

# **Learning Foreign Ownership Regulations in China through Networks: Case studies on Japanese subsidiary with post-entry mode change**

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## **Abstract**

In order to explore what motivates post-entry mode change of the MNC (Multinational Corporation) in China, this paper proposed a theoretical framework that has highlighted MNC flexibility influenced by learning ownership regulations through relationship networks. A company is embedded in a number of relationships with identifiable counterparts and this web of relationships can be called a network. Learning ownership regulations refers to obtaining, interpreting or confirming foreign ownership regulations in China. In this paper, MNC flexibility is defined as the MNC's ability to manage the risks and exploit the opportunities that arise from the diversity and volatility of foreign ownership regulations in China; Post-entry mode change is specified as the change from joint venture to wholly foreign-owned enterprise. Japanese subsidiaries in China were studied, specifically, 3 wholly foreign-owned enterprises in Shanghai, all of which were initially set up as joint ventures. The case studies showed that superior networks contribute to excellent learning ownership regulations, which leads to enhanced MNC flexibility, which in turn motivates post-entry mode change. However, the enhanced MNC flexibility by excellent learning ownership regulations through superior networks can motivate not only the change from joint venture to wholly foreign-owned enterprise but also keeping joint venture.

## **Keywords:**

Network, Learning, Institutional knowledge, Foreign ownership, Mode change, Mode choice, Flexibility

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## Introduction

Foreign ownership regulations in China have been changing since Reform and Opening Policy<sup>2)</sup>. The Joint Venture Law<sup>3)</sup> of 1979 allowed Equity joint ventures (EJVs) between foreign multinational corporations (MNCs) and state-owned enterprises (SOEs) for the first time. Chinese government launched Law of Wholly Foreign-owned Enterprises<sup>4)</sup> in 1986, permitting MNCs to establish wholly foreign-owned enterprises (WFOEs) for the first time. At that time, however, WFOEs were allowed only in a few industries. A lot of industries were still closed to foreign investment (e.g. logistics, retailing, urban networks of water supply etc.). Gradually, some were opened for WFOEs (e.g. logistics was allowed in 2005), while some were only opened for JVs with or without stipulating that Chinese SOEs should hold majority share (e.g. urban water supply was opened in 2002 for JVs stipulating the Chinese SOEs as the majority shareholder and in 2008 for JVs without such stipulation). Until 1995, the most prominent foreign ownership laws Regulations for Guiding the Direction of Foreign Investment and its appendix Catalogue for Guiding Foreign Investment in Industries<sup>5)</sup> were issued. The former categorizes Chinese industries into those that are *encouraged*, *permitted*, *restricted* and *prohibited* for foreign investment and was revised in 2002. The latter was revised in 1997, 2002, 2004 and 2007 respectively and these various versions altogether are called the Catalogues, which list industries in terms of encouraged, restricted or prohibited categories. Those not listed belong to the permitted category. The investment in encouraged category often enjoys the right to establish WFOEs, while that in restricted category is often limited to JVs. The prohibited category refers to industries in which foreign investment is completely not allowed. During the revision of the Catalogues, more and more

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2) As China's international trade policy introduced after Deng Xiaoping took office, it is also termed as China's policy of opening up to the outside world. Deng Xiaoping, under his new capitalist-inclined system that promoted market forces, committed China to adopting policies which promote foreign trade and economic investment. He set in train the transformation of China's economy when he announced a new "open door" policy in December 1978. Before then, China's main trading partners had been the USSR and its satellites. Deng realized that China needed Western technology and investment, and opened the door to foreign businesses who wanted to set up in China.

3) In the 1970's, China's trade pacts became increasingly complicated, partly because China started engaging in contractual joint ventures, in which the foreign partner does not have ownership rights and the partners do not necessarily share risks. Economic laws are needed to provide a framework for resolving legal problems not encountered in previous business transactions. The equity joint venture law, enacted July 1979, is the first of these laws. In equity joint ventures, the foreign partner does have ownership rights and the partners share risks.

4) Adopted on 12 April 1986 at the 4th Session of the 6th National People's Congress, Law of Wholly Foreign-Owned Enterprises stipulates in Article 1 that China permits foreign enterprises and other economic organizations or individuals to establish enterprises with sole foreign investment within Chinese territory, and this law was revised in 2000 (see <http://eastlaw.net/chineselaws/FDI/wfoel.pdf>). Before the issue of this law, foreign organizations could only be allowed to set up joint ventures with Chinese domestic organizations.

5) In 1995, the first version was issued

(see <http://wzs.mofcom.gov.cn/aarticle/n/200208/20020800036872.html?522833741=360834781>).

In 2002, Regulation for Guiding the Direction of Foreign Investment was revised

(see <http://www.china.com.cn/chinese/PI-c/111845.htm>)

prohibited or restricted industries have upgraded to permitted and even encouraged categories, although some were downgraded from encouraged to restricted or even to prohibited categories (The trend can be observed through the Catalogues). In addition, other industry-specific regulations can make effect and may be taken priority over the Catalogues. Thus, foreign ownership laws and regulations in China are complex.

Due to geographic proximity, Japanese MNCs are among the pioneers investing in China. Since 1980, they have started setting up JVs in China (This can be observed through Toyo Keizai KAIGAI SHINSHUTSU KIGYO SORAN). Yan and Warner (2002, in Puck et al., 2009) noted that JVs can be the most popular entry mode before 1997. Most Japanese subsidiaries established as JVs during 1980s and 1990s are still JVs nowadays. Nevertheless, many of them (e.g. 11%-15% in Shanghai) were changed to WFOEs during 2000s. More of them continue this type of change. Post-entry mode change refers to the MNC changes its mode of operation after initial entry into a foreign market<sup>6)</sup>. The change from initial JV to WFOE is a specific type of post-entry mode change. Such a type is focused in this paper. Then what motivates the post-entry mode change from JV to WFOE? How can the motives be related to the complex foreign ownership regulations in China? We will not simply look at the regulation itself, as the research industry is not specified in this paper. WFOE is allowed in some industries but hindered in others. Rather, we are interested in learning—obtaining, interpreting or confirming—the regulation through relationship networks, and the resulted MNC flexibility—the MNC's ability to manage risks and opportunities that arise from the regulation.

Relationship networks are becoming increasingly more involved in international business studies, as Powell (1990) posited that firms are increasingly adopting network forms of organization and are subject to influences of non-economic factors. Hagedoorn and Duysters (2002) noted that networks are a source of learning and extracting information. Rangan (2000) further noted that networks are a source of learning about markets and institutions in the host country. Foreign institutional knowledge is the experiential knowledge of foreign government, institutional framework, rules, norms and values, including among other things the knowledge about foreign ownership regulations. Since knowledge is the outcome of learning process, knowledge about foreign ownership regulations is the outcome of learning foreign ownership regulations. Complying with Johanson and Vahlne (2009), I regard networks as vehicles in learning institutional conditions, specifically in this paper, as an important source of learning foreign ownership

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6) Post-entry mode strategy refers to mode strategy after entry into a foreign market for a period of time. Only in a few previous studies has the adjustment of Multinational Corporation operations to host-country conditions been linked to post-entry mode strategy. For example, Gomes-Casseres (1987) pointed out that mode change from joint venture to wholly-owned subsidiary in some cases represented adjustment to host-country conditions. Calof and Beamish (1995) found that mode change can arise because of adjustment to host-country markets. Post-entry mode change is a specific type of adjustment of post-entry mode strategy.

regulations.

Learning ownership regulations is in effect learning about risks and opportunities that arise from foreign ownership regulations. This is essential to managing these risks and opportunities. As we utilize MNC flexibility to mean the MNC's ability to manage the risks and exploit the opportunities that arise from foreign ownership regulations in China, learning ownership regulations impacts on MNC flexibility.

