Chinese fund management industry by examining how governance variables affect board effectiveness.

Our results suggest that a listed company as a controlling shareholder will enhance board performance. However, shareholding from state-owned financial institutions has no impact on FMC TER. This result suggests that concentrated shareholdings, even when the majority shareholders tend to be state-owned financial institutions, make no difference in board effectiveness. The presence of foreign ownership in FMC increases total expense level. That may be due to the initial higher set up and running costs due to adoption of foreign operational and remuneration standards in FMC with the presence of foreign shareholders compared to FMC with wholly domestic company as FMC shareholders.

The evidence also shows that neither board size nor board independence have significant impact on board effectiveness. Because of the absence of well-functioning financial markets, and with its concentrated ownership, a weak investor protection environment and shortage of qualified independent directors in China, it is unlikely that independent directors will play an effective role in monitoring and control.

The female as the top executive (female CEO or Chairman) could enhance board effectiveness because of different perspective and approach to the male dominated board

environment. However, increasing the number of females on the board actually weakens board performance in China's business environment. The presence of remuneration committee significantly enhances board performance. As expected, the supervisory board is found to have no impact on board effectiveness.

The findings of this dissertation help to better understand how governance mechanisms may affect board effectiveness under the contractual form of FMC in China. It also extends the current literature from a focus on the corporate form of FMC in the US to the contractual form in China.

CHAPTER 8

IMPACT OF GOVERNANCE MECHANISMS ON PERFORMANCE

8.1 Introduction

While the level of fees in FMC is analytically considered by researchers to exhibit the central conflict of interests between fund investors and FMC, FMC performance is certainly also a key concern for fund investors, and enhancing performance is vital to attract and retain the interests of investors. FMC therefore would be willing to enhance their performance to attract investors in order to increase their AUM so that more income could be earned. Examining how FMC performance may be enhanced by the quality of corporate governance therefore provides further clues to addressing the governance issues inherent in the fund industry.

Using CGI as a proxy of the overall quality of FMC governance, this chapter first examines how the totality of FMC governance affects FMC performance under the contractual form of fund organization in China. It further investigates the relationship between the identified governance variables and FMC performance.

The relevant literature review and theoretical analysis on the relation between governance variables and FMC performance are provided in Chapter 4. Chapter 5 discusses the methodology and data used in this chapter. This chapter first provides a statistical summary of the full sample. We then present our analysis of the relevant governance variables with univariate analysis - correlation between main governance variables and FMC performance measures. Regression models are employed to explore the relations between governance variables and FMC performance.

8.2 Summary of Statistics

Table 32 provides an overview of the main summary statistics of the full sample. Included are the mean, standard deviation, minimum, and maximum values for the variables of FMC performance measures, governance characteristics, and FMC characteristics except dummy variables.

Panel A contains a description of FMC performance measurements. FMC MPF is on average 0.044 with a maximum value of 0.491 and a minimum value of -0.392. OAPF is on average -0.161 with a big standard deviation of 0.733. M2PF and JENSENPF are 0.353 and 0.332 respectively after adjusting the original data by multiple 1000.

Governance variables and FMC characteristics in Panel B of Table 31 are the same as those introduced in Chapter 7.2.

Table 32: Descriptive statistics of main variables.

	Mean	Std. Dev.	Min	Max
Panel A: FMC performance measurements				
Continuous monthly FMC returns (MPF)	0.044	0.137	-0.392	0.491
Objective-adjusted FMC returns (OAPF)	11.56	8.02	-0.0177	31.861
M2pf*1000 (M2PF)	0.353	0.436	-0.747	1.759
Jensen Performance*1000 (JENSENPF)	0.332	0.386	-0.585	1.5
Panel B: Shareholder and BOD characteristics				
HHI	0.428	0.144	0.1	1
Total state-financial institutions shareholding (%) (TSTATESH)	59.781	17.98	10	100
Board size (BODSIZE)	8.622	1.729	4	13
ID Percentage (*100) (IDPERCENT)	42.025	10.196	33.33	80
Number of female on the board (FEMALEBOD)	0.983	0.953	0	3
Number of Supervisors (SUPERVIORNO)	3.724	1.453	1	8
Panel C: FMC characteristics and Control variables				
FMC age (FMCAGE)	5.7	3.056	0	13
FMC AUM(billion) (AUM)	144.5	83.283	1	288
FMC total expense ratio(%) (TOTALTER)	2.52	1.177	0.391	8.578
Panel D: Dummy variables				
	Number	Per cent		
Listed controlling shareholder (LISTEDCONTROL)	96	33.33%		
Foreign companies' shareholding (FOREIGNSH)	158		54.86%	
Senoir female (FEMALESENOIR)	28		9.72%	
Remuneration Committe (REMUNERATION)	110		38.19%	

Notes: our sample comprises 288 firm-year observations covering over 95% of all AUM in Chinese fund industry over 2006 - 2010. The definition and measurement of above variables are presented in Appendix A. We use “Box Plot” to identify outliers and replace them using mean-value.

CGI

As noted in Chapter 5.6, Corporate Governance Index (CGI) constructed by China Centre for Institutional Investors (CCII, based in Nanjing University) is used as a proxy for overall

quality of corporate governance and is applied to examine whether it could enhance FMC performance in China. The overall scores are divided into five groups where the highest group rated 5 star, and 1 star have the lowest marks. CGI of 2007-2009 (MCG0709) is used, and there are overall 174 observations as shown in Table 33.

Table 33: Description of CGI

CGI Rates	Number	Percent (%)
1 Star	34	20
2 Star	35	20
3 Star	35	20
4 Star	35	20
5 Star	35	20

Source: CCII.

8.3 Results and discussion

8.3.1 Correlation analysis

We start our analysis in the examination of the Pearson correlation test to understand the approximate relations between governance variables and FMC performance, and then explore these relations using panel-data regression models in the subsequent Section. Table 34 reports that the Pearson correlations of main governance variables and four measures of performance.

Total state-owned financial shareholding (SHSTATEFIN) has a positive relation with the performance measures of Objective-adjusted performance (OAPF), Modigliani and Modigliani (M2PF) and Jensen alpha (JENSENPF), except Monthly returns (MPF), suggesting increasing shareholding by the state enhances performance. This positive relation is inconsistent with *Hypothesis 11* that shareholding by the state in FMC damage FMC returns.

Herfindahl index (HHI) affects all performance measures negatively, significant at 10% level when using JENSENPF. It indicates higher shareholding concentration in FMC damages performance, which is consistent with Hypothesis 12. There is a mixed relation between BODSIZE and measures of performance.

Most of the performance measures positively correlate with proportion of independent directors (ID) on the board, indicating that increasing board independence enhances FMC performance. This result is consistent with Hypothesis 16. Female members on board

(FEMSENOIRBOD) correlates negatively with FMC performance, suggesting increasing the number of female members on the board could damage FMC performance.

