

THE IMPACT OF DUAL CLASS SHARES STRUCTURE ON THE FIRM'S INNOVATION, EVIDENCE AND IMPLICATIONS

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Received : September 19, 2024; **Revised** : March 20, 2025; **Accepted** : April 29, 2025

Abstract

This study takes corporate innovation as the dependent variable, dual equity governance structure as the independent variable, and establishes a core conceptual framework through demographic variables such as industry of engagement and length of service. This study proposes the following hypotheses: 1). There is a significant positive correlation between the existence of dual equity governance structure and the level of corporate innovation. 2). There is a significant difference between different background variables on dual equity governance structure and corporate innovation. 3). The relationship between dual equity governance structure and corporate innovation is affected by the stage of the corporate life cycle. 4). In this study, a total of 550 and 526 questionnaires were distributed and returned to the employees of Chinese stock companies in different industries as a case study.

This study found: There is a significant positive association between the existence of dual equity governance structure and the level of firm innovation. The length of service and position variables are significantly different in terms of firm innovation. 3. The relationship between dual equity governance structure and firm innovation is influenced by the stage of the firm's life cycle. That is, the positive association between dual equity governance structure and firm innovation is more pronounced in the growth and maturity stages than in the decline stage.

Keywords: Dual Class Shares Structure, The Firm's Innovation

Introduction

Enterprises are crucial for economic wealth creation and national development, requiring innovation to stay competitive. Technology-oriented firms face challenges in financing due to their asset-light nature, leading them to prefer equity financing. However, traditional same-share models dilute founders' control. Dual-shareholding structures, particularly through different voting rights, emerged as a solution. Hong Kong and Mainland China initially restricted such structures but later relaxed regulations to promote innovation and attract high-tech companies.

This shift addressed the dilemma of financing versus control, allowing founders to maintain influence through high-voting shares. While this system has boosted innovation, concerns about insider control and minority shareholder rights persist. The China Securities

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Regulatory Commission (CSRC) has strengthened supervision and disclosure requirements for companies with dual-shareholding governance structures.

Xiaomi, listed in Hong Kong with a dual-shareholding structure, serves as an example for empirical research due to its innovative profile. Theoretical studies on equity structure and corporate performance have increased, with a focus on agency costs and the impact of dual shareholding on innovation. Dual-listing studies by Stapleton and Subrahmanyam have provided a theoretical basis for further research.

Research on dual-share structures in China is still limited, leaving room for empirical studies. Existing empirical research emphasizes the positive impact of voting rights on corporate innovation in dual-share structures. Theoretical studies have explored the relationship between equity structure, agency costs, and firm performance, highlighting the need for more empirical research in this area.

Dual equity governance structures, especially dual classes of shares, are gaining prominence in corporate governance. This structure, characterized by varying voting rights for different share classes, has sparked extensive debates among scholars, policymakers, and market participants. While existing literature has explored the broader implications of dual-class shares, there is a notable gap in understanding their precise impact on a critical aspect of firm functioning: innovation.

The lack of a comprehensive exploration of the intricate relationship between dual equity governance structures and firms' innovation propensity is a central issue. Despite the increasing prevalence of dual shareholdings in contemporary capital markets, there is a distinct absence of nuanced inquiry into whether these structures foster or impede innovation. This gap necessitates rigorous empirical investigation and theoretical elaboration to unveil the inherent complexity in the interplay between ownership and control dynamics and firms' innovation efforts.

To address this significant knowledge gap, this study aims to scrutinize the impact of dual equity governance structures on corporate innovation from various perspectives. The objective is to dissect intricate relationships, identify mechanisms at play, and offer actionable insights for policymakers, business leaders, and investors.

Research Objectives

1: To systematically examine the relationship between dual equity governance structures and the level of corporate innovation within listed companies.

2: To analyze the relationship between dual equity governance structure and corporate innovation based on relevant theories and the changes in the relationship between the two in different life cycles, and to formulate research hypotheses accordingly.

3: To validate the hypotheses proposed in the theoretical analysis by reviewing and collecting actual data, constructing an empirical model, and conducting an empirical test.

4: To analyze and summarize the conclusions obtained from the previous paper and to point out the shortcomings of this paper as well as the directions for future research.