Thus, we argue that MNC flexibility influenced by learning ownership regulations through networks contributes to the change from initial JV to WFOE, a specific type of post-entry mode change. In the following, a theoretical framework about this argument will be developed. Then methodology and case studies on Japanese subsidiaries will be elaborated. Finally, discussion will be followed by conclusion.

## **Literature Review**

### **1. Relationship Networks**

A company is embedded in a number of relationships with identifiable counterparts and this web of relationships can be called a network. Powell (1990) divided inter-firm exchanges into market ties and network ties. The former are impersonal and constantly changing exchange partners; the latter are stable and keeping close social relationships. Impersonal market transactions become concentrated and exclusive, forming dyadic embedded ties, i.e. ongoing and exclusive relationships with one another. Uzzi (1997) argued that these dyadic embedded ties assemble into extended networks of embedded ties, and by this means, each firm's ties and ties of these ties form a relationship network.

Granovetter (1985) criticized the 'markets and hierarchies' argument that treats social structural impacts on market behavior as exceptions, and combined the embeddedness approach with the economic approach. Uzzi (1997) commented that the combination can better explain economic behavior and competitiveness than the pure economic approach. Gulati (1999) noted that the embeddedness perspective was firstly applied to the study of individuals and their networks and later to firms and their interorganizational networks. In other words, the various types of networks can be divided to individual-level and organization-level. Moreover, Halinen and Tornroos (1998) utilized 'micronet-macronet embeddedness' to categorize networks from a different perspective, i.e. micronet refers to the network composed of only business actors whereas macronet involves both business and non-business actors.

Early IMP (International Marketing and Purchasing) research such as Hakansson and Snehota (2000) focused on business networks only with inter-firm exchange relations,

which are formed through interaction between firms. This tradition continues in some of the later and even recent studies. Madhok (1997) and Parkhe (1993) thought of inter-firm relations as economic exchanges due to rational calculation for each member's resource needs. Coviello and Munro (1997) examined the small MNC's network relationship with large MNCs for which it distributed. Forsgren et al. (2005) focused on business networks of market exchange relations with suppliers and customers. Similarly, Andersson et al. (2002) examined the effect of business embeddedness and technical embeddedness in subsidiary's network with local suppliers and customers. In their computational model, Lin et al. (2008) searched suppliers in terms of resource needs, thus forming the network of exchange relations.

Another stream of research studying inter-firm networks stressed strategic alliance networks. According to Vyas et al. (1995), a strategic alliance is an agreement between two or more partners to share knowledge or resources which could be beneficial to all parties involved, shaped from technology and product development to manufacturing and marketing. Gulati and Singh (1998) noted that along its structural spectrum, joint ventures occupy one end, with partners creating a new entity in which they share equity and most closely replicate the hierarchical control features of organizations, and at the other end, alliances without sharing of equity and with few hierarchical controls, i.e. alliances with arm's-length contracts. Madhavan et al. (1998) examined the role of key industry events in the creation of inter-organizational alliance networks. Gulati and Gargiulo (1999) evaluated the effect of attributes such as joint centrality in strategic alliance network on new alliance formation. Gulati (1999) highlighted that external resources residing in previous strategic alliance network can influence the extent to which firms secure information about potential partners and further influence new alliances treated as strategic action. Hagedoorn and Duysters (2002) investigated the effect of network behavior in strategic technology alliances on technological performance. Zaheer and Venkatraman (1995) examined effects of alliance networks on the structure and performance. Gulati (1995) underscored the impact of alliance networks on the choice of alliance partners. Walker et al. (1997) focused on the role of networks in alliances with new partners.

Nevertheless, in terms of Welch and Wilkinson (2004), business networks in early research composed only of business actors such as customers, suppliers, distributors and competitors have been expanded to a broader concept, i.e. networks with a variety of relationships. Such networks should also include a firm's relationships with non-business actors such as government and industrial associations, as well as managers' social relations, e.g. family and community ties, school and university ties, banking and boardroom ties, chamber of commerce and trade association ties, and employer and co-worker ties. These relationships are as important as inter-firm relationships. Granovetter

(1985) asserted that all economic action is embedded in networks of social relations. Stated differently, networks of social relations both between and within firms are overlaid on business relations. Hadjikhani and Ghauri (2001) noted that even business network approach itself originates from social network theory. Halinen and Tornroos (1998) treated business networks as complex embedded structures of inter-firm relationships in that these relationships are embedded in broader contextual settings.

Hallen (1992) classifies networks to inter-firm level, organization-centered infrastructural level and person-centered infrastructural level. In his opinion, inter-firm networks include not only a firm's relationships with actual exchange partners such as suppliers and customers but also with third parties such as legal, financial and technical consultants. In terms of such logic, consultant companies are regarded as business actors. On the other hand, infrastructural networks are composed of non-task relationships with non-business actors. Unlike inter-firm networks, infrastructural networks are characterized by weak ties, which are alive and can revive when required. Organization-centered infrastructural networks include a focal firm's relationships with nonbusiness actors such as government, trade unions, industrial federations and private-interest associations. Person-centered infrastructural networks develop around specific individuals both as businessmen and as private persons, i.e. 'managerial ties' referred by Peng and Luo (2000) and Zhang and Li (2008) as executives' interpersonal contacts with external entities. The heart of networking activity is formed by contacts between people, both formally and informally, in both social and work situations. Hallen (1992) argued that person-centered infrastructural networks have denser and closer ties than organization-centered infrastructural networks. It may explain the conclusions made by Peng and Luo (2000) that managerial ties with top executives of other firms and with government officials can improve firm performance and by Zhang and Li (2008) that managerial ties in emerging economies greatly influence firm growth. I regard Hallen's classification of network levels (1992) as the most appropriate cross-classification, in terms of both individual/organization-level and micronet/macronet.

A firm's management activity is divided into business area considering interaction with business actors and political area involving interaction with political actors (Boddewyn, 1988). Political actors are among nonbusiness actors. According to Hadjikhani and Hakansson (1996), political actors include bureaucrats, government ministers, parliament members, opposition parties, interest groups and the media. Political actors constitute the political network. Unlike industrial network characterized by longevity, political network features by temporality and discontinuity. In contrast, Hadjikhani (2000) incorporated political actors into the business network and highlighted their proactive effect on business actors. Following this viewpoint, I regard political actors as a constituent in the infrastructural network cited by Hallen (1992).

Ghoshal and Bartlett (1990) treated MNCs as networks of both internal and external relationships. Internally, subsidiaries exchange information horizontally with each other and vertically with the headquarters, thus forming a communication network. Externally, different subsidiaries are embedded in different local networks (host government, competitors, customers, suppliers, financial institutions, intermediaries, alliance partners etc.), and thus the MNC as a whole tends to be embedded in differentiated networks simultaneously. Accordingly, a subsidiary is among a complex system of multiple linkages of internal and external relationships. Welch and Welch (1993) identified three subsidiary networks, i.e. headquarter-subsidiary network, subsidiary-subsidiary network and subsidiary-external environment network. Their interconnection results in a complex web of linkages. The link between headquarter and subsidiary is said by Martinez and Jarillo (1989) to be both formally by organization structure and standardized procedure and informally via interpersonal contact and socialization. In such a link, various actors exchange resources such as information. In terms of Thorelli (1986), the subsidiary-subsidiary network features by not only interdependency and interconnectedness but also friction and conflict. Although Welch and Welch (1993) categorize the external environment into local environment, foreign environment and alliance partners, I only look at the local environment among which alliance partners exist. That is, operating in foreign markets, MNC subsidiaries have to build up relationships with a wide range of organizations and individuals in the external environment including local suppliers and customers, host government, local labor, local competitors, stakeholders (Welch and Welch, 1993), as well as intermediaries, banks, government officials (Benito and Welch, 1994), and local alliance partners. However, according to Forsgren et al. (2005), internal units<sup>7)</sup> are not significantly different from external units<sup>8)</sup> to a focal subsidiary, as the subsidiary may depend on local external units to the same extent as or even more than on sister subsidiaries and headquarters. Similarly, relationships among the internal units are regarded by Ghoshal and Bartlett (1990) as inter-organizational, just as the internal units' relationships with external units. Thus, internal and external units of the MNC are treated equal in this paper. Moreover, I focus on the subsidiary-level networks, in which I consider not only relationships with business actors but also with non-business actors, not only inter-organizational but also interpersonal relationships. Taking Hallen's classification (1992) into consideration, I highlight the three levels of a subsidiary's network, i.e. inter-firm network including relationships with both internal units (sister subsidiaries and headquarters) and external business firms (e.g. suppliers, customers, alliance partners, consultants); organization-centered infrastructural network including relationships with external non-business organizations; person-centered infrastructural network including managers' business ties and social ties both personal-level.

