DEVELOPING VENTURE CAPITAL LAWS IN CHINA: LESSONS LEARNED FROM THE UNITED STATES, GERMANY, AND JAPAN

1. INTRODUCTION

DateLINE: Aug. 5, 1995, Silicon Valley—Today, Netscape Communications Corporation (Netscape) made history on Wall Street by becoming the hottest initial public offering (IPO) of all time.1 Netscape’s underwriters initially priced the 3.5 million shares to be offered at $12 to $14 per share.2 As the IPO date approached, however, demand for the stock was so high that the offering was expanded to five million shares, and the price was increased to $28 per share.3 Nevertheless, even doubling the price of the offering, a virtually unprecedented occurrence in an IPO, the underwriters still did not aim high enough.4 At the opening bell on the NASDAQ5 the stock went out at $71 per share and rose as high as $75 in the same day before settling down around the $50s,6 making venture capitalist Jim Clark the first “Internet billionaire,” and netting Netscape’s co-founder, 24-year-old Marc Andreesen, a fortune close to $100 million.7 Not bad for a single day’s work.


2. An IPO is the offering of a company’s securities to the public for the first time. See JAMES D. Cox et al., SECTORS REGULATION, CASES AND MATERIALS 2 (5th ed. 1997). A company engaged in the process of an IPO is also commonly referred to as “going public.” See id.


4. Id.


The ripple effect of the Netscape IPO was felt throughout the world, especially in the People’s Republic of China (China), where the government is keenly developing venture capital to fuel the growth of its burgeoning high-tech industry. Even though China has attracted significant venture capital financing in the last decade, venture capital laws currently do not exist in China.  The Chinese government recently announced plans to draft venture capital laws in an effort to improve the investment environment and encourage venture capital financing of the high-tech sector. The government acknowledged, however, that this would be a lengthy, multi-year process. Given China’s unique political, social, and financial structure, the Chinese government recognizes the need for comprehensive regulations.

This Comment focuses not only on the types of laws required, but also on the larger institutional structure necessary for the development of a vibrant venture capital industry in China. Additionally, this Comment explores the role of law in the relationship between corporate governance and the growth of venture capital. Part II analyzes the U.S. venture capital industry in the context of the U.S. market governance model. Part III surveys the German and Japanese bank-centered model. Using these two contrasting models as a conceptual template, Part IV assesses China’s nascent venture capital industry. The author also notes that "Japan has yet to produce an IPO as successful as Netscape." 8

8. See Sibbit, supra note 5, at 60 (noting that the Netscape IPO "helped boost the interest and the World Wide Web," and "promoted the funding of other ventures"). The author also notes that "Japan has yet to produce an IPO as successful as Netscape." Id. at 86.


12. Id. (reporting that the first few years, China has attracted more overseas venture capital than any other developing country in Southeast Asia).

13. Id.


15. Id. (reporting that China, for the first time, the China’s National People’s Congress, stated that the drafting process would take at least three years).

16. See discussion infra Part IV.

17. See discussion infra Part IV.

Corporate governance concerns the distribution of power among shareholders, officers, directors, and in a lesser extent, other constituents such as employees and creditors of a corporation. See Arthur R. Miller, The United States, in THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS 253, 262 (Arthur R. Miller & George W. Arons eds., 1991).

II. THE U.S. MODEL

The venture capital industry has played a significant role in the growth of the U.S. economy. Particularly in the last decade, venture capital has been the engine that propelled the spectacular rise of the Internet economy and the high-tech sector. 17 Stocks of "dot-coms" reached dizzying heights and created instant millionaires by the week. 18 In 1999 alone, venture capital investment averaged $2 billion per week, or more than $100 billion per year, up 19% from the previous year.

19. By most accounts the success of the U.S. venture capital industry is the envy of the world. 20 Such success is by no means the result of importance or good timing; rather, it is the product of the institutional structure—that unique confluence of laws, financial markets, regulatory systems, and social norms long in existence in the United States. 21 Much scholarly discourse has been devoted to the role of the U.S. financial framework in the development of


21. See Millenport, supra note 16, at 680 (noting that venture capital is "almost an essential form of financing" for high-tech, high-tech companies).