The Pearson correlation results provide some insights into the linkage between performance measures and key governance variables. As discussed above, most of the signs of relations are as predicted. It should be noted that univariate analysis only considers the relationship of two variables. Performance measures may be influenced not only by governance variables but also by other variables. We further investigate these relationships between governance variables and performance measures through regression models that incorporate all governance variables into one model, while other variables are controlled.

Table 34: Correlations of main governance variables and measures of performance.

	MPF	OAPF	M2PF	JENSENPF
TSTATESH	-0.079	0.071	0.105	0.059
HHI	-0.058	-0.095	-0.053	-0.134*
BODSIZE	0.040	-0.024	-0.038	0.089
IDPERCENT	-0.030	0.1237*	0.076	0.078
FEMALEBOD	-0.053	-0.003	-0.068	-0.065
SUPERVIORNO	-0.030	-0.054	0.008	0.095

8.3.2 Major findings

Results for FMC CGI and governance variables

We examine the impact of the overall quality of corporate governance on FMC performance using the following model (detailed information about models and hypotheses are given in Chapter 5) :

$$\begin{aligned}
 PERFORMAN\epsilon_{i,t} = & \alpha + \beta_1 CGI_{i,t-1} + \beta_2 AGE_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 TURNOVERR\epsilon_{i,t} \\
 & + \beta_5 FMCTER_{i,t} + \epsilon_{i,t}
 \end{aligned}
 \tag{2}$$

Two FMC performance measures are used: FMC annual continuous monthly returns (MPF) and risk-adjusted performance (Modigliani and Modigliani: M2PF) in model (1).

Detailed of FMC performance measures are given in Appendix A. FMC performance measures are calculated by sum of asset-weighted fund performance measures under the same FMC.

Table 35: RE estimation of the impact of lagged CGI on FMC performance.

VARIABLES	Model 1 MPF	Model 2 MPF	Model 3 M2PF	Model 4 M2PF
CGI	0.017*** [3.05]	0.019*** [5.07]	0.059*** [4.36]	0.052*** [6.01]
FMCSIZE	0.006 [0.25]	0.004 [0.17]	0.015 [0.19]	0.028 [0.34]
FMCAGE	0.000 [0.049]	0.001 [0.096]	0.048*** [3.39]	0.047*** [3.16]
TURNOVERRATE	0.87** [2.29]	0.90** [2.57]	0.41 [0.41]	0.27 [0.26]
AWTER	-0.023*** [-2.78]		-0.088*** [-4.51]	
TOTALTER		-0.074* [-1.84]		-0.064* [-4.18]
Constant	0.07 [0.61]	0.074 [0.66]	0.039 [0.11]	0.013 [0.034]
Year Fixed Effects	Y	Y	Y	Y
Observations	174	174	174	174

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1. There are overall 174 firm-year observations which cover greater than 95% of overall AUM of fund industry in China. CGI is from 2007-2009, dependent variables are from 2008-2010. Detailed explanation of variables is given in Appendix A.

All models in Table 35 show that higher overall quality in corporate governance (CGI) impacts on FMC performance positively and these effects are statistically significant at 1% level. It suggests corporate governance is important in enhancing FMC performance. For instance, Model 4 provide strong evidence that increasing one level in CGI rating could enhance performance (M2) by 0.059, this is significant given the mean of M2PF is 0.397.

All model shows that the size of FMC has no impact on performance, indicating there is no evidence of economies of scale in China's fund industry during this period. When using M2 as performance measure, coefficient of the FMC age (FMCAGE) is positive and statistically significant at 1% level, indicating FMC with longer period of experiences enhance performance. It also suggests that FMC with longer period of experiences tend to focus on risk-adjusted performance rather than continuous monthly returns (MPF). All models find that coefficients of FMC turnover rate (TURNOVERRATE) is positive, and this relation

is significantly at 5% level when using MPF as a performance measure. All models show that both measures of FMC TER have significant effect on FMC performance. For instance, Model 4 shows one percentage point increase in AWTER could reduce performance by 0.088, and this effect is statistically significant at 1% level. ***This result suggests that increasing level of FMC total fees does significantly reduce FMC performance, thus affirming the expectation that a more effective board can on the whole produce better performance.***

Robustness test for CGI

When sample size is relatively small, the asymptotic behaviour of statistics could lead to poor approximation of the true one (Wooldridge 2009). Using Bootstrap method could provide a solution so that the mean and standard deviation could be estimated with minimal bias (Cremers et al. 2009).

The results from Bootstrap method in Table 36 are highly consistent with our findings from the REM model (Table 35) although at lower significance level. Similar results from bootstrap to REM indicate REM could provide reasonable evidence on these findings we investigate even though the sample size is relatively small.

Table 36: Robustness test: Bootstrap method test impact of lagged CGI on FMC performance.

	Model 5	Model 6	Model 7	Model 8
VARIABLES	MPF	MPF	M2PF	M2PF
CGI	0.017*** [2.93]	0.015*** [2.69]	0.061* [1.92]	0.059** [2.08]
FMCSIZE	0.0057 [0.54]	0.0071 [0.96]	-0.0032 [-0.096]	0.017 [0.65]
FMCAGE	0 [0.19]	0 [0.20]	0.052*** [5.35]	0.050*** [5.05]
TURNOVERRATE	0.87*** [4.79]	0.92*** [4.94]	0.58 [1.16]	0.35 [0.79]
AWTER	-0.023*** [-3.46]		-0.061*** [-2.64]	
TOTALTER		-0.0095 [-1.35]		-0.075*** [-4.83]
Constant	0.07 [0.61]	0.074 [0.66]	0.039 [0.11]	0.013 [0.034]
Year Fixed Effects	Y	Y	Y	Y
Observations	300	300	300	300

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1.

Results for internal governance mechanisms and FMC performance

Regression models to investigate the relation between corporate governance quality in terms of the identified specific governance mechanisms and FMC performance are presented in Chapter 5. The description of variables is in Chapter 4.

$$PERFORMANC\ E_{i,t} = \alpha + \beta \sum_j CG_{j,t-1}^i + \gamma CV_{i,t} + \varepsilon_{i,t} \quad (3)$$

There are four measures of FMC performance: continuous monthly returns (MPF), objective-adjusted performance (OAPF), M2PF and Jensen's alpha. Detailed explanation of variables is given in Appendix A. FMC performance measures are calculated by sum of asset-weighted fund performance measures under the same FMC.

Table 37 reports the results of RE estimation for the above-presented equations. Model 1-4 comprises different FMC performance measures, MPF, OAPF, M2PF, and JENSENPF respectively.

Hypothesis 12 investigates the association between FMC state ownership and FMC performance. The coefficients for shareholding by state have inconsistent signs and are statistically insignificant. The results suggest that shareholding from state has no discernible impact on performance. As discussed in Chapter 7, the state as major shareholder has no significant impact on FMC governance and management, therefore, has no impact on either board effectiveness or FMC performance.