Literature Review

In the context of corporate governance pluralism, this paper focuses on the relatively understudied dimension of the impact of dual equity governance structures on corporate innovation. While existing literature comprehensively addresses the broader implications of governance arrangements, there is a notable lack of focused exploration regarding how dual shareholdings, represented by the dual equity governance structure, influence firms' innovative activities.

The research is driven by the understanding that innovation is fundamental for long-term competitiveness, value creation, and sustainability in modern businesses. With the business landscape rapidly evolving due to technological advancements and shifting consumer

expectations, there is an increasing urgency to comprehend the intricate relationship between governance structures and innovation.

The subsequent sections of this paper will delve into the theoretical foundations, empirical evidence, and the impact of dual equity governance structures on corporate innovation. This investigation aims to contribute not only to academic research but also to provide valuable insights for practitioners, policymakers, and other stakeholders in modern corporate governance and innovation capabilities.

Corporate governance is the foundation of modern business structures and encompasses the mechanisms, processes and relationships that guide and control a company. It defines the distribution of rights and responsibilities among different stakeholders, including shareholders, board members, executives, employees and other stakeholders. A well-designed corporate governance framework is essential to ensure transparency, accountability and protection of stakeholders' interests (Tricker, 2015).

The evolution of corporate governance theories over time reflects adaptive responses to dynamic changes in the business environment. One of the fundamental frameworks is the agency theory proposed by Jensen and Meckling (1976), which emphasizes the principal-agent relationship between shareholders and managers. The theory emphasizes the need for mechanisms to coordinate the interests of these two parties. In the ensuing decades, corporate governance theories have expanded to incorporate a wider range of stakeholder considerations, resulting in theories such as stakeholder theory (Freeman, 1984) and stewardship theory (Donaldson & Davis, 1991).

The essence of the dual shareholding governance structure lies in the differentiation of voting rights among different classes of shares within a company. Unlike traditional structures with equal voting rights for each share, dual equity structures introduce a tiered system, typically involving common shares with limited or no voting rights and special shares held by insiders with enhanced voting rights (Hermalin & Weisbach, 2003).

Originating in the United States, dual equity garnered more theoretical attention from foreign literature than domestic sources. Scholars have explored this structure through case studies and theoretical analyses. Banerjee (2005) studied both same-shareholding and dual-shareholding enterprises, finding that the latter encourages managers to engage in financing behaviors, addressing the issue of diluted shareholder control during financing. Liao et al. (2019) conducted a case study on Baidu and Sina, affirming that the dual shareholding structure promotes the stability of Baidu's business development. Some scholars' express skepticism, suggesting that dual equity may lead to internal shareholders infringing on external investors' interests due to excessive control. Jensen and Meckling (1976) argued that the separation of power in the organization under the dual equity system creates agency problems, potentially resulting in lazy behavior by the actual controller and negatively impacting enterprise development.

Song et al. (2016) discussed the application of dual equity in China's capital market, offering suggestions for its rational use based on case studies of Jingdong and Alibaba. Wang (2021) identified shortcomings in the current implementation of dual equity and proposed measures to protect the interests of small and medium-sized shareholders.

Regarding the impact on firm performance, studies present mixed conclusions. Dimitrova and Jain (2006) found that the two-tier shareholding system significantly incentivizes the increase in shareholder value through empirical research on 176 firms over 20 years. Du (2020) studied the role of heterogeneous capital in firms with dual equity systems, discovering a significant contribution to performance among Chinese stock firms that went public in the U.S. from 1991-2017.

Dual shareholding governance structures can take a variety of forms, suited to different governance objectives and preferences. One common form is the issuance of a two-tier stock, with different classes of stock conferring different voting rights. This two-tier structure is usually represented by Class A and Class B shares, with Class B shares typically having higher voting rights compared to Class A shares (Bebchuk & Kastiel, 2017).

Enterprise innovation, as defined in the business management domain, involves the economic activities of creating a new production function or combining economic factors in the course of an enterprise's operations (Hansen and Wakonen, 1997). Innovation is crucial for business development, extending the life cycle of a firm, and achieving economic benefits beyond traditional objectives. Joseph A. Schumpeter introduced the concept of innovation, emphasizing the entrepreneur's role in recombining production factors through new products, production methods, market exploration, control of resources, and novel business organization (Di & Zhang, 2017). Enterprise innovation encompasses not only technological advancements but also the exploration of new products, raw materials, markets, and management systems (Fang & Hu, 2023). Scholars have categorized enterprise innovation into institutional and technological innovation, with the innovation system comprising technological, market, institutional, and management innovation (Wang, 1992).