22. See, e.g., Safire, supra note 2.

23. See Venture Capital Beach, SALARY.COM, at 1, available at http://www.salary.com/ at the "article detail" page, article_id=50546814&type=5 (Sept. 26, 2005) (reporting National Venture Capital Association statistics). See also JOSEPH W. BARFETT, VENTURE CAPITAL: LAW, BUSINESS STRATEGIES, AND INVESTMENT PLANNING 12 (1995) (commenting that "venture capital is the one technique out of a thousand other techniques that other industrial countries have as yet to master.").

24. 28 C.F.R. Part 20 (c).
venture capital. Legal commentators and economists alike largely attribute the unparalleled growth of the venture capital industry in the United States to the U.S. market-centered system. They argue that a well-developed stock market is fundamental to the development of the venture capital industry. This Comment expands on their theory by further positing that the U.S. venture capital industry owes its success in large measure to the operations of law at each stage of its development. Just as a corporation "operates under a series of legal rules, markets, and private ordering" and these legal rules "shape the basic structure of corporate organs, define the rights of corporate actors, and set the boundaries for private ordering," the venture capital industries in the United States, Germany, and Japan are similarly shaped by the operations of law.

A Primer on the Venture Capital Industry

Venture capital in the United States is perhaps best defined as "investment by specialized organizations . . . in high-growth, high-risk, often high-technology firms that need [capital] to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt." Unlike banks, which lend money to the borrower, venture capitalists provide financing to a startup company by acquiring part ownership in the company through equity investments. The companies that receive venture capital funding are called "portfolio companies."

References

23. See, e.g., Black & Gilson, supra note 20, at 243–45.
24. Id.
26. Black & Gilson, supra note 20, at 245. Alternatively, venture capital has also been defined as "a professionally managed pool of capital that is invested in equity-linked securities of private ventures at various stages in their development." William A. Salomon, The Structure and Governance of Venture-Capital Organizations, 27 J. FIN. ECON. 472, 473 (1990).
29. The term "portfolio company" denotes the fact that the company is but one in the venture capitalist’s portfolio of companies. See Bartlett, supra note 27, at 3, 4.

Along with the significant risk associated with the investment—the company could fail and render the venture capitalists’ investment worthless—comes huge upside potential. Venture capitalists expect that the company will take the infusion of cash to fund its growth, and create a business that is worth substantially more than before the venture capital investment. In exchange for their investment in the startup, the venture capitalists often obtain a significant stake in the company. Along with ownership comes the right to monitor management, whereby the venture capitalists are directly involved in corporate governance, including determining the company’s business strategy, its products and services, its capital structure, its personnel, and even its name. In addition, venture capitalists often receive annual management fees of approximately 2% to 2.5% of committed capital and a share of the company’s profits. The biggest financial payoff for venture capitalists occurs at the point of exit, usually three to five years after initial investment, when the venture capital fund "cashes out" of the company via an IPO or sale to another entity.

The Role of Law

The U.S. institutional structure—laws, business practices, and social norms—has been cited as the driving force of the U.S. venture capital market. In particular, the success of the U.S. venture capital industry, to a large extent, is attributable to the existence of laws that govern all aspects of the venture capital investment process from formation, to entry, to exit.

References

31. Id.
32. See Christopher B. Barry et al., The Role of Venture Capital in the Creation of Public Companies, 27 J. FIN. ECON. 447, 448 (1990) (noting that at the time of an IPO, the aggregate holdings by all the venture capitalists represents, on average, 34% of the outstanding shares of the portfolio company).
33. Venture Capital Basics, supra note 19, at 2; see also Salomon, supra note 26, at 506.
34. Venture Capital Basics, supra note 19, at 2; see also Salomon, supra note 26, at 491.
35. See Black & Gilson, supra note 20, at 237.
1. The Venture Capital Fund and the Role of Law in Its Development

Venture capitalists invest in startups through venture capital funds. In the United States, a venture capital fund is generally organized as a limited partnership, where the partners are the capital providers. At the inception of the venture capital fund, a limited partnership agreement between the fund and the capital providers is executed. Like any limited partnership, the agreement sets forth the rights, obligations of the general partners and limited partners, the duration of the partnership, and dissolution procedures. A limited partnership enjoys several advantages over corporations and general partnerships. First, unlike general partners who are personally liable for all of the debts and obligations of the partnership, a limited partner is only liable up to the extent of his or her capital contribution. In other words, a limited partner stands to lose only the capital contribution if the venture capital fund fails. Thus, the limited partner is shielded from exposure to liabilities incurred by the partnership. The legislature designed this limited liability feature to encourage investment by a limited partner, particularly the small individual investor, who does not wish to live in fear that his or her investment in a venture capital fund could result in losing the family home.