Hypothesis 13 predicts that a listed company as the controlling shareholder of FMC will enhance FMC performance. Our result provides strong support for this hypothesis, with all models showing the coefficients for dummy variable of a FMC with a listed controlling shareholder positive and statistically significant. For instance, the presence of listed company as controlling shareholder for FMC on average increase FMC OAPF substantially by 0.27, and this result is significant at 1% level given the mean of FMC OAPF is -0.161. With an average of 48.7% shareholdings holding by the controlling shareholder, a listed company as the controlling shareholder in Chinese FMC can dramatically improve FMC performance. As discussed in Chapter 7, the presence of listed companies as the controlling shareholder could also enhance board effectiveness. Therefore, it could be argued that when the controlling shareholder is a listed company, the anticipated higher governance standards of those controlling shareholders could have a significant positive impact on FMC board effectiveness and governance mechanisms, which help to increase FMC performance.

Table 37: RE estimation of the impact of lagged governance variables on FMC performance.

VARIABLES	Model 1 MPF	Model 2 OAPF	Model 3 M2PF	Model 4 JENSENPF
TSTATESH	0.000 [0.18]	-0.002 [-1.10]	0.001 [0.81]	-0.000 [-0.28]
LISTEDCONTROL	0.025* [-1.78]	0.27*** [2.89]	0.13* [1.78]	0.11** [2.19]
FOREIGNSH	0.011 [0.94]	0.100 [1.19]	0.160** [2.31]	0.072* [1.81]
HHI	-0.065*** [-3.00]	-0.25* [-1.87]	-0.28* [-1.74]	-0.22** [-2.54]
BODSIZE	0.006 [1.61]	-0.036* [-1.66]	-0.006 [-0.22]	-0.016 [-0.047]
IDPERCENT	-0.0066 [-0.80]	-0.020 [-0.34]	-0.015 [-0.33]	0.016 [0.61]
FEMSENOIR	0.027 [1.26]	0.16 [1.07]	0.037 [0.27]	0.050 [0.59]
FEMALEBOD	-0.010 [-1.49]	-0.067* [-1.70]	-0.043 [-1.47]	-0.053** [-2.56]
REMUNERATION	-0.0061 [-0.52]	-0.094 [-1.32]	-0.064 [-1.21]	-0.027 [-0.72]
SUPERVIORNO	-0.0091 [-0.51]	-0.080 [-0.73]	-0.15 [-1.31]	-0.18** [-2.34]
AUM	0.0044 [0.39]	0.0092 [0.17]	0.021 [0.79]	0.029 [1.17]
FMCAGE	-0.0022 [-1.10]	0.028** [2.18]	0.039*** [3.30]	0.022*** [3.17]
Year Dummies	Yes	Yes	Yes	Yes
Observations	288	288	288	288
Number of FMC	58	58	58	58

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1. Variance inflation factor (VIF) is used to evaluated muti-collinerity among the key variables. We find no evidence of a collinerity problem in our main governance and control variables (see Table 29)

Hypothesis 14 predicts that the presence of foreign shareholding in FMC enhances FMC performance. We find the presence of foreign shareholding in FMC affect FMC performance positively for all the measures, and these positive relations are significant using risk-adjusted performance (M2PF and JENSENPF). These results indicate that FMC with a presence of foreign ownership have higher risk-adjusted performance. It is generally accepted that foreign shareholders possess more advanced risk management skills and techniques, which is the major reason the Chinese government welcomes well-chosen foreign companies to enter into Chinese financial sector. As explained in Chapter 7, the presence of foreign financial institutions in FMC shareholding could incur higher costs such as higher

compensation and costs for foreign directors to attend meetings. However, the presence of foreign shareholding does enhance FMC performance.

Hypothesis 15 predicts that higher ownership concentration damages FMC performance. We find evidence to support this hypothesis, as evidenced by the negative relation between Herfindahl index (HHI) and FMC performance by all measures of performance, and are significant at 1% level (when using OAPF and M2PF measures), at 5% level (using JENSENPF) and 10% level (using MPF measures). As discussed in Chapter 7, concentrated ownership in FMC has no impact on FMC fee level. However, it could be argued that increasing number of shareholders from different financial background such as banks, insurance companies, and investment companies would facilitate access to more expertise and information, and greater capacity to identify qualified fund managers to attain good FMC performance.

Hypothesis 16 predicts that smaller FMC board size enhances FMC performance. We find reasonable evidence to support this hypothesis as three out of four models document board size affects FMC performance negatively and Model 6 finds this relation significant at 10% level. These results are consistent with the findings of Liu, J (2009) in Chinese listed companies, and Adams, Mansi et al. (2010), Kong and Tang (2008) and Dann, Del Guercio et al. (2002) in U.S. mutual fund. It could be argued that larger boards are likely to have higher coordination costs and communication problem, which may lead to the negative effect of board size has on FMC performance. Overall, we find the size of board has no impact on board effectiveness but increasing the size of board harm FMC performance.

Hypothesis 17 predicts that higher proportion of independent directors enhances FMC performance. We find no evidence that board independence thus defined influences FMC performance, which is consistent with the findings by Khorana, Servaes et al. (2007a) in the context of U.S. mutual funds. This paper documents that the proportion of independent directors has no impact on either board effectiveness or FMC performance. As discussed in Chapter 7, with its concentrated ownership and shortage of qualified independent directors in China, it is unlikely that independent directors will play an effective role in monitoring and control, resulting in compromised independence and ineffectual board in China's circumstance.

Hypothesis 18 predicts that the presence of female senior executive (CEO/ board chair) enhances FMC performance. All models show that there is positive relation between the presence of female senior executive and FMC performance, but this relation is insignificant in

all models, indicating presence of female senior executive does not improve FMC performance. While Chapter 7 documents that the presence of female senior executive enhances FMC board effectiveness, the impact of female senior executives on FMC performance is not found.

Hypothesis 19 predicts that board with greater gender diversity enhances FMC performance. Results rejects H19, showing increasing number of females on board actually damages FMC performance in all models. It suggests that having more female members on the board just for the sake of “Guan Xi” or “Gender diversity” would not enhance board effectiveness but is likely to incur costs as explained in Chapter 7. As a result, FMC performance are damaged because of extra costs incurred. In China, the appointing of female and male is probably subject to the same shortcomings and constraints of the existing governance processes so that superficial diversity makes little difference.

Hypothesis 20 predicts that the presence of remuneration committee enhances FMC performance. Our findings show that there is positive relation between the presence of remuneration committee and FMC performance, but this relation is insignificant in all models, indicating the presence of remuneration committee plays no role in enhancing FMC performance. A possible explanation is that the quality and skills of fund managers plays a key role in FMC performance. The presence of remuneration committee plays negligible role in motivating Chinese fund managers in enhancing their performance because of the high turnover rate in Chinese fund managers. Therefore, even the presence of remuneration committee could enhance board effectiveness; it has limited effect to influence FMC performance.