Innovation, viewed as a capability by Burns and Stalker (1961), required various entrepreneurial capabilities, including learning, marketing, resource development, and network management capabilities (Oura et al., 2016). Fitz and Nordqvist (2017) emphasize perceptual, grasping, assimilative, acquisitive, deploying, and transformational capabilities as crucial for innovation. Coccia (2015) argued that firms' technological innovations depend on their ability to create novelty in the production process, involving the acquisition of knowledge from interactions with other firms or organizations.

Recent research on corporate innovation spans individual, enterprise, and societal levels. Individual-level studies explore factors like executive characteristics, employee stock ownership, and CEO work experience, highlighting their impact on corporate innovation (Liu et al., 2017; He et al., 2019). Enterprise-level research delves into financing constraints, equity structure, social responsibility, and corporate culture (Zhang et al., 2017; Chen et al., 2018; Gu et al., 2020). Social-level studies examine industrial policies, tax policies, and market environments, demonstrating their influence on innovation (Yu et al., 2016; Liu et al., 2020; Gu et al., 2020).

Characteristics of enterprise innovation include high uncertainty and risk due to external market demand uncertainties and internal R&D result uncertainties (Hansen and Wakonen, 1997). Innovation requires substantial input but yields high profitability, involving financial, material, and knowledge investments. Furthermore, innovation is non-exclusive and non-competitive, leading to knowledge and technology spillovers, with intellectual property protection providing partial exclusivity (Hansen and Wakonen, 1997).

Empirical studies on dual equity governance structures and corporate innovation reveal nuanced insights, reflecting industry variations, firm attributes, and geographical distinctions. Bebchuk and Kastiel's (2017) study on stocks with perpetual dual shareholding structures highlights persistent valuation discounts, indicating potential challenges in governance and innovation.

Comparative research by Braff et al. (2020) suggested that dual equity firms may excel in innovation, benefiting from insulation against short-term market pressures. Founder control, explored by Hochberg and Lindsey (2010), correlated positively with innovation, emphasizing the influence of managerial control on R&D intensity.

Larker and Tayan's (2016) study on sunset clauses reveal higher R&D expenditures, suggesting that the expectation of reduced control motivates increased innovation investment. These studies underscore the intricate relationship between dual shareholding structures and innovation, with potential challenges and positive contributions.

Factors influencing this relationship include industry dynamics, firm life cycle stages, and specific provisions in the dual-tier structure. Industries with rapid technological change may experience different outcomes, aligning closely with the benefits of a two-tier structure (Bebchuk & Kastiel, 2017).

The firm's life cycle stage also plays a role; early growth phases may benefit from protection against short-term pressures, promoting strategic innovation investment, while entrenched control in decline phases may hinder adaptive strategies (Hitt et al., 2019).

Provisions within a two-tier structure, such as sunset clauses, can impact innovation. Understanding these factors is crucial for shareholders, managers, policymakers, and industry participants. Shareholders must weigh trade-offs between control and innovation, considering the structure's terms and the company's innovation track record.

Managers in two-tier structures should balance control with innovation, emphasizing transparent communication and strategic R&D investment. Policymakers need to carefully regulate dual structures, balancing shareholder protection and corporate flexibility for innovation. Industry observers must comprehend the impact on innovation dynamics.

In conclusion, the dual equity governance structures' impact on innovation is complex, influenced by various factors. Theoretical perspectives and empirical evidence provide diverse views and outcomes. Stakeholders must make informed decisions, recognizing the complexity of governance structures and their impact on organizational behavior. The relationship is nuanced, shaped by industry dynamics, firm attributes, and regulatory changes.

Methodology

In this study, the adoption of a quantitative approach will facilitate the study of a large-scale dataset covering different industries and life cycle stages. The statistical rigor inherent in quantitative analysis ensures the reliability and validity of the findings and contributes to the credibility of the research results.

The Dual Equity Governance Structure Scale was adapted with reference to various scholars' scales such as Adams, & Ferreira (2007), La Porta, Lopez-de-Silanes, Shleifer, & Vishny (2000).

Corporate Innovation Scale Reference Afuah, & Tucci, (2001). Davila, Epstein, & Shelton, (2006). A number of scholars' scales adapted from the real world.