Second, like partnerships, a limited partnership enjoys favorable tax treatment because limited partnership income is not subject to taxation at the partnership level. Limited partnerships are not taxed as separate entities; rather, the profits from the
invest in venture capital funds, much less assume a significant role as do their counterparts in Germany and Japan. 66 Without the dominating presence of banks, U.S. venture capital developed other private funding sources and independently grew 67

3. The Role of Law at the Point of Entry

At the point of entry, when venture capitalists make the initial investment in a startup, the risk they assume is great due to the uncertainty over the company's viability. 68 The company is usually in its embryonic stage, with no proven track record and negative cash flow. 69 Venture capitalists, especially general partners of venture capital funds who bear the highest risk, are naturally interested in protecting their investment. 70 Venture capitalists ensure that their investments are protected through contracting with the management of the companies in which they invest. 71

This particular form of venture capital contracting, based on a corporate governance system centered on the stock market, is unique to the United States. 72 Once again, law plays a pivotal role both in defining and limiting the terms of the venture capital contract. Though these contracts vary from transaction to transaction, certain provisions are standard. 73 The contracts

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66. See id. at 1948. Roet also argues that if U.S. banks came to initiate German banks, they would lose status as major every U.S. financial regulator. Id. at 1949. In addition to Glass-Steagall and the Bank Holding Company Act, the FDIC Act of 1933(1) failed to open branches only if permitted by state law. Id. at 1949. Up until recently, state laws prohibited local branches. FDIC Act, ch. 191, 71, 91 Stat. 3724 (1973) (codified as amended at 12 U.S.C. § 1460 (1983)).

67. See Commercial, supra note 24, at 468.

68. See Venture Capital Funds, supra note 19, at 3 (citing U.S. Small Business Administration statistics indicating that about 80% of all startups fail in the first six years).


70. See generally Subramanian, supra note 5, at 36.


72. See K & Shin, supra note 8, at 460 (arguing that the particular venture capital contracting model that aligns the incentives of the various contracting parties is prevalent in the United States only).

73. Smith, supra note 71, at 104.
invariably include the following terms: board representation and restrictive covenants on management. 74

a. Representation on the Company’s Board of Directors

"Venture capitalists often demand a significant voice on the board of directors. They generally obtain at least enough actual representation to block important board actions. "This is one of the most significant mechanisms through which venture capitalists exercise control over management of their portfolio companies." As members of the board, venture capitalists are in a position to monitor management’s activities. 85 Given the great risk venture capitalists face at this stage, one might rationalize that they would be inclined to actually assume full control of the portfolio company in order to minimize the risk of mismanagement. 79 The law, however, works to provide a disincentive to assuming control.

Venture capitalists generally avoid gaining actual control of the company by occupying less than half of the seats on the company’s board of directors in order to avoid the regulatory consequences of gaining control over companies. Another way, among other things, being deemed a "controlling person" may expose an individual to liability to creditors and other investors. 37 As one commentator notes, control entails legal responsibility. 38 Because venture capital investment is already risky, taking on liability to creditors and other shareholders increases the risk exponentially. Thus, the law provides a check on the venture capitalists as well.

74. Id.
75. Id. at 107.
77. Smith, supra note 71, at 107.
78. Block & Gibson, supra note 39, at 235.
79. See, e.g., Smith, supra note 71, at 103.
80. Id. at 107.
82. Smith, supra note 71, at 108-09.
83. See BARTLETT, supra note 22, at 4.

b. Restrictive Covenants that Constrain the Behavior of Managers

"In addition to representation on the board of directors, venture capitalists generally constrain the action of management by negotiating a number of different kinds of restrictive covenants to help protect their investment." These covenants prohibit self-dealing by the management, and prevent managers from "exploiting corporate opportunities and competing with the firm." Some provisions even call for managers to cooperate with the company even after their departure. Another significant form of managerial control is through compensation packages that emphasize stock options over present income so that managers have an incentive to maximize shareholder value. Further, the stock options usually vest over a period of years so that if a manager leaves before the options are fully vested, he or she loses all of the invested options. This helps to ensure that the manager does not endeavor to maximize his or her own personal short-term profit at the expense of the company’s future.