Hypothesis 21 predicts that increasing the number of supervisors does not enhance FMC performance. All models show that increase in number of supervisors on supervisory board damages FMC performance, and the result is significant at 5% level in Model 4. This affirms the general expectation that supervisors are ineffective in enhancing FMC performance.

For control variables, we find that FMC asset under management has no effect on FMC performance, and is consistent with previous findings of this study, which affirms the arguments of misalignment of interests between FMC and fund investors. It suggests that FMC scale of operation does not help with its performance. Three out of four models show that older FMC have better FMC performance. This result is significant and important at 1% level in Model 3 and 4, and at 5% in Model 2. Therefore, older FMC may be more

experienced in investments and have more extensive networks in obtaining useful information and “Guan Xi” to enhance FMC performance.

Robustness test for internal governance mechanisms and FMC performance

Given the small total number of FMC in China, sample size is therefore relatively small. We use Bootstrap regression to test the robustness of our findings from REM. GMM is also used to deal with endogeneity problem and dynamic panel data to examine the appropriateness of REM. All similar studies in the literature use OLS to examine the relation between governance variables and fund performance in the U.S. (Adams et al. 2010; Ferris & Yan 2007; Kong & Tang 2008; Meschke 2007), Pooled OLS is therefore also adopted to examine whether our tests by REM generate similar findings.

Results from Bootstrap method (Table 38), GMM (Table 39), and Pooled OLS models (Table 40) show the signs of all main variables are qualitatively unchanged although with slightly lower statistical significance compared to results from REM. It can therefore be concluded that REM provides robust evidence for those findings.

Table 38: Bootstrap method: examines the robustness of the prior findings reported from RE estimations about the impact of governance variables on following year FMC performance.

	MPF	OAPF	M2PF	JENSENPF
TSTATESH	0.0001 [0.23]	-0.0023 [-1.30]	0.00017 [0.11]	0.00046 [0.33]
LISTEDCONTROL	0.021 [1.41]	0.24*** [2.58]	0.11 [1.27]	0.11** [2.06]
FOREIGNSH	0.007 [0.58]	0.074 [0.85]	0.097* [1.69]	0.096** [2.09]
HHI	-0.053** [-2.28]	-0.18 [-1.22]	-0.15 [-0.95]	-0.28*** [-2.76]
BODSIZE	0.0046 [1.06]	-0.016 [-0.70]	-0.0047 [-0.22]	0.0053 [0.20]
IDPERCENT	-0.0056 [-0.67]	-0.063 [-1.09]	0.0071 [0.14]	0.015 [0.38]
FEMSENOIR	0.026 [1.46]	0.1 [0.77]	0.067 [0.47]	0.02 [0.18]
FEMALEBOD	-0.0074 [-1.13]	-0.054 [-1.27]	-0.047 [-1.43]	-0.037** [-2.26]
REMUNERATION	0.005 [0.41]	0.028 [0.39]	0.024 [0.41]	0.028 [0.62]
SUPERVIORNO	-0.0077 [-0.42]	-0.0068 [-0.056]	-0.046 [-0.48]	-0.22** [-2.39]
AUM	0.005 [0.48]	-0.0085 [-0.17]	-0.0051 [-0.15]	0.023 [0.92]
FMCAGE	-0.003 [-1.56]	0.035** [2.42]	0.038** [2.54]	0.029*** [3.00]
Year Dummies	Yes	Yes	Yes	Yes
Constant	-0.056 [-0.58]	-0.049 [-0.53]	0.035 [1.51]	-0.18*** [-2.81]
Observations	288	288	288	288
R-squared	0.35	0.34	0.6	0.56

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1

Table 39: GMM examines the robustness of the main results reported from RE estimations about the impact of governance variables on following year FMC performance.

VARIABLES	MPF	OAPF	M2PF	JENSENPF
TSTATESH	0.0077*** [4.14]	-0.017 [-0.067]	0.013 [1.01]	0.011 [1.47]
LISTEDCONTROL	4.66 [0.56]	10.7 [0.032]	2.16 [0.46]	1.75* [1.81]
FOREIGNSH	-0.03 [-0.16]	10.2*** [3.33]	0.18 [0.46]	0.082 [0.22]
HHI	-0.16 [-0.93]	-1.6 [-0.19]	0.079 [0.22]	-0.43** [-2.07]
BODSIZE	0.10* [1.79]	-1.54 [-0.31]	-0.23*** [-5.11]	-0.24*** [-4.55]
IDPERCENT	2.53 [0.71]	203 [0.028]	-1.81 [-0.15]	9.17 [0.072]
FEMSENOIR	0.18** [2.20]	11.1** [2.57]	0.34* [1.82]	1.01*** [3.35]
FEMALEBOD	-0.82 [-0.053]	1,544 [0.034]	-0.12* [-1.67]	-0.33*** [-2.66]
REMUNERATION	-3.18 [-0.44]	-14.2 [-0.056]	1.99 [0.46]	-1.07 [-0.14]
SUPERVIORNO	-0.40*** [-3.74]	-1.69 [-0.21]	-0.18 [-0.66]	-0.22 [-1.02]
AUM	0.026 [1.31]	0.2 [0.26]	0.074 [1.60]	0.070* [1.78]
FMCAGE	0.59 [1.03]	-2.22 [-0.012]	1.24 [0.35]	-0.7 [-0.070]
FMCTER	-0.44 [-0.38]	-63.3 [-1.00]	0.94 [0.44]	1.39 [0.50]
LMPF	-0.26*** [-4.62]			
LOAPF		0.25*** [2.80]		
LM2PF			0.11 [0.88]	
LJENSENPF				0.055 [0.22]
Year Dummies	Yes	Yes	Yes	Yes
Constant	0	0	-7.19 [-0.53]	-22.2 [-0.089]
Observations	232	232	232	232
Number of fmc	58	58	58	58

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1

Table 40: Robustness test: OLS estimation of the impact of governance variables on FMC performance.