This study focuses on U.S.-listed Chinese firms from 1995 to 2022 for two primary reasons: first, the adoption of the dual equity governance structure by domestic companies for listing occurred later, with a limited number of cases in the Hong Kong Stock Exchange and Science and Technology Innovation Board (STB) as of March 19, 2023, making the overall sample size small and empirical study feasibility low. Second, despite being listed in the U.S., Chinese companies predominantly operate in the mainland Chinese market and must adhere to the rules of the domestic capital market. This sample choice aligns with the characteristics of domestic listed companies, facilitating empirical testing and allowing extrapolation of findings to the domestic capital market. This approach provides valuable insights and reference experience for the potential implementation of the dual equity governance structure in China.

Utilizing the snowball sampling technique, mid-cap companies meeting inclusion criteria were initially identified through industry contacts and publicly available databases. These identified companies were then invited to participate in the study. Subsequently, each participating firm was requested to provide referrals to other eligible firms within its professional network or industry cluster, creating an iterative process that expanded the sample through a "snowball" effect until reaching the desired sample size.

The snowball sampling method was deliberately selected to target firms that might be challenging to reach through conventional random sampling methods and to leverage the interconnected relationships among firms in related fields.

To enhance the precision of findings and the generalizability of conclusions, a questionnaire study was conducted among employees of Chinese stock companies. A total of 550 questionnaires were distributed, resulting in 526 valid responses.

Results

The p-value of the test for males and females on Dual Equity Governance Structure is 0.788 which is greater than 0.05 and hence it can be concluded that there is no significant gender difference in Dual Equity Governance Structure. The p-value of the test for males and

females on firm innovation is 0.112, which is greater than 0.05 and hence it can be concluded that there is no significant gender difference in firm innovation.

The p-value for the test of variance on dual equity governance structure is 0.565, which is greater than 0.05, indicating that the age variable does not have a significant effect on dual equity governance structure; the p-value for the test of corporate innovation is 0.279, which is greater than 0.05, indicating that the age variable does not have a significant effect on corporate innovation.

The p-value of ANOVA test for dual equity governance structure is 0.467, which is greater than 0.05, indicating that age variable has no significant effect on dual equity governance structure; the p-value of corporate innovation is 0.018, which is less than 0.05, indicating that age variable has significant effect on corporate innovation.

The p-value of ANOVA test for dual equity governance structure is 0.438, which is greater than 0.05, indicating that there is no significant effect of educational qualification variable on dual equity governance structure; the p-value of corporate innovation is 0.665, which is greater than 0.05, indicating that there is no significant effect of educational qualification variable on corporate innovation.

The p-value of ANOVA test for dual equity governance structure is 0.105, which is greater than 0.05, indicating that position variable has no significant effect on dual equity governance structure; the p-value of corporate innovation is 0.007, which is less than 0.05, indicating that position variable has significant effect on corporate innovation.

The p-value of dual equity governance structure of ANOVA test is 0.844, which is greater than 0.05, indicating that industry variable has no significant effect on dual equity governance structure; the p-value of corporate innovation is 0.181, which is greater than 0.05, indicating that industry variable has no significant effect on corporate innovation.

The p-value of dual equity governance structure of ANOVA test is 0.469, which is greater than 0.05, indicating that there is no significant effect of corporate life cycle variables on dual equity governance structure; the p-value of corporate innovation is 0.434, which is greater than 0.05, indicating that there is no significant effect of corporate life cycle variables on corporate innovation.

After analyzing the Coefficient coefficient, we find that the unstandardized coefficient of dual equity governance structure is 0.609, the standardized coefficient is 0.852, and the p-value is 0.000, which indicates that there is a positive and significant relationship between dual equity governance structure and corporate innovation.

Selecting only the case of Life Cycle = decline stage, after analyzing the coefficients of coefficients, we find that the unstandardized coefficient of dual equity governance structure is 0.577, the standardized coefficient is 0.803, and the p-value is 0.000, which indicates that there is a positive and significant relationship between the dual equity governance structure and firm innovation. Combining the results, 0.861 is greater than 0.803, indicating that the relationship between dual equity governance structure and corporate innovation is affected by the stage of the corporate life cycle, i.e., the positive correlation between dual equity governance structure and corporate innovation is more pronounced in the growth and maturity stages than in the decline stage.