Venture capital contracts also require periodic disclosures of financial information by management to the venture capitalists. These include adherence to prescribed levels of current ratio, working capital, short and long-term debt, net worth, and restrictions against encumbrances of assets. Obviously, these terms assume the existence of generally accepted accounting principles (GAAP) so that the financial statements can be meaningfully interpreted and relied upon by the user, namely the venture capitalists.

4. The Role of Law at the Point of Exit

Perhaps the greatest benefit U.S. law provides to the venture capital industry is in the regulation of the U.S. stock market.
that securities markets are fair, efficient, and transparent.426 The SEC
performs its watchdog function primarily via the Securities Act of
1933 (1933 Act)427 and the Securities Exchange Act of 1934
(1934 Act).428 The 1933 Act governs the public offering of
securities; it provides that any such offering must be registered
with the SEC before securities may be sold.429

The hallmark of both the 1933 Act and the 1934 Act is
disclosure.430 The 1933 Act requires full and fair disclosure to be
made in the registration statement that must be filed with the SEC
as part of the company's public offering process.431 The disclosure
requirements are voluminous, ranging from information
concerning the company's business to the background of
management personnel and perceived risk factors of the
offering.432 The registration statement also requires audited
financial statements.433

The 1934 Act covers securities trading and requires periodic
reporting by registered companies.434 Companies whose stocks
are listed on a national stock exchange, such as the New York
Stock Exchange or the NASDAQ, are subject to the reporting
requirements of the 1934 Act.435 These companies must file
an annual report (10-K) with the SEC, including audited financial
statements, and quarterly reports (10-Q) with unaudited financial
statements.436 Additionally, they must also report events of
material importance soon after the events occur.437

These extensive reporting requirements, more stringent than
those of any other country,438 serve to protect investors, provide
transparency to the system, prevent fraud, and thereby promote
investor confidence in the market.439 They are directly

93. See Stock & Gibson, supra note 20, at 245.
94. Id. at 255.
95. Id. at 252 (defining reputational capital as the reputation of a venture capital fund
that enables it to engage venture third parties, such as investors, and develop the
portfolio company).
96. Id. at 254.
97. Id. at 255.
98. Id. at 249.
99. See id.
100. Roberta S. Kaplan, Stock Market and the Globalization of Retirement Savings—
101. Id.
102. Id. at 971.
103. Id.
105. See Karmel, supra note 100, at 971.
107. See id. § 77q.
108. See id. § 77t.
110. Id. § 78q(a).
111. HAMILTON, supra note 46, at 334.
112. Id.
113. Merritt B. Fox, Required Disclosure and Corporate Governance, 62 LAW &
114. See Karmel, supra note 100, at 962.
responsible for making the U.S. stock market the success it is today.115 Additionally, a complex set of civil liability provisions supplements the SEC’s enforcement of these regulations.116

The strict reporting requirements of U.S. securities laws are made possible by high quality accounting standards—a critical component of the U.S. regulatory system.117 A company’s financial statements must be prepared according to GAAP, which are “concepts and standards underlying accounting for financial reporting purposes.”118 These principles provide “a common financial language to enable informed users to read and interpret financial statements.”119 The financial statements are then audited by independent certified public accountants, who verify the accuracy of the financial statement representations according to generally accepted auditing standards (GAAS).120 Both GAAP and GAAS are designed to provide investors with relevant and reliable financial information to facilitate decision-making.121 Such comprehensive disclosure requirements have given investors confidence in the U.S. stock market and spurred its growth.122 Consequently, venture capital investors are able to rely on the stock market as the primary means of exit.123

115. See id.
117. See id. at 875, see also Keenan, supra note 100, at 692.
119. GAAP primarily come from pronouncements of the accounting profession and governing bodies such as the Financial Accounting Standards Board, other groups affiliated with the American Institute of Certified Public Accountants, and the SEC. B.
120. Id.
121. Id.
123. Audited financial statements must include the balance sheet, the income statement, the retained earnings statement, and the cash flows statement. Flamini, et al., supra note 118, at 50-54.
124. Statutory standards have demonstrated the value of U.S. GAAP to investors. For example, in a study published in the 1993 Journal of Accounting Research, researchers compared several earnings and accounting measures and stock prices based on a sample of several thousand annual reports from investors, concluding from 1980 to 1990. Andrew Abel et al., The Relative Information of Accounting Disclosures in Culturally Omnivorous 31, J
125. Res. 185 (Supp. 1995). The study found high degrees of correlation between accounting measures and stock prices, particularly in the United States, evidencing the relevancy of financial statement information to investment decision. Id. A much lesser degree of correlation was found in Germany. Id.
126. See Black & Gilson, supra note 20, at 257