VARIABLES	MPF	OAPF	M2PF	JENSENPF
TSTATESH	0.000073 [0.15]	-0.0018 [-1.06]	0.00071 [0.58]	-0.00039 [-0.40]
LISTEDCONTROL	-0.025 [-1.11]	0.27*** [2.70]	0.13** [2.12]	0.11** [2.33]
FOREIGNSH	0.011 [0.50]	0.1 [1.18]	0.15*** [2.76]	0.067* [1.76]
HHI	-0.065* [-1.75]	-0.25* [-1.70]	-0.25** [-2.10]	-0.21*** [-2.74]
BODSIZE	0.0056 [0.79]	-0.036 [-1.31]	-0.0026 [-0.15]	0.000059 [0.0044]
IDPERCENT	-0.0066 [-0.43]	-0.02 [-0.30]	-0.02 [-0.56]	0.016 [0.58]
FEMSENOIR	-0.027 [-0.71]	0.16 [1.14]	0.039 [0.39]	0.052 [0.70]
FEMALEBOD	-0.01 [-0.90]	-0.067 [-1.45]	-0.046* [-1.76]	-0.053*** [-2.61]
REMUNERATION	-0.0061 [-0.32]	-0.094 [-1.04]	-0.06 [-1.36]	-0.025 [-0.70]
SUPERVIORNO	-0.0091 [-0.32]	-0.08 [-0.64]	-0.14* [-1.90]	-0.17*** [-2.98]
AUM	0.0044 [0.32]	0.0092 [0.16]	0.012 [0.43]	0.026 [1.11]
FMCAGE	-0.003 [-1.56]	0.035** [2.42]	0.038** [2.54]	0.029*** [3.00]
FMCTER	-0.14 [-0.17]	9.36* [1.83]	0.11 [0.050]	1.32 [0.70]
Year Dummies	Yes	Yes	Yes	Yes
Constant	-0.056 [-0.58]	-0.049 [-0.53]	0.035 [1.51]	-0.18*** [-2.81]
Observations	288	288	288	288
R-squared	0.35	0.34	0.6	0.42

Notes: z-statistics in brackets with *** p<0.01, ** p<0.05, * p<0.1

8.4 Conclusion

Operating under a regulatory environment with weak enforcement of investor protection, the contractual form of fund management companies (FMC) in China's emerging fund industry presents some complex governance issues in addition to the conventional agency problems associated with modern public corporations. The lack of fund investor's voice in the governance of FMC highlights the importance of the quality of FMC governance in ensuring FMC performance to produce results for fund investors. However, research on FMC governed is scant. This dissertation presents the first systematic study on whether the quality of corporate governance matters in the performance of the contractual form of FMC organizations by investigating evidence from China.

Using panel data of 288 firm-year observations covering more than 98% of fund management companies in China from 2006 to 2010, this Chapter examines how overall quality of corporate governance affect FMC performance, and to investigate the relationship between identified governance variables and FMC performance. Compared to conventional OLS estimator, this study apply RE and GMM to examine the relationship between quality of governance and FMC performance. Our results suggest that FMC with good corporate governance does matter in generating performance for fund investors in China.

Using CGI as the measure of overall quality of corporate governance to examine how corporate governance affects FMC performance, our results suggest that corporate governance quality is significant important in determining FMC performance.

In examining the relationship between specific internal governance mechanisms and FMC performance, we find that a listed company as shareholder not only enhances board effectiveness, but also improves FMC performance. It highlights the importance of higher governance standards a listed company have to operate, resulting in more positive impact on the governance standards of its subsidiary (FMC).

The findings affirm the importance of the controlling shareholders in determining FMC board effectiveness and performance. While higher ownership concentration in FMC has no impact on FMC board effectiveness, it damages FMC performance. It could be argued that with highly concentrated ownership, increasing the number of shareholders from diversified financial background could enable more easy access to financial information and/or more

capacity to identify qualified fund managers to operate the AUM of FMC. Therefore, FMC performance is increased.

We document the role of foreign shareholding in FMC performance. We find board size affects FMC performance negatively, indicating the small board is more effective in enhancing FMC performance. However, board independence has been documented have no impact on either board effectiveness or FMC performance. This affirms the widely accepted view that director independence in China is problematic. Increasing number of females on the board is found to have no impact on board effectiveness and damage FMC performance, which suggests that having more female members on the board just for the sake of “Guan Xi” or “Gender diversity” would not enhance board effectiveness but could incur costs.

The result shows that FMC with remuneration committee has in practice limited power to enhance FMC performance because of the very high turnover rate in Chinese fund managers, even though the presence of remuneration committee helps to enhance board performance. It also shows that increasing the level of FMC total fees does significantly reduce FMC performance, affirming that a more effective board can on the whole produce better performance. Overall, the internal governance mechanisms are important for FMC performance in China.

In addition, the result shows that the size of FMC’s asset under management has no effect on FMC performance, suggesting that FMC scale of operation does not help its performance but will certainly increase the income of FMC through the fees FMC could charge, which affirms the existence of misalignment of interests between FMC and fund investors. It is also found that older FMC have better performance. A possible explanation is that older FMC may be more experienced in investments and have more extensive networks in obtaining useful information to enhance FMC performance.

CHAPTER 9

CONCLUSION

9.1 Introduction

The growth of the fund management industry is an important part of China's financial development. The contractual form of FMC organisation in China presents a variety of industry- and country- specific governance issues in addition to the conventional agency problems associated with modern corporations. This study explores how governance mechanisms help protect the interests of fund investors. This thesis provides an in-depth analysis of the governance problems under the contractual form of FMC in China, and investigates how governance mechanisms in FMC affect FMC board effectiveness and financial performance. The thesis presents the first systematic study to investigate how governance settings work in Chinese FMC, contributing new perspective, insights, and new empirical evidence to the literature.

This chapter provides a summary and some conclusions of the thesis and is organised as follows. Section 9.2 outlines the research questions addressed in the thesis and summaries the analytical approach, hypothesis development and testing, and findings of the study by chapters. Section 9.3 review key contributions. Several limitations and future research directions are outlined in Section 9.4.

9.2A Summary of the thesis

It is widely accepted that given the right institutional conditions, the quality of corporate governance can enhance firm performance in conventional firms. Improving FMC performance in financial institutions is important for a transition economy as the development of the fund industry forms an important aspect of a reforming economy's path to financial development. Given the complex governance issues in FMC, therefore, how to protect the interests of fund investors in China is key for the healthy development of the fund industry. As a result, it is important to examine whether quality of corporate governance could enhance firm performance in Chinese fund industry when there is an immature capital market, weak legal enforcement and poor external institutional condition. Board effectiveness is considered as the central mechanism to protect fund investors, how to enhance board effectiveness is important. FMC performance is vital to the interests of fund investors. There is therefore a

need to understand how governance mechanisms could enhance FMC performance. The key research questions of this dissertation are:

What are the key agency problems that Chinese FMC are exposed to? (Chapter 5)

How do specific internal corporate governance mechanisms impact on board effectiveness? (Chapter 7)

How does the overall quality of FMC corporate governance affect FMC performance? (Chapter 8)

What specific FMC governance mechanisms enhance FMC performance? (Chapter 8)

Chapter 2 provides a general theoretical background of corporate governance for a better understanding and analysis of corporate governance of Chinese FMC. Theories of corporate governance including agency theory, stewardship theory, resource dependence theory and global governance theory are explored. This study uses agency theoretical perspective to examine whether certain governance settings in Chinese FMC could mitigate the conflict of interests between fund investors and the FMC. The role of the board of directors and its effectiveness as the central governance mechanisms is discussed. The role of institutional investors in capital market development and corporate governance of investee firms are also highlighted.