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7) I think internal units should belong to the headquarter-subsidiary network and subsidiary-subsidiary network identified by Welch and Welch (1993).

8) I think external units should be in the subsidiary-external environment network identified by Welch and Welch (1993).

## 2. Learning Ownership Regulations through Networks

According to Duncan and Weiss (1979, in Weick, 1991), organizational learning is “the process within the organization by which knowledge about action-outcome relationships and the effect of the environment on these relationships is developed”<sup>9)</sup>. From this viewpoint, knowledge is the outcome of learning process. Previous studies such as Ford (1990) have highlighted the link between networks and organizational learning. Particularly, Welch and Welch (1996) suggested that the learning process underlying internationalization activities is closely related to the development and utilization of foreign networks. In terms of Delios and Beamish (1999), local knowledge of the host country includes political and legal rules and social norms for business transactions. From my point of view, part of the key knowledge about host country markets is created and maintained through network actors.

Johanson and Vahlne (1977) classify the knowledge of international markets into objective knowledge easily acquired and experiential knowledge that firms can accumulate only through engaging in international operations. Eriksson et al. (1997; 2000) identify three components of experiential knowledge: internationalization knowledge, business knowledge and institutional knowledge. Foreign institutional knowledge, the experiential knowledge of government, institutional framework, rules, norms and values, concerns institutions found in foreign markets, foreign governments and bureaucracies, and the ways in which these work. “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (North, 1990, p.3). These constraints include both formal and informal. In terms of Seyoum (2009), formal institutions include laws, regulations and rules that establish the basis for production, exchange and distribution, e.g. rules governing property rights or ownership rights. According to Karabay (2010), foreign ownership restriction is the most obvious way of restricting ownership shares of MNCs in foreign direct investment (FDI) projects, and many countries allow FDI only through ventures with local firms. On the other hand, emerging countries such as China have recently liberalized foreign ownership restrictions to some extent. Thus, rules governing foreign ownership shares and rights include not only restrictions but also promotions. In this paper, laws and regulations on foreign ownership restrictions and promotions are termed as foreign ownership regulations. According to Chen et al. (2009), informal institutions refer to rules and norms shaped by the industry and the society, and networks are regarded among informal institutions. Thus, institutional knowledge includes knowledge not only on formal institutions like foreign ownership regulations but also on informal institutions such as networks.

According to Murtha and Lenway (1994), foreign institutional knowledge is a source

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9) See Duncan and Weiss (1979, p. 84) in Weick, K.E. (1991): The nontraditional quality of organizational learning. *Organization Science*, 2 (1), pp. 116-124.



of competitive advantage<sup>10)</sup>, and law enforcement in practice is even more important than what the law says particularly in emerging economies. Thus, it is insufficient to understand technical and commercial laws and norms in a foreign market without experiential institutional knowledge. In other words, knowledge beyond what formal institutions say cannot be obtained without informal institutions. In this paper, learning ownership regulations refers to obtaining, interpreting or confirming foreign ownership regulations in China. As the outcome of learning ownership regulations, knowledge about and particularly beyond what foreign ownership regulations say can be insufficient without such informal institutions as networks. Networks have been proved important in China. For example, Luo (2003) argued that relationship networks in China enable firms to countervail institutional uncertainties in the face of regulatory changes. According to Elango and Pattnaik (2007), one important source that MNC subsidiaries in emerging markets use to acquire foreign institutional knowledge is their networks. In my opinion, networks as informal institutions are used to acquire knowledge particularly beyond what formal institutions like foreign ownership regulations say. Stated differently, networks are used by MNC subsidiaries in emerging markets for learning foreign ownership regulations. These subsidiaries can obtain such knowledge not only directly through their own experiences in both organizational-level and personal-level networking with local actors such as host government and business partners, but also through experiences of other firms in headquarter-subsidiary and subsidiary-subsidiary networks, i.e. experiences of headquarters and sister subsidiaries.

Institutional knowledge is “information about the governance structures in specific countries and their rules, regulations, norms and values” (Eriksson et al., 2000, p. 29). Information is among the most important functions of a firm’s networks. Networks are a source of learning opportunities from outside the firm. Much of the critical information about foreign markets can be found in the network a MNC develops, especially key actors within the network. For example, Delios and Beamish (1999) considered relationships with local business partners essential to acquiring local knowledge. Information flow is among network resource flows. Nohria (1992, in Gnyawali and Madhavan, 2001) noted that the MNC subsidiary may access internal resources held by connected actors in a network. Such internal resources include among other things internal information. Banerji and Sambharya (1996) stressed heavy information flows between network actors. The information flow includes information and knowledge not only gathered from connected business actors (Harrigan, 1986, in Gnyawali and Madhavan, 2001), but also from nonbusiness actors in the network. According to Hallen (1992), when business relations

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10) “a firm has a competitive advantage when it is able to create more economic value than rival firms.” (see page 10, Strategic Management and Competitive Advantage, Jay B. Barney and William S. Hesterly, 2012, 4<sup>th</sup> ed., Pearson)  
Cost leadership and differentiation are the two basic types of competitive advantage. (see page 3, Competitive Advantage: Creating and Sustaining Superior Performance, Michael E. Porter, 1985, Free Press)

are absent, infrastructural networks are essential to obtain information. However, in my opinion, infrastructural networks can be more important than business relations with regard to acquiring institutional knowledge. Hadjikhani and Ghauri (2001) pointed out that business actors can obtain experience and information about values and activities of political actors through interaction with them. In this way, MNC subsidiaries obtain institutional knowledge by building up direct relationships with political actors such as the host government. On the other hand, Kogut (2000) contended that a firm can access wider knowledge base through its network of important suppliers, customers and other business partners. In this case, the firm's business partners may become the intermediary in its relationship with government. For example, a large number of MNCs chose joint venturing with Chinese state-owned enterprises (SOEs) as the initial entry into China in 1980s and 1990s. As the SOEs are more familiar with Chinese policy than foreign MNCs, these MNCs can acquire institutional knowledge through their Chinese partners. Thus, MNC subsidiaries acquire institutional knowledge indirectly from their business partners. Moreover, personal ties are overlaid on the above relationships. Research on social networks underscores interpersonal ties. Uzzi (1996) argued that social networks make information not only transferable but also interpretable and valuable. Likewise, Rangan (2000) contended that wide and deep interpersonal business and private relationships bring about cheap, expeditious and effective information.