C. The Role of Culture

The popular perception is that the United States is a country of adventurous risk-takers.127 Certainly, a society that produced twenty-something Wunderkinds such as Bill Gates, Steve Jobs, and Marc Andreessen cannot be said to brown upon risk-taking.128 Entrepreneurial zeal alone, however, is insufficient to create sustained innovation; it is the institutional structure and related legal framework in the United States that has enabled entrepreneurs to succeed.129 Venture capital epitomizes the synergistic combination of law, economics, and entrepreneurship.130

Netscape, the brainchild of venture capitalist Jim Clark and programmer Marc Andreessen, provides a prime example of this synergy.127

Andreessen was an undergraduate at the University of Illinois writing software code for $6.85 an hour for the university’s National Center for Supercomputing Applications when he came up with an Internet browser program called Mosaic.131 Andreessen put the browser on the Internet for anyone to download for free.132 The browser proved to be quite popular and frequently downloaded, but Andreessen could not figure out a way to make money from it.133 Enter Clark, a seasoned venture capitalist who previously co-founded Silicon Graphics, Inc., a successful Silicon Valley computer company.134 Clark became aware of Andreessen’s efforts through the Internet.135 In short order, the two met and Clark decided to invest in Andreessen’s browser technology—a new company was born.136 Andreessen’s programming wizardry and Clark’s business acumen combined to

124. SHAPIRO, supra note 5, at 83.
125. Respectively the founders of Microsoft Corporation, Apple Computer, and Netscape, both of whom started their company while still in their early twenties. Bill Gates, Web Site—Biography, http://www.microsoft.com/BillGates/0,1633, 1
126. See supra Part II.B;
127. See Wagner, supra note 1.
128. See id.
129. Id.
131. Id.
132. See id.
133. See id.
make Netscape one of the most successful Internet companies of the 1990s.\textsuperscript{134}

As previously discussed, but for the unique U.S. venture capital contracting model that enabled Clark and Andressen to quickly come to terms on the formation of the company, the existence of the NASDAQ stock market made it attractive for Clark to invest in Netscape (because of the possibility of cashing out via an IPO).\textsuperscript{135} and the SEC's regulation of the NASDAQ that gave investors the confidence to invest in Netscape, Andressen's innovative browser could have conceivably remained just that—a single-purpose program to be downloaded for free from the Internet.\textsuperscript{136}

Another, perhaps lesser-known fact demonstrated the U.S. legal system at work in unexpected ways. Although Andressen wrote the Mosaic program, the program actually belonged to Andressen's employer, the University of Illinois, which subsequently claimed rights to the name "Mosaic" and sued to block Clark and Andressen from naming their new company "Mosaic Communications Corporation."\textsuperscript{137} Clark and Andressen had to rename the new company Netscape.\textsuperscript{138} As frustrating as the ensuing legal battle was for Andressen,\textsuperscript{139} it provides a valuable lesson to all would-be entrepreneurs that the U.S. legal system safeguards the interests of innovators of all shapes and sizes.

Shareholders are also protected by the U.S. legal system.\textsuperscript{140} For example, an investor bilked by fraud or misrepresentation in an IPO has a myriad of legal options available to him or her.\textsuperscript{141} The investor can see the company's management, its board of directors, its accountants, its underwriters, and even its lawyers, 2001] Venture Capital Laws in China 503

both individually and derivatively.\textsuperscript{142} Should the shareholder prevail in a court of law, the defendants can be held jointly and severally liable for monetary damages.\textsuperscript{143} Additionally, such an investor does not lack access to legal representation, as there is one lawyer for every 300 people in the United States.\textsuperscript{144}

Contingency fee arrangements also make legal representation affordable to the average investor.\textsuperscript{145} Legal recourse has served as a check on corporate management's execution of its duties and continues to bolster investor confidence.\textsuperscript{146}

III. THE GERMAN AND JAPANESE MODELS

By all accounts the venture capital industries in Germany and Japan have not achieved anywhere near the exponential growth as the venture capital industry in the United States.\textsuperscript{147} In comparison to the United States, the venture capital industries in Germany and Japan are smaller both in terms of the relative number of venture capital funds and in the actual dollar amount of investment by the funds.\textsuperscript{148} There are approximately one-fifth fewer venture capital firms in Japan than in the United States.\textsuperscript{149} These firms also invest less capital in both cumulative and annual bases.\textsuperscript{150} For example, in 1993 alone, 637 U.S. venture capital firms disbursed over $3 billion in funds, while 121 Japanese venture capital firms disbursed $76 million.\textsuperscript{151}

This lack of an active venture capital market is also reflected in the far smaller number of startup companies listed on the over |

\textsuperscript{134} Id. at 599. A shareholder derivative suit is brought by a shareholder on behalf of a company for the benefit of the company and other shareholders. See SIEH, supra note 5, at 53.