Chapter 3 discusses Chinese corporate governance in terms of external and internal governance mechanisms. The role and efficacy of capital market development and legal infrastructure as the key external governance mechanisms in China are examined. The relationship between corporate governance development and the development of China's financial system are complementary. Tam and Yu (2011) stress that "well-functioning capital market and effective corporate governance at the firm level are widely accepted as mutually reinforcing". Corporate governance is critically vital to enhance the credibility and confidence in company management, and is fundamental to the development of capital market. Development of a country's capital market will also help drive the building of a well-functioning and effective system of corporate governance. Tam and Yu (2011) point out that the pace and quality of Chinese capital market development is a major challenge for corporate governance to evolve, and there is an urgent need to speed up China's financial development. Institutional investors could also play a crucial role in helping the steady growth of capital market.

Well-functioning regulatory infrastructure and legal system provide an effective set of external mechanisms in establishing good governance practices, building the capacity of institutions and individuals to implement and enforce formal and informal rules and regulations. External governance mechanisms in China are in general weak with poor legal enforcement and underdeveloped capital market, as well as ineffective and negligible market for corporate control. Corporate governance reforms in China have in practice relied on the development internal mechanisms with a particular focus on the responsibilities of directors and managers.

China imposes a two-tier board structure, consisting the board of directors and supervisory board. Chapter 3 also investigates in the Chinese context some key features of internal governance mechanisms such as the state as the dominant owner with a concentrated ownership, the function of supervisory board, and the independence of directors.

A better understanding of the historical development and structure of the Chinese fund industry is important for analysing the governance of China's FMC. Chapter 4 examines the overall development and pertinent changes in the fund industry, the governance structure and governance issues of Chinese FMC, and to review the relevant literature of FMC governance in China. A comparison of the organizational form between Chinese FMC and U.S. mutual fund is outlined so as to better understand to what extent governance issues in U.S. mutual fund could be considered in the context of the Chinese fund industry, and how the rich literature of corporate governance of U.S. mutual funds could inform and be used in this study given that most of the extant literature of corporate governance of the industry and FMC focuses on the U.S.

Chapter 5 provides an analysis of key agency problems in Chinese FMC and outlines the two major research questions for this study. Under the contractual form of FMC, fund investors in China are not shareholders of FMC, as distinct from the corporate form of mutual fund in the U.S. where fund investors are fund shareholders (discussed in Chapter 4). This study investigates the impact of governance profile on board effectiveness and performance at the FMC level rather than at the fund level as in most studies, taking into account the contractual nature of Chinese FMC as funds within the FMC are managed under the same set of governance mechanisms. A conflict of interests between FMC and fund investors arises from the misalignment of objectives regarding the fund fees which enriches FMC but reduces fund performance for fund investors. The complex structure of FMC provides additional governance issues compared to the conventional publicly listed companies. Both in the

literature and in practice, the board of directors is considered as the central governance mechanism to protect the interest of investors. The first major research question for this study is to investigate what specific governance setting could enhance board effectiveness.

FMC performance is a key concern for fund investors, and improving FMC performance is to protect the interests of fund investors given the presence of conflict of interests between FMC and fund investors with fund fees being FMC's major income source which could harm FMC performance.

Therefore, the second research question of this study is to examine how the totality of corporate governance quality affects FMC performance, and the relation between the specific governance mechanisms and FMC performance. The extant literature on U.S. mutual fund focuses on how board composition and characteristics influence board effectiveness. This study also considers the impact on board effectiveness and FMC performance from shareholder profile and composition, but will also incorporate some unique characteristics of supervisory board, and the role of compensation committee.

Chapter 6 presents the data set, descriptive statistics of key governance variables and the methodology used in this thesis. Our sample comprises 288 firm-year observations covering 58 FMC over 5 years from 2006 to 2010 (Table 20). Our sample FMC own more than 98% of all open-end funds (OEF) funds, managing more than 95% of AUM in fund industry (WIND database) and accounting for 58 of the 61 FMC in China.

As some of the key explanatory variables (governance variables) are time-invariant in the analysis of the impact of governance variables on FMC board effectiveness and financial performance in Chapter 7 and 8, REM is generally accepted as more appropriate than Fixed Effects Model because REM allows for the inclusion of time-invariant variables. REM is therefore applied in chapter 7 and 8 in the main empirical tests. Following most previous relevant studies in the literature, Pooled-OLS is used as a robustness test in both Chapters. This study has 288 year firm observations, which may be considered as having a small sample size. Bootstrap method is therefore used as robustness test to examine whether results from REM are robust to those from Bootstrap methods in Chapter 7 and 8.

Factors influencing firm performance are generally hard to capture and measure. Results will be biased if heterogeneity is ignored. In examining the relation between internal governance mechanisms and FMC performance in Chapter 8, Generalized Method of

Moments (GMM) is applied to eliminate unobservable heterogeneity (using panel data methodology) and to control for potential endogeneity (using instruments).

Chapter 7 examines how certain governance mechanisms affect board effectiveness using FMC total expense ratio (TER) as proxy for board effectiveness. Our results show that a listed company as a controlling shareholder enhance board performance. Given that the controlling shareholders on average holds 47% of total shareholding in Chinese FMC over the period under investigation, controlling shareholders could influence FMC board effectiveness. FMC with a listed company as the controlling shareholder are found to exhibit higher governance standards than those FMC whose controlling shareholder is not listed, thus leading to better board effectiveness.

However, increasing shareholding by state-owned financial institutions and the level of shareholding concentration in FMC are found to have no impact on board effectiveness. Most of the shareholders of FMC are state-owned financial institutions, or foreign financial institutions, and state-owned non-financial institutions. The result may suggest there is no impact from shareholding by state-owned enterprises financial institutions as FMC shareholders. But the presence of foreign shareholding in FMC is associated with higher FMC total expense ratio. That may be because of higher set up and running costs due to the adoption of foreign operational and remuneration standards in FMC with the presence of foreign shareholders compared to FMC with domestic company particularly state-owned enterprises as FMC shareholders.

While there is wide range of board size from 4 to 13, and large variation from 33% to 80% of board independence among FMC, we find that neither board size nor board independence are associated with FMC board effectiveness. This study provides strong evidence that a female as CEO or board chair improves board effectiveness significantly. This suggests a female as top officer could contribute their skills and different mindset from men to enhance board performance. However, FMC with gender diversity in the membership of the board does not enhance board performance. Most of female directors are appointed to be independent directors. This may suggest that if females serve on the board only for diversity purpose, they will have little to contribute to enhance board effectiveness.