### **3. Post-Entry Mode Change and MNC Flexibility**

Flexibility is a subject researched by a wide range of disciplines, from military strategy and economics, through strategic management and decision theory, to child psychology and environmental research. Flexibility is also a multi-faceted concept, including adaptability, agility, versatility, resilience and robustness (Bahrami and Evans, 2005). In other words, the content assigned to the concept varies from one author to another. Bruce Kogut (1985) argued that the MNC needs to create operational flexibility in order to profit from global strategies. Hence, it is also termed as strategic flexibility of the MNC. This concept is captured and termed as multinational flexibility by Bartlett et al. (2008). They define multinational flexibility as the ability of a company to manage the risks and exploit the opportunities that arise from the diversity and volatility of the global environment. I comply with this definition. However, I focus on such specific environment as foreign ownership regulations in China. Thus, *flexibility* is redefined as the MNC's ability to manage the risks and exploit the opportunities that arise from the diversity and volatility of foreign ownership regulations in China, i.e. a specified formal institutional environment in a specified country rather than a variety of environment in the globe. In order to differentiate this flexibility from previous definitions, I term it MNC flexibility.

Although there has been a lot of research on initial entry mode choice, relatively little is studied about what Puck et al. (2009) noted as post-entry change of foreign firms'

ownership forms, or as changes in ownership forms of operation abroad after initial entry. It points to the mode change based on the same operation. For instance, the Japanese company Omron initially established a joint venture in Shanghai in 1993. In 2005, however, this joint venture was changed to a wholly Japanese-owned enterprise through Omron's acquisition of shareholding owned by the local partner, a Chinese state-owned enterprise (SOE). Another Japanese company Sato Metal set up a representative office in Shanghai in 1999. Later in 2005, this office was changed to a wholly Sato-owned enterprise. A more interesting example is the Japanese company Hitachi Cable, which set up a wholly owned subsidiary in Shanghai in 1994. A few years later, this subsidiary was changed to a joint venture. But after a while, this joint venture was again changed back to wholly Japanese-owned enterprise.

Uppsala model or stages theory advocates that the process of internationalization is incremental in the sequence of 'export via an agent—sales subsidiary (acquisition of the agent or organized around employees of the agent)—local production' (Johanson and Vahlne, 1977). In other words, if a MNC chooses exporting as the initial entry mode, it will give up exporting to set up sales subsidiary, and later change the same sales subsidiary to local production. According to Buckley and Casson (1981), the evolution of MNC entry modes is from export through licensing to FDI, but the MNC may expand directly from exporting to FDI skipping licensing in some cases, and in other cases, may evolve only from exporting to licensing but not from licensing to FDI. Thus, if the MNC chooses exporting when entering the foreign market, it may give up exporting to utilize licensing and later change the licensee to joint venture partner (or give up licensing to directly set up wholly owned venture). The "post-entry changes of foreign firms' ownership forms", "process of internationalization", and "evolution of MNC entry modes", all can indicate the way by which MNCs may change their operation modes after initially entering the foreign markets. We term this "post-entry mode change", which is defined as the MNC changes its mode of operation after initial entry into a foreign market.

It should be noticed that "evolution of MNC entry modes" and "process of internationalization" include more than post-entry mode change. The evolution (Buckley and Casson, 1981) can also mean that the MNC chooses exporting when initially entering a foreign market and later accrues licensing or/and FDI as entry modes for new operations while keeping exporting. Similarly, the sequential internationalization process (Johanson and Vahlne, 1977) can also include the situation that a MNC chooses exporting initially, later accrues sales subsidiary and finally local production in new entries. For example, the Japanese company Suzuki began providing technology for Chinese market in 1984, later set up a representative office in Beijing in 1995, during the same year, established joint

ventures in Jiangxi<sup>11)</sup> and Chongqing<sup>12)</sup>, and set up a wholly owned venture in Beijing in 2004. Until present, these affiliates exist simultaneously. These mode changes in subsequent/late entries are different from post-entry mode change.

Many MNCs change their operation modes after initial entry into China (Ye, 2011). In that article, the ‘change of operation modes’ refers to both post-entry mode change and subsequent entry mode change. However, this paper excludes consideration of subsequent entry mode change. More importantly, for the sake of research focus, post-entry mode change is specified as the MNC changes to wholly foreign-owned enterprise (WFOE) after initial entry as joint venture (JV, including Chinese-foreign Cooperative Enterprise and Chinese-foreign joint venture).

#### **4. A Theoretical Framework**

In this paper, I have specified post-entry mode change as the change from initial JV to WFOE. What motivates this type of change? How can the motives be related to the complex foreign ownership regulations in China? Foreign ownership regulations are not consistent for all industries in China, and may not be coherent in the same industry due to spatial and temporal disparities. As a result, simply considering foreign ownership regulations in motivating post-entry mode change is not reasonable, even though the change can be directly related to the regulations in certain occasions.

The foreign ownership regulation is among formal institutions, and thus knowledge about the regulation—as the outcome of learning it—is among formal institutional knowledge. The most important part of such knowledge is the meaning behind what foreign ownership regulations say literally. Such knowledge is the outcome of not only obtaining but also interpreting or confirming what foreign ownership regulations say. Such knowledge is insufficient without informal institutions. Among informal institutions, relationship networks are indispensable in China. Relationship networks are called Guanxi networks in China, although Hackley and Dong (2001) pointed out the difficulty to find an equivalent English word to accurately express the meaning of Guanxi, since it is a unique social and cultural phenomenon deeply rooted in Chinese culture and gradually developed throughout the thousand-year-old society. Yan (1996, in Hackley and Dong, 2001) defined Guanxi as a strategically constructed network of personal relationships. In Chinese society, however, Guanxi is considered not only personal but also organizational relationships. Yang and Wang (2011) also argued that Guanxi refers to dynamic, interactive relationships at both individual and organizational levels. Hence, in this paper, Guanxi or relationship networks are referred to as including a business organization’s

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11) Jiangxi is the name of a province in China.

12) Chongqing is the name of a municipality in China, which is important in western China and governed directly by Chinese central government.

relationships with other business or non-business organizations, and a business person's relationships with other business or social persons. For instance, a business manager builds up relationships with his/her colleagues in the same company, or with employees of relational companies such as supplier and customer, or with his/her friends and relatives. It has to be noticed that family or kinship tends to be the center of Guanxi or relationship networks in China. Empirical studies such as Peng and Luo (2000) provide evidence on the importance of relationship networks in China. They are important for firm behavior and even more important for firm growth in transitional economies (Peng and Heath, 1996). Thus, relationship networks are a source of knowledge beyond what foreign ownership regulations say, and are vehicles in learning ownership regulations particularly interpreting or confirming what the regulations say.

A subsidiary's relationship networks are composed of its relations with headquarters and sister subsidiaries, external business firms such as suppliers and consultant companies, external non-business organizations like government, as well as managerial ties. Which kind of relationship or Guanxi networks is superior and which kind inferior to learning ownership regulations? We assume that the network featured by embedded relations with multiple actors or with only a few key actors is superior to learning ownership regulations. In contrast, the network in which neither multiple sources of actors nor key actors are connected is inferior to learning ownership regulations. The purpose of building up a superior relationship or Guanxi network for a subsidiary is to acquire a better source of knowledge beyond what foreign ownership regulations say.

The information flow shaped by relationship networks provides both opportunities and risks for firms and influences their strategic behavior (Gulati, 1999). Accordingly, in the current research, the essence of learning ownership regulations is regarded as learning opportunities and risks that arise from the complex foreign ownership regulations in China. Such learning enables MNC subsidiaries to exploit these opportunities and manage these risks. In other words, learning ownership regulations through relationship networks influences MNC flexibility—MNC's ability to exploit opportunities and manage risks that arise from the diversity and volatility of foreign ownership regulations in China. Not all the MNCs recognize the importance of establishing superior networks. Even if they do, not all are able to establish such networks. Hence, learning ownership regulations is excellent for some MNCs but insufficient for others. Excellent learning opportunities and risks that arise from foreign ownership regulations enhances MNC's ability to manage these opportunities and risks—MNC flexibility. On the contrary, insufficient such learning decreases MNC flexibility.