Discussion

This study investigates the impact of the dual equity governance structure on corporate innovation, comparing it with traditional equity structures and considering the dynamic changes across different stages of the corporate life cycle. Several key points emerged:

1). Dual Equity Governance Structure and Corporate Innovation:

The unique institutional arrangement of the dual equity governance structure enhances executive negotiating power, reduces investor control, and promotes long-term company development and innovation.

It aids in alleviating shareholding concentration, fostering a cooperative environment between companies, and facilitating sustained corporate development.

Ensures stability in core management positions, enhancing risk tolerance and decision-making in favor of promoting corporate innovation.

2). Interplay of Variables (Length of Service, Position, and Governance Structure):

Employee tenure, hierarchical positions, and governance structures collectively shape organizational dynamics, influencing innovation outcomes.

The organizational environment is depicted as a multifaceted ecosystem where these variables synergistically contribute to the innovation landscape.

3). Corporate Life Cycle Impact on Dual Equity Governance Structure:

In the growth phase, dual equity governance structure optimally enhances managerial efficiency, decision-making, and resource support for innovation activities, promoting corporate innovation.

In the maturity stage, dual equity governance structure positively influences corporate innovation due to a strong resource base, unique advantages, and a focus on long-term value creation.

During economic recession, the negative effects of the dual equity governance structure, driven by self-interest motives of managers, outweigh the positive effects, leading to a dampening effect on innovation.

The positive impact of employee tenure is highlighted in terms of tacit knowledge accumulation and social network cultivation. Leadership positions play a crucial role in shaping innovation strategies, with executives setting overall direction and lower-level employees actively contributing. The dual equity governance structure introduces a dynamic element with stage-specific nuances across the firm's life cycle, influencing innovation outcomes.

Conclusion

1). Dual Equity Governance Structure and Corporate Innovation:

The study establishes a significant positive correlation between dual equity governance structures and corporate innovation. Drawing on established corporate governance theories, such as agency theory and stewardship theory, the research enhances understanding of how dual equity structures positively influence innovation outcomes. The presence of family and non-family shareholdings in governance contributes to an innovation-conducive environment.

Mechanisms underlying this correlation involve the need for diverse perspectives within dual equity structures, mitigating agency problems and balancing short- and long-term goals. This balance fosters a strategic imperative for innovation, accommodating diverse equity holder preferences. The study emphasizes the necessity for governance practices to adapt to the complexities inherent in dual equity structures.

2). Contextual Variables on Dual Equity Governance Structure and Firm Innovation:

Regarding contextual variables, the study identifies significant differences based on the length of service and hierarchical position.

Length of Service:

Longer employee tenure is positively associated with firm innovation, aligning with the accumulation of tacit knowledge and the cultivation of social networks over time. The study emphasizes the role of length of service in fostering knowledge transfer and collaborative dynamics.

Hierarchical Position:

The hierarchical position within an organization significantly impacts firm innovation outcomes. Distinct roles are played by individuals in different organizational levels, emphasizing the multifaceted nature of leadership roles. Executives and lower-level employees contribute uniquely to the innovation process.

Practical implications suggest a nuanced approach to leadership and organizational structures, encouraging collaboration and open communication. Executives should foster a culture of risk-taking, while empowering employees at all levels to contribute valuable insights.

3). Dual Equity Governance Structure and Firm Innovation across Firm Life Cycle Stages:

The study reveals a stage-dependent relationship between dual equity governance structure and firm innovation. The positive association is more pronounced in the growth and maturity stages, contrasting with a weaker correlation in the decline stage.

Growth and Maturity Stages:

Dual equity governance structures thrive in the complexity of the growth and maturity stages. Synergies between family and non-family equity enhance stability and long-term orientation, aligning with organizational strategic needs and reinforcing the positive correlation with innovation.

Decline Stage:

In the decline stage, the study suggests organizations reassess their governance structures and innovate alternative mechanisms to address challenges and stimulate creativity. The weaker correlation during this stage necessitates careful consideration of governance dynamics.

In conclusion, the study provides nuanced insights into the intricate relationships between dual equity governance structures, contextual variables, and firm innovation across different stages of the firm life cycle. It contributes to theoretical understanding and offers practical implications for organizations seeking to optimize innovation efforts in varying governance and life cycle contexts.

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