The results also show that FMC with the presence of remuneration committee significantly enhances board performance compared to those FMC without remuneration committee. Having a remuneration committee could better align the interests of board members and senior management to those of fund investors, and motivate and review senior

management performance systematically and regularly. The establishment of remuneration committee is particular important in Chinese FMC amidst the complex relations between FMC shareholders and fund investors. Better alignment of interests between senior officers in FMC and fund investors enhances board effectiveness. Increasing the size and number of the supervisory board is found to have higher total expense ratio, indicating the ineffectiveness of supervisory board.

Chapter 8 use corporate governance index as the measure of quality of corporate governance to examine how corporate governance affects FMC performance, the result shows that corporate governance quality is important in enhancing FMC performance.

In examining the relationship between governance variables and FMC performance in Chapter 8, we find that FMC with a listed company as controlling shareholder outperform those FMC whose controlling shareholder that are not listed. The results affirm the importance of controlling shareholders on FMC performance. It is also found that FMC with higher ownership concentration damages FMC performance.

We document the presence of foreign shareholding in FMC affecting FMC performance positively across all the measures, and these positive relations are significant using risk-adjusted performance (M2 and JENSENPF). We could argue that foreign shareholders pay more attention to risk adjusted performance rather than raw return (MPF). This result is consistent with Yoshikawa and Gedajlovic (2002) that show foreign ownership is positively associated with firm performance in conventional listed company.

We find board size affects FMC performance negatively, indicating smaller board is more effective in enhancing FMC performance. This result is consistent with the findings from Adams, Mansi et al. (2010), Kong and Tang (2008) and Dann, Del Guercio et al. (2002) that board size is negatively related to fund performance. We may argue that larger boards are likely to have higher coordination costs, which reduces their ability to effectively monitor management.

However, there is again no evidence of the importance of board independence on FMC performance which is consistent with the findings by Khorana, Servaes et al. (2007a). As discussed above, in the Chinese context, it is hard to ensure true independence and quality of the board. We find FMC with longer tenure of fund managers enhances FMC performance.

In addition, as a form of robustness test, this study also uses FMC total expense ratio as a proxy of board effectiveness to examine the relation between the key governance

mechanism (board performance) and FMC performance, this thesis document that increasing the level of FMC total fees does significantly reduce FMC performance, affirming that a more effective board can on the whole produce better performance.

Overall, this thesis provides evidence that even in the Chinese fund industry where there is an immature capital market, weak legal enforcement and poor external institutional conditions, the quality of corporate governance could make a difference by enhancing board effectiveness and FMC financial performance.

As shown in Table 41, we find that FMC with a listed controlling shareholder significantly enhances board effectiveness and improves FMC performance compared with those FMC with non-listed controlling shareholder. It could be explained that when the controlling shareholder is a listed company, the higher governance standards expected of those controlling shareholders could have a significant positive impact on the effectiveness of FMC board and governance mechanisms, which increases FMC performance.

While the presence of foreign ownership in FMC increases FMC TER, it enhances FMC performance substantially especially when using risk-adjusted returns as proxies to measure performance. The introduction of foreign investment could significantly enhance FMC Performance, which affirms the benefits of the introduction of foreign investment in Chinese market especially during the period of global finance crisis. The concentrated ownership in FMC is found to have no impact on FMC board effectiveness but harms FMC performance. It could be argued that increasing the number of FMC shareholders from different financial background such as banks, insurance companies, and investment companies could lead to better access to more financial information, and/or they have more capacity to identify and appoint qualified fund managers to manage AUM so that could increase FMC performance.

This paper documents that larger board size has no effect on board effectiveness but harms FMC performance, affirming the ineffectiveness of board size in China and higher coordination costs leading to the negative effect on FMC performance. The proportion of independent directors is found to have no impact on either board effectiveness or FMC performance. With its concentrated ownership and shortage of qualified independent directors in China, it is unlikely that independent directors will play an effective role in monitoring and control, resulting in ineffectual board independence in China's circumstance.

Although the presence of female senior executive's is found to enhance FMC board effectiveness, the impact of female senior executives on FMC performance is not found.

We found increasing number of females on board have no impact on board effectiveness but actually damages FMC performance. It suggests that having more female members on the board just for the sake of "Guan Xi" or "Gender diversity" would not enhance board effectiveness but is likely to incur costs. In China, the appointing of female and male is probably subject to the same shortcomings and constraints of the existing governance processes so that superficial diversity makes little difference. This thesis shows that while the presence of remuneration committee could enhance board effectiveness; it has limited power to influence FMC performance.

The results show that FMC with the presence of remuneration committee significantly enhances board performance than those FMC without setting up remuneration committee because the presence of Remuneration committee institute more rational incentive system to better align the interests of board members and senior management to those of fund investors, can help better align of interests between senior officers in FMC and fund investors enhance board effectiveness. However, the presence of remuneration committee plays no role in enhancing FMC performance. A possible explanation is that the quality and skills of fund managers plays a key role in FMC performance. The presence of remuneration committee plays negligible role in motivating Chinese fund managers in enhancing their performance because of the high turnover rate in Chinese fund managers.

The number of supervisors does not enhance either FMC board effectiveness or FMC performance. This affirms the general expectation that supervisors are generally ineffective in performing their roles in China.

The result also shows that there is no relation between the size of FMC's asset under management (AUM) and FMC performance, suggesting that FMC's scale of operation does not help to increase FMC performance. However, increasing FMC AUM enriches FMC because of the fees FMC could charge, thus affirming the arguments of misalignment of interests between FMC and fund investors.

It also shows that older FMC have better FMC performance. It could be explained that older FMC may be more experienced in investments and have more extensive networks in obtaining useful information to enhance FMC performance.

Table 41: Governance variables' impact on TER and Performance

VARIABLES	Measures for Board effectiveness		Measures of PERFORMANCE			
	LOG (TOTALTER)	AWTER	MPF	OAPF	M2PF	JENSENPF
TSTATESH	+	-	+	-	+	-
LISTEDCONTROL	+ **	+ **	+ *	+ ***	+ *	+ **
FOREIGNSH	- **	-	+	+	+ **	+ *
HHI	+	+	- ***	- *	- *	- **
BODSIZE	-	-	+	- *	-	-
ID	+	+	-	-	-	-
FEMSENOIRBOD	+ *	+	+	+	+	+
FEMALEBOD	-	-	-	- *	-	- **
REMUNERATION	+ *	+	-	-	-	-
SUPERVIORNO	+	+	-	-	-	- **

9.3 Contributions

The thesis contributes to the existing literature in the following ways: First, it presents as a systematic study with quite comprehensive empirical evidence on the quality of corporate governance and its impacts under the contractual form of FMC, providing new perspectives and findings in an area of research much neglected in the literature.