Furthermore, firm capability of dealing with environmental opportunities and risks is important to its strategic choice. We assume that enhanced MNC flexibility motivates

post-entry mode change from initial JV to WFOE. Thus, we develop the following theoretical framework:

Relationship networks influence learning ownership regulations, such learning affects MNC flexibility, which in turn influences post-entry mode change (see Diagram 1).

Surrounding the motivation of post-entry mode change, the framework can be specified as follows:

Superior networks facilitate excellent learning ownership regulations, such excellent learning leads to enhanced MNC flexibility, which in turn motivates post-entry mode change from JV to WFOE.

## Methodology

### Data Collection

Through Toyo Keizai<sup>13)</sup> and company websites (These websites are not revealed for the sake of company confidentiality), I chose 20 Japanese MNC subsidiaries in Shanghai. Shanghai is one of the most developed metropolitans in China and has long become an investment hotspot for foreign particularly Japanese firms, perhaps because of its geographic proximity to Japan. During 1980s and 1990s, MNCs headquartered in Japan invested 507 branches in Shanghai excluding representative offices, 30% of all Japanese branches in China during the same period, leading Chinese provinces, municipalities and other administrative areas (Toyo Keizai, 2011)<sup>14)</sup>. The main objective of this research was to explore what caused post-entry mode change from JVs to WFOEs. As a result, all the 20 subsidiaries chosen were set up as JVs during 1990s but were changed to WFOEs during 2000s. During 2010, I did a survey on these 20 subsidiaries by email, telephone and/or fax to ask if I could interview their top managers. Despite various difficulties in contacting these companies, I finally visited 3 out of the 20 wholly Japanese-owned enterprises in Shanghai (companies A, B, C) and interviewed their managers. The interview results were primary components of case studies.

### Measurement by Interview Questions

The interviews were semi-structured (part of the interview questions see appendix 1). Previously, no empirical studies examined foreign ownership regulations quantitatively.

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13) Toyo Keizai's micro-data: Kaigai Shinshutsu Kigyō Soran (Directory of Japanese Subsidiaries Abroad). More information can be found at <http://www.ier.hit-u.ac.jp/Common/publication/DP/DP394.pdf>.

Such directories have been published once a year and for a few decades. Whether these subsidiaries were joint venture or wholly Japanese owned at the point of establishment or whether they have ever been changed from joint to wholly Japanese-owned venture usually cannot be observed from only one year's directory. Consequently, the author combined various years' directories as well as company websites (when necessary), in order to find subsidiaries that have been changed from joint ventures to wholly Japanese-owned enterprises.

14) Toyo Keizai's Kaigai Shinshutsu Kigyō Soran: CD-ROM-ban 2011 (Directory of Japanese Subsidiaries Abroad: CD-ROM version 2011). The number 507 can be observed directly in the CD-ROM, while the number 30% was calculated by the author through observations in it.

This paper tried to fill this gap by setting original questions. Although foreign ownership regulations in China are complex, I focus on two primary aspects in order to examine effectively. One is various versions of “Catalogue for Guiding Foreign Investment in Industries” (the Catalogues). The other is industry-specific ownership regulations. Thus, the extent to which the subsidiary knows about these two dimensions of foreign ownership regulations was asked respectively. Answers were measured on a 7-point likert scale<sup>15)</sup> where 1 denoted ‘very little’ and 7 denoted ‘very much’. Such design of scale has been common to assess ‘extent’ or ‘degree’. For instance, Peng and Luo (2000) measured the extent of ties with relevant network actors on a 7-point scale, ranging from ‘very little’ to ‘very extensive’. Answers to the two questions on foreign ownership regulations were averaged to create a composite measure of ‘learning ownership regulations’. Such composite measurement using multiple questions (indicators) to measure the same construct also has been popular (e.g. Forsgren et al., 2005).

Interviewees were asked to identify relationships important to their obtaining, interpreting or confirming foreign ownership regulations in China. Not only the number of influential actors but also the analysis of key actors in the network for learning foreign ownership regulations was useful to elaborate relationship networks.

Answers to the open-ended questions “Was this change related to foreign ownership regulations in China? If not, what factors caused this change?” and “Why didn’t your company change the operation mode immediately after deregulation?” demonstrated related process, through which MNC flexibility as well as its intermediate role between learning ownership regulations and post-entry mode change were analyzed.

## Analysis and Results

### Company A

This company is a subsidiary of a Japanese multinational corporation (MNC) in Shanghai, China. It is engaged in the production and sales in the electronics industry. It was established as a Chinese-foreign joint venture with a Chinese state-owned enterprise (SOE) in 1993, with the Japanese MNC holding majority share. Later in 2005, it was changed to a wholly foreign-owned enterprise (WFOE).

3 persons were interviewed simultaneously—Japanese general manager, Chinese department manager, and Interpreter. The general manager was relatively new comer,

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15) A Likert scale, named after its inventor-psychologist Rensis Likert, is the most widely used approach to scaling responses in survey research. Respondents specify their level of agreement or disagreement on a symmetric agree-disagree scale for a series of statements. Thus, responses are scored along a range, capturing the intensity of their feelings for a given item.

while the department manager had worked for the company for over 10 years and been quite familiar with the company's developmental progress. Languages used include Chinese, Japanese and English. The interview lasted for one hour.

According to the managers, foreign ownership regulations in China might be one of the reasons causing the change from JV to WFOE, but were not the main reason. Learning (obtaining, interpreting and confirming) the policy change was important to the ownership change only to some extent, say, 20%-30%. The ownership change from JV to WFOE was mainly attributed to three reasons. Firstly, at the time of change, the Japanese MNC intended to invest a project which is lucrative. But the process of the Chinese SOE to make a decision on the investment was complex and slow. In order not to miss the opportunity to invest and make a profit, the Japanese MNC decided to buy the share owned by the Chinese SOE. Secondly, the Chinese SOE did not have enough cash to invest. Even if it agreed the project, it could not invest immediately. Thirdly, more profit and control would be made with the establishment of a WFOE.

Its industrial sector, which is listed in the encouraged category in the 1995 Catalogue, has been allowed to set up WFOE since 1995. However, the company kept being a JV until 2005. In 1995, the company was young and still needed the Chinese SOE to positioning in Chinese market and networking with the local government. With the establishment of market position and the decreased importance of Chinese SOE in networking with government, the company was changed to WFOE after being JV for over 10 years. However, according to the managers, if the Chinese SOE was not so weak in the ability to invest, the Japanese MNC would not change the venture from JV to WFOE.

According to the managers, the company's relationships with its customer companies, with its headquarter especially law consultants in the Chinese headquarter, with government, and its managers' relationships with friends including alumni, former colleagues, friends in social clubs such as Golf club and Japanese manager club, friends' friends, are important to learning foreign ownership regulations. Nevertheless, the most important source should be the inner networking among Japanese headquarter, Chinese headquarter and the company.

According to the managers, they have extremely excellent learning in the Catalogues (score on 7), and have excellent learning on industry-specific ownership regulations (score on 5). They regard the Catalogues as opportunities and simultaneously as risks for the company's operation. The managers extremely agree "how a policy is enforced in practice at a particular time by a particular government agency is more important than what the policy says".



**Company B**

This company is a subsidiary of a Japanese multinational corporation (MNC) in Shanghai, China. It is engaged in the production and sales in the pharmaceutical industry. It was established as a Chinese-foreign cooperative enterprise between the Japanese MNC and a Chinese state-owned enterprise (SOE) in 1999, with the Japanese MNC holding 95% of the total share. Later the Japanese MNC changed its shareholding to 98%, and finally in 2007, changed to 100%. Thus, the company was changed to a wholly foreign-owned enterprise (WFOE).

Chinese administrative director of this company was interviewed. He has been very familiar with the company's developmental progress and has constructive ideas about operation modes. Hence, the language used is Chinese. The interview lasted for one hour.

According to the director, the ownership change from JV to WFOE was related to foreign ownership regulations in China. Learning ownership regulations was important to the company's ownership change to the extent of 80%. The Japanese MNC intended to establish a WFOE at the beginning, but this was not permitted by Chinese policy. Thus, the Japanese MNC adopted the suggestion of law consultants to set up a JV and was preparing for the change to a WFOE. After its industrial sector was listed in the encouraged categories of the 2002 Catalogue, the company was changed to WFOE. However, the ownership change did not happen immediately after the change of ownership regulations. In the initial cooperative agreement of the two partners, it was stipulated that the Japanese partner could not set up WFOE until the Chinese partner recouped all the investment.

According to the director, relationships important to learning ownership regulations include those with strategic alliance partners, the government, business/industrial associations, law consultants, managers of other companies, and managers' friends (alumni, former colleagues, friends in social clubs and friends in the government). However, the most important is the relationship with the government. Moreover, law consultants have influenced the company's learning (obtaining, interpreting and confirming) ownership regulations to a great extent. Among them, 70% are government consultants who provide the policy information, 30% are private consultant corporations which keep strong networking with the government and research on the policy information obtained. Thus, the company has adopted multiple sources of law consultant to obtain, interpret and confirm the changing policy including ownership regulations.

According to the director, they have extremely excellent learning in the Catalogues (score on 7) and excellent learning on industry-specific ownership regulations (score on 6). They do not any more regard the Catalogues as great opportunities or huge risks for

the company's operation. The director agrees "how a policy is enforced in practice at a particular time by a particular government agency is more important than what the policy says".

Additionally, the director highlighted the importance of Chinese partner who could obtain more development opportunities for the company, thus express the opinion that continuing to be JV might be better than changing to WFOE. As it is difficult to have post-entry mode change, most MNCs prefer to change operation mode in their late entries if the change can benefit.

### **Company C**

This company is a subsidiary of a Japanese multinational corporation (MNC) in Shanghai, China. It is engaged in the industry of environment pollution control, which has been listed in the encouraged category of the 1995 Catalogue, meaning its industry has been allowed to set up WFOE even before the company's initiation. Nevertheless, the company was established as a Chinese-foreign joint venture with a Chinese state-owned enterprise (SOE) in 1997, with the Japanese MNC holding 65% of the total share. Later in 2000, the Japanese MNC changed its shareholding to 90%, and finally in 2007, changed to 100%. From then on, the company became a wholly foreign-owned enterprise (WFOE).

2 persons were interviewed simultaneously—Chinese vice general manager and Chinese administrative director. Both have worked in the company for many years and been familiar with the company's developmental progress. The language used is Chinese. The interview lasted for one hour.

According to the managers, the ownership change from JV to WFOE was irrelevant to foreign ownership regulations in China. Learning ownership regulations was not important at all to the company's ownership change. The ownership change was caused by the market, management mode and corporate culture. At the time of establishment in 1997, foreigners were prohibited to apply for the kind of qualification which has been necessary to operation in the environment pollution control industry. In order to use the qualification of Chinese partner, the Japanese MNC set up JV with the Chinese partner. However, the qualification of Chinese partner was not so useful to the company, as most clients were Japanese companies and the Chinese qualification was not needed. Thus, the Japanese MNC wanted to buy shares from the Chinese partner. On the other hand, the JV had made a loss for a few years since establishment. Without profit and lack of cash, the Chinese partner proposed to withdraw shares in 2005. As a result, the company was changed to WFOE without any difficulties.

According to the managers, the relationship with headquarter in Japan is very important

to learning ownership regulations, relationships with law consultant and managers of other companies are important to some extent. Ties with strategic alliance partners are very weak. When the Chinese qualification is needed occasionally, the company tends to find a temporary Chinese partner.

According to the managers, they have extremely excellent learning on industry-specific ownership regulations (score on 7) but only have learning in the Catalogues to some extent (score on 4). They regard the Catalogues not as opportunities but as huge risks for the company's operation. The managers totally agree "how a policy is enforced in practice at a particular time by a particular government agency is more important than what the policy says".

### **Cross-Case Analysis**

All the cases show that relationship networks are important to learning government policies such as foreign ownership regulations. Hence, various subsidiary networks constitute a complex web for learning ownership regulations. However, the constituents in the web tend to be discrepant for different subsidiaries (see figures 1, 2, 3). All the 3 subsidiaries are featured by superior networks, although the way of superiority is disparate. Both company A and company B are connected with multiple influential actors in their webs. Simultaneously, a few key actors exist in both webs. Nonetheless, key actors are different. For company A, the most important actors are Chinese headquarter and Japanese headquarter, while for company B, government and law consultants. Moreover, company B set up relations with and reliance on multiple sources of law consultant. Government consultants accounting for 70% provide policy information. Private consultant corporations which account for the left 30% and are closely connected with the government justify the policy information. In contrast, company C is embedded in a sparse network, with only one key actor—Japanese headquarter. This headquarter in Japan may have a variety of contacts such as government and managerial ties for learning foreign ownership regulations in China, thus being intermediary between company C and those contacts. All the 3 subsidiaries get high scores in learning ownership regulations (6 for company A, 6.5 for company B, 5.5 for company C). As a consequence, superior networks contribute to excellent learning ownership regulations.

Company A's excellent learning on foreign ownership regulations—particularly interpreting and confirming through its superior networks such opportunities as permission to establish WFOE—enhanced its ability to exploit these opportunities. Such enhanced MNC flexibility, in turn, facilitated its change to WFOE. Similarly, company B's excellent learning about opportunities to establish WFOE from foreign ownership regulations—with the help especially of law consultants—enhanced its ability to exploit such opportunities and in turn facilitated its change to WFOE. Company C was changed

to WFOE after the Japanese MNC was allowed to apply for the necessary qualification in China, suggesting that its excellent learning about opportunities from foreign ownership regulations enhanced its ability to exploit the opportunities. Consequently, enhanced MNC flexibility by excellent learning ownership regulations can motivate post-entry mode change from JV to WFOE.

All of the 3 companies had been JVs before changing to WFOEs. The Japanese MNC now owning company C was already allowed by the Catalogues to set up WFOE at the beginning (1997), but it could not apply for the necessary industry-specific qualification in 1997, and thus it established a JV with a Chinese partner who had owned the qualification. This in fact shows how important enhanced MNC flexibility by excellent learning ownership regulations is to its keeping JV before post-entry mode change. As industry-specific regulations can make effect and may be taken priority over the Catalogues, the Japanese MNC learned about risks from foreign ownership regulations. It had kept a JV just because its excellent learning on foreign ownership regulations enhanced MNC flexibility, particularly its ability to manage risks arisen. Similarly, company B had been kept as JV before permission to establish WFOE in 2002, because its excellent learning about risks from foreign ownership regulations enhanced its ability to manage these risks. Likewise, company A's keeping JV before permission to set up WFOE in 1995 was due to its enhanced MNC flexibility by excellent learning about risks particularly from the Catalogues. In this situation, MNC flexibility especially refers to its ability to manage these risks. Thus, it can be inferred from the before-change situations that keeping JV after initial entry as JV in some cases is attributed to enhanced MNC flexibility (particularly the ability to manage risks) by excellent learning ownership regulations (particularly learning about risks). Combing the situations that initial JVs were changed to WFOEs, we can generally say that enhanced MNC flexibility by excellent learning ownership regulations can motivate not only post-entry mode change from JV to WFOE but also keeping JV. Specifically, however, 'enhanced MNC flexibility by excellent learning ownership regulations motivates post-entry mode change' is particularly related to opportunities, while 'enhanced MNC flexibility by excellent learning ownership regulations motivates keeping JV' is especially relevant to risks.