Second, this research represents a step forward from the extant studies focusing on how board characteristics and composition by investigating a wider range of governance mechanisms that affect board effectiveness which, to the best of our knowledge, no other study has attempted. For instance, this thesis introduces governance mechanisms such as shareholder profile and shareholding structure, the role of the supervisory board, and presence of remuneration committee. In China's highly (although not necessarily effective) regulated contractual organisational form of FMC, the misalignment of the interests between FMC shareholders and fund investors also unwittingly makes the role of shareholder important and unique as they could influence board appointment and tenure, and compensation (Article 45, '*Corporate Governance Code for FMC*'), therefore ultimately influencing board effectiveness. The presence of remuneration committee in fund industry has not been examined previously, in contrast to the recent extensive media reports in the West about excessive pay for senior executives in firms. In an emerging economy like China, there is as yet no regulation mandating FMC to establish a remuneration committee.

Third, applying corporate governance scores to proxy for corporate governance quality, this study is a first study to investigate the link between the governance quality indicator (rating) and FMC performance. Fourth, a set of unique but important governance variables is introduced in this study to which the literature has given relatively little attention. For instance, we test the impact of the presence of female directors and top executives or board chair on board effectiveness. In fact, influence from female as top executive or board chair in general has not been studied at all in China even in the context of non-FMC corporate boards.

Fifth, we use 5-year panel data while most of the existing studies usually on U.S. fund industry only use one-year data. The advantage of using panel data is the ability to control for individual-specific, time-invariant, unobserved heterogeneity, the presence of which could lead to bias in standard estimators like OLS. Most of extant studies use either OLS (Ferris & Yan 2007; Kong & Tang 2008) or pooled OLS (Adams et al. 2010; Ding & Wermers 2009; Meschke 2007). We use both random effect model and GMM in panel data to produce better estimation. Finally, our data cover nearly all FMC that together account for more than 95% of AUM of the fund industry in China. Selection bias is therefore minimised.

In brief, this study bridges a gap in the literature by examining how governance mechanisms matter in the development of an effective and well-functioning board in FMC and in the enhancement of FMC financial performance. Fund management companies as the major institutional investors could play a major role in the development of capital market and governance of investee companies. With the weak legal environment for investor protection and a short history of the Chinese fund industry, both fund investors and regulatory authorities would like to see enhanced fund performance to protect the interests of investors and sustain the healthy development of fund industry. This study sheds light on several areas of governance issues in the Chinese fund industry, and the findings of this study show how practices and quality of governance could enhance board effectiveness and improve FMC performance.

9.4 Limitations and directions for future research

While more than 95% of AUM in Chinese fund industry were included, our sample size on FMC is small (288 firm-year observations in 2006-2010) because of the relatively small size of fund industry in China, although the sample still provide reasonable level of evidence and the findings of this study are found to be robust.

Second, findings from this thesis may not be generalised to another countries, as the legal environment and institutional setup all affect corporate governance practices and outcomes. Finally, we only investigate China's fund industry; further research focusing on comparative analysis of FMC in other countries will uncover both common and specific traits and characteristics of corporate governance practices and challenges across economic systems and social conditions for more insights on the advancement of the interest of fund investors.

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Appendix A. Variables Definitions and Measurement

Abbreviations	Definition & Measurement
Performance measures	
A fund i's return	$R_{it}^j = (AUM_t - AUM_{t-1}) / AUM_{t-1}$ <p>R_{it}^j refers to the return for fund i in FMC j, where return is calculated by AUM at the end of the year minus AUM at the beginning of the year, then divided AUM at the beginning of the year.</p>
Continuous monthly FMC return (MPF)	FMC performance(MPF) = asset weighted individual fund return where return is calculated by continuous monthly returns
M2PF	$M2PF_{it} = \frac{\sigma_{mt}}{\sigma_{it}} (\bar{R}_{it} - R_{ft}) - \bar{R}_{mt} + R_{ft}$ <p>Where σ_{mt} is standard deviation of market index, “Shanghai composite index” is adopted;</p> <p>σ_{it} is fund i's standard deviation, $\bar{R}_{it} - R_{ft}$ is fund's average excess return, R_{ft} use “China 7 Day Repo Rates”. FMC M2PF is asset-weighted fund's M2PF within a FMC.</p>
Objective-adjusted risk free FMC return (OAPF)	FMC style-adjust performance (SAPF) = $\sum$ (fund AUM/ FMC AUM) * (Fund return - the investment objective's average return) / the cross-sectional standard deviation of a fund's return within an investment objectives.
Jensen Performance (JENSENPF)	$\alpha_{it} = R_{it} - [R_{ft} + \beta_i (R_{mt} - R_{ft})]$ <p>Where R_{it} is fund i's return for time period t; R_{ft} is return for risk-free assets during time period t, R_{ft} use “China 7 Day Repo Rates”; β_i is beta coefficient for fund I; and R_{mt} is market return during the same time period. FMC JENSENPF is asset-weighted fund's JENSENPF within a FMC.</p>
Governance Variables	
Total state-owned financial shareholding (SHSTATEFIN)	Total shareholding of state-owned financial shareholders.
A listed company as controlling shareholder dummy (CSHLISTED)	Controlling shareholder equals to 1 if the controlling shareholder is a listed company, otherwise 0.
Foreign ownership dummy (SHFOREIGN)	Foreign ownership equals to 1 if there is the presence of foreign ownership, otherwise 0.
Ownership concentration (HHI)	<p>Herfindahl index will be used to calculate:</p> $HHI = \sum_{i=1}^N S_i^2$ <p>, where S stands for the percentage of each</p>

	shareholders' shareholding within a FMC.
Board Size (BS)	Number of directors in a board.
Independent Directors (ID)	The percentage of outside directors.
Female member on board (BOARDFEMALE)	Number of females on board.
Female senior dummy (SENOIRFEMALE)	Female as CEO or board chair.
Remuneration committee dummy (REMUNERCOMM)	Remuneration committee equals to 1 if there is the presence of remuneration committee, otherwise 0.
Number of members on supervisory board (NOSUPERVISOR)	Number of members on supervisory board.
Control variables	
FMC Size (FMCSIZE)	Total net assets under management by all funds within a FMC.
FMC Age (FMCAGE)	FMC age is calculated, if months are greater than 6 months in a year, and then it is 1 year older.
FMC turnover ratio (TURNOVERRATE)	Asset-weighted turnover rate of each fund within a FMC. Turnover rate of each fund is calculated by dividing the average asset of a fund in a year by the lesser of the value of purchases and the value of sales during the same period.
FMC lag performance (LPF)	Previous year's FMC performance.
Total expense ratio (TOTALTER)	$\text{FMC TER} = \text{FMC fees and expenses} / \text{FMC asset under management (AUM)}$
Asset-weighted expense ratio (AWTER)	$\text{Asset-weighted FMC TER (AWTER)} = \sum \text{fund expense ratio} * (\text{fund AUM} / \text{FMC AUM})$