Although enhanced MNC flexibility by excellent learning ownership regulations is essential to post-entry mode change of company B and company C, it seems not always be the key factor. In terms of the managers' opinion, company A's change from JV to WFOE was mainly attributed to reasons other than MNC flexibility influenced by learning ownership regulations. Firstly, at the time of change, the Japanese MNC intended to invest a project which is lucrative. But the process of the Chinese SOE to make a decision on the investment was complex and slow. In order not to miss the opportunity to invest and make a profit, the Japanese MNC decided to buy the share owned by the

Chinese SOE. Secondly, the Chinese SOE did not have enough cash to invest. Even if it agreed the project, it could not invest immediately. Thirdly, more profit and control would be made with the establishment of a WFOE. However, company A would not change to WFOE without the change of ownership regulations from restriction to promotion.

It can be inferred that enhanced MNC flexibility by excellent learning ownership regulations may not always be taken priority over other factors to influence keeping JV. Company A had kept as JV for 10 years even after permission to establish WFOE. At that time, the company was young and still needed the Chinese partner for positioning in Chinese market and networking with the local government. In other words, its post-entry mode change did not happen until the establishment of market position and the decreased importance of Chinese partner in networking with government. This complies with the finding of Makino and Delios (1996) that the utility of joint venturing with a local partner compared to setting up a wholly owned subsidiary decreased with greater levels of international experience due to the foreign firm's development of local knowledge. Company B had kept as JV for 5 years after permission to set up WFOE. In the initial cooperative agreement of the two partners, it was stipulated that the Japanese partner could not establish WFOE until the Chinese partner recouped all the investment.

## **Discussion**

It seems that enhanced MNC flexibility by excellent learning ownership regulations through superior networks may not always be the decisive factor motivating post-entry mode change. Nevertheless, without excellent learning about foreign ownership regulations in China and related opportunities and risks, Japanese companies would not initiate post-entry mode change from JV to WFOE, even if they want to have more control and profits. Although managers of company A and company C stated that learning ownership regulations are not so important to their companies' post-entry mode change, the above case analysis showed the opposite.

Foreign ownership regulations in China vary in industries and involve various government agencies and thus policies, increasing the complexity of learning ownership regulations. In automobile component industry, restrictions have been relaxed gradually. At the beginning, only JV was allowed. After a while, some products were opened for WFOE. Finally, most automobile components have been allowed for WFOE. In automobile industry, although WFOE is never permitted, when and how the restriction will change is uncertain. The function of learning ownership regulations is to decrease the uncertainty. Furthermore, the enforcement of foreign ownership regulations is flexible within some scope. For example, logistics industry was limited to JV generally

but permitted for WFOE at Zhangjiagang Free Trade Zone<sup>16)</sup> in 1990s. With the help of Free Trade Zone Administration Committee, the Japanese logistics company Marukyo established its wholly-owned subsidiary within such a special area in 1994. Meanwhile, following the law consultant's suggestion, Marukyo set up a Chinese domestic company outside of the Free Trade Zone in 2000, with a Chinese employee registered as Chairman of the company. In this way, Marukyo had operated in China before logistics industry was opened for WFOE in 2003.<sup>17)</sup> Thus, excellent learning ownership regulations can be essential for any foreign company operating in China, whether or not its managers realize the essentiality.

Without building up superior Guanxi or relationship networks, excellent learning particularly interpreting and confirming ownership regulations is impossible, because China is a society of Guanxi or relationship networks. Guanxi is pervasive in every aspect of the business and social world in China, and its essentiality for firm survival and growth has been proved by previous studies such as Peng and Luo (2000). Guanxi network is an important form of social capital in China. According to Xin and Pearce (1996), social capital theory treats Guanxi network as an invaluable resource for management involving informal exchanges of social obligations. Chen and Wu (2011) argued that people turn to Guanxi network when formal institutions are unavailable. Thus, Guanxi or relationship networks can be regarded among informal institutions and as a substitute for formal institutions in China (Chen et al., 2009; Peng and Heath, 1996; Luo, 2003). In this paper, however, we treat the informal institutions—Guanxi or relationship networks, not as a substitute for formal institutions but as a means of learning formal institutions. In terms of Chen et al. (2009), formal institutions in China are often confusing or conflicting and information got from relationship networks becomes more reliable and valuable. Nevertheless, Guanxi networks become less important with gradually improved formal market-oriented institutions (Peng, 2003; Peng et al., 2008). Hence, for the Guanxi or relationship network, being a means of obtaining information beyond what laws and regulations write is more reasonable than completely substituting for formal institutions. Establishing and maintaining superior relationship networks and thus obtaining excellent information beyond what foreign ownership regulations say becomes essential to post-entry mode change from JV to WFOE.

The superior network of company C is featured by embedded relations with only a few actors, particularly one key actor—Japanese headquarter. Corporate and regional

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16) A special area in Jiangsu province of China, within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities. Only when the goods are moved to consumers within the country in which the zone is located do they become subject to the prevailing customs duties.

Though a municipality directly administered by China's central government, Shanghai is actually located in Jiangsu province.

17) The author visited Marukyo Transportation and Trade Co., Ltd. in Shanghai and interviewed its general manager.

headquarters are among the most important functions within the MNC. According to Dicken (1998), the corporate headquarter processes and transmits information to and from other parts of the MNC, while the regional headquarter intermediates between the corporate headquarter and its affiliates within its specific region. In addition, corporate headquarters handle relationships and information with high-level organizations such as major business service providers (financial, legal or advertising) and major departments of foreign/domestic governments. However, in my view, whether the corporate headquarter or the subsidiary establishes and manages relationships with external business as well as nonbusiness actors relies on the MNC strategies. In terms of Murtha and Lenway (1994), usually, MNCs based in pluralist countries such as USA tend to adopt nationally responsive strategies. I argue that subsidiaries in this case tend to be more autonomous in dealing with relationships in the embedded networks. Murtha and Lenway (1994) also posited that MNCs headquartered in corporatist countries such as Japan prefer global integration strategies, which centralize most value chain activities in the home country and treat the world as a unified market served through national market and sales affiliates. I contend that under this circumstance corporate headquarters exert more control over subsidiaries and hence over their relations with local networks. Besides company C, company A also falls into the typical Japanese strategies and is more controlled by their headquarters. As a result, headquarters are the most important for them with regard to learning ownership regulations.

Direct links with Chinese government are crucial to both company A and company B. Company A may have set up direct connection with local government and thus depreciated the importance of previous JV partner (Chinese SOE) in networking with government. In this situation, however, law consultants tend to be intermediaries in the relationship with government, substituting for local business partners especially JV partners. This may explain why the most important sources to company B's learning ownership regulations are government and its related law consultants, and why law consultants are essential to all the three companies. Bjorkman and Kock (1995) argued that the Chinese intermediary's relationships with government officials within a particular province are so strong that the foreign firm is able to extend market prospects through these relationships. Welch and Welch (1996) noted that part of such relationships remains unseen even though it may come into play over time. Blankenburg and Johanson (1992) further pointed out that such ambiguity will reinforce as the extent and complexity of such relationships expands over time. In China, intermediaries have their own networks producing unexpected connections. Accordingly, Welch and Welch (1996) asserted that it is difficult for MNCs to understand in advance which relationships ought to be formed and whether the Chinese intermediary owns the appropriate network. Thus, company B adopted various law consultants as multiple sources of learning the government policy.

Both individual learning and organizational learning are important (Welch and Welch, 1996). Thus, from network perspective, both personal-level and organizational-level networks influence learning. According to Welch and Welch (1993), people are key links in relationship networks, which are established and maintained via personal contacts. Manager's business ties as well as social ties are highlighted in the case studies. For example, former colleagues are a source of learning such policy as foreign ownership regulations in both company A and company B. Former staff can function as continuing sources of information even working for competitors. Nevertheless, Welch and Welch (1996) noted that whether former staff can be powerful in information transfer relies on the strength of relationships between former and current staff.

### **Conclusion**

In order to explore what motivates the MNC's post-entry mode change from joint venture (JV) to wholly foreign-owned enterprise (WFOE), we highlighted the complex foreign ownership regulations in China, by looking at learning such regulations through relationship networks and the resulted MNC flexibility. Thus, a theoretical framework was developed assuming that MNC flexibility influenced by learning ownership regulations through relationship networks affects post-entry mode change. In this paper, it was examined whether enhanced MNC flexibility by excellent learning ownership regulations through superior networks motivates post-entry mode change from JV to WFOE, i.e. whether superior networks facilitate excellent learning ownership regulations, whether such learning leads to enhanced MNC flexibility, and whether the enhanced MNC flexibility in turn motivates post-entry mode change.

Case studies on 3 Japanese subsidiaries in China that have changed from initial JVs to WFOEs partially exemplified the framework. Superior networks facilitate excellent learning ownership regulations, although the way of superiority is disparate in different companies. Enhanced MNC flexibility by excellent learning ownership regulations can motivate post-entry mode change, under the circumstance that enhanced MNC flexibility particularly refers to enhanced ability to exploit opportunities and excellent learning particularly relates to excellent learning through superior networks opportunities arisen from foreign ownership regulations. Although such enhanced MNC flexibility unexpectedly can motivate keeping JV, the nature is particularly about excellent learning risks and enhanced ability to manage these risks. As a result, the original proposition can be supported contingent upon excellent learning opportunities and enhanced ability to exploit these opportunities.

It seems that enhanced MNC flexibility by excellent learning ownership regulations through superior networks may not be the key to post-entry mode change. However, in



Chinese context, Guanxi and relationship networks are so important and popular in every aspect of the social life that learning particularly interpreting and confirming foreign ownership regulations in China depends on the quality of such networking. In turn, the quality of learning ownership regulations determines MNC flexibility and thus post-entry mode change. As a consequence, the most important factor influencing post-entry mode change should be enhanced MNC flexibility by excellent learning ownership regulations through superior networks, no matter what the managers subjectively consider the key factor(s).

The motivation of keeping JV is as important as that of post-entry mode change according to the case study results. Thus, the theoretical framework can also be specified as—Inferior networks lead to insufficient learning ownership regulations, which results in decreased MNC flexibility, which in turn motivates keeping JV. Furthermore, the conclusion about keeping JV was only inferred from the study of Japanese subsidiaries with post-entry mode change, rather than directly drawn on those with keeping JV. Hence, it will be necessary and fascinating to study Japanese subsidiaries that have been kept as JVs, in order to further examine the theoretical framework.

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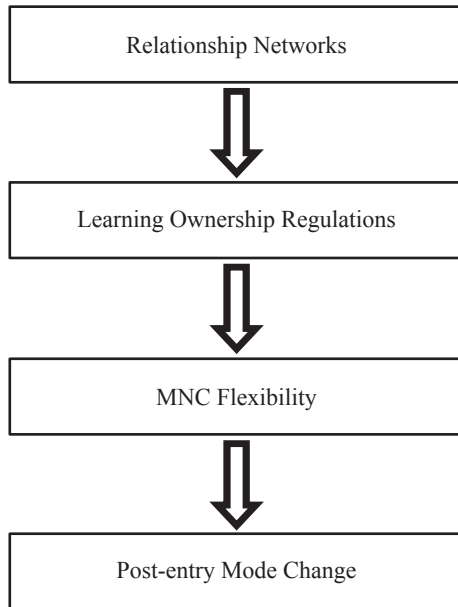
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### Appendix 1 Interview Questions

1. Has your company ever changed from joint venture (JV) to wholly foreign-owned enterprise (WFOE)?  
 Yes ( ) No ( )  
 the year of establishing a JV:  
 the year of becoming a WFOE (if applicable):
2. Was this change related to foreign ownership regulations in China? If not, what factors caused this change?
3. Why didn't your company change the operation mode immediately after deregulation?
4. Which of the following relationships are important to your obtaining, interpreting and confirming foreign ownership regulations in China?
  - ( ) relationships with suppliers
  - ( ) relationships with customers
  - ( ) relationships with strategic alliance partners
  - ( ) relationships with headquarter in China (if applicable)
  - ( ) relationships with headquarter in Japan
  - ( ) relationships with sister subsidiaries in China
  - ( ) relationships with law consultants
  - ( ) relationships with Chinese government
  - ( ) relationships with business associations

- ( ) relationships with managers of other companies
  - ( ) relationships with friends (please state what kind of friends, for example, friends in social clubs, friends in the government etc.) \_\_\_\_\_
  - ( ) other relationships, please state \_\_\_\_\_
5. To what extent do you know foreign ownership regulations in China?
- (1) Industry-specific ownership regulations  
very little 1 2 3 4 5 6 7 very much
  - (2) **Catalogue for Guiding Foreign Investment in Industries** (the Catalogues)  
very little 1 2 3 4 5 6 7 very much

**Diagram 1**



**Figure 1**

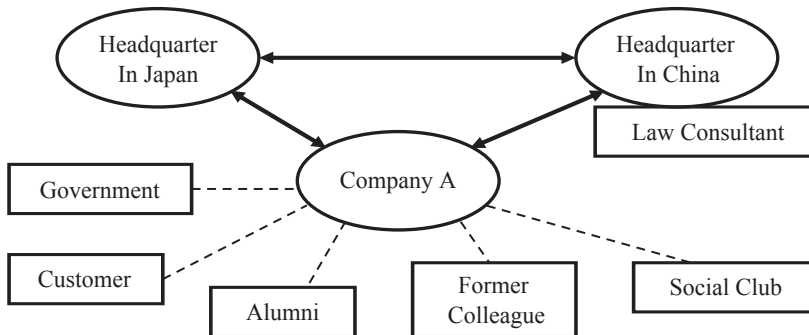


Figure 2

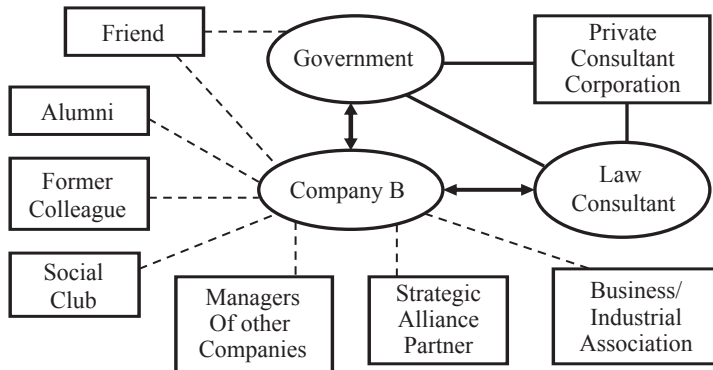


Figure 3