\textsuperscript{135} Id. at 599. Such suits are brought by a minority shareholder on behalf of the company, not the minority shareholder. See SIEH, supra note 5, at 53.

\textsuperscript{136} Id. at 599.

\textsuperscript{137} Id. at 599.

\textsuperscript{138} Id. at 599.

\textsuperscript{139} Id. at 599.

\textsuperscript{139} Id. at 599.

\textsuperscript{140} Id. at 599.

\textsuperscript{141} Id. at 599.

\textsuperscript{142} Id. at 599.

\textsuperscript{143} Id. at 599.

\textsuperscript{144} ID. at 599.

\textsuperscript{145} Id. at 599.

\textsuperscript{146} Id. at 599.

\textsuperscript{147} Id. at 599.

\textsuperscript{148} Id. at 599.

\textsuperscript{149} Id. at 599.

\textsuperscript{150} Id. at 599.

\textsuperscript{151} Id. at 599.
the-counter (OTC) stock market in Japan.\textsuperscript{152} The dominant OTC market in the United States (the NASDAQ) is nine times the size of the Japanese equivalent.\textsuperscript{153} In Germany, venture capital investments accounted for 0.01\% of German Gross Domestic Product in 1994, only one-fifth of the U.S. level.\textsuperscript{154}

Scholars and legal commentators attribute this lack of venture capital growth to the bank-centered corporate governance system in both Japan and Germany, as compared to the U.S. market-driven system.\textsuperscript{155} Indeed, German and Japanese venture capital development must be positioned in the context of the bank-centered governance system in order to understand its lack of vitality.\textsuperscript{156}

A. The Impact of Law on the Structure of Venture Capital Funds in Germany and Japan

The German and Japanese venture capital markets are strikingly different from that in the United States; their characteristics "bear the strong influence of a bank-oriented governance system."\textsuperscript{157} Banks in Germany and Japan wield enormous power over their respective country's economy by virtue of controlling the largest corporations.\textsuperscript{158} While such an institutional structure has largely determined the development of the financial markets in both countries, it is coextensive with the role of law in terms of the impact on the venture capital industry. As one commentator points out, "[t]he centrality of law and regulations in restraining the generation and formation of venture businesses" in both countries is unmistakable.\textsuperscript{159}

\textsuperscript{152} Siblett, supra note 5, at 52. OTC refers to the secondary stock market where stocks of smaller companies are often traded, as compared to the primary stock market, such as the Tokyo Stock Market in Japan or the New York Stock Exchange in the United States, where stocks of more established companies are traded. East Kelly, "The Switch to Big Board Listings Nearing With Bad Times," WALL. ST. J., Feb. 13, 2000, at C39.

\textsuperscript{153} Siblett, supra note 5, at 60.

\textsuperscript{154} Black & Gilson, supra note 20, at 206.

\textsuperscript{155} See, e.g., id. at 483.

\textsuperscript{156} Milhaupt, supra note 16, at 860.

\textsuperscript{157} id. at 877.

\textsuperscript{158} See Ros, supra note 59, at 1937-39 (noting, for example, that the three largest German banks together own over 23\% of the stock of Siemens, and over 60\% of Daimler-Benz prior to its merger with Chrysler). Likewise in Japan, the five largest financial institutions have historically owned over 21\% of Toyota Motors, and almost 20\% of Matsushita. Id. at 1943.

\textsuperscript{159} Siblett, supra note 5, at 285.
business failure.\textsuperscript{169} Likewise in Germany, over 50% of the money comes from banks, and slightly less than 10% comes from the German government.\textsuperscript{170}

Additionally, investment by corporate pension funds, a staple of U.S. venture capital, is completely absent in Japan and Germany.\textsuperscript{171} The Japanese MOF does not permit pension funds to invest in venture capital funds.\textsuperscript{172} "Restrictions on the use of pension funds... clearly impede the funding of venture businesses."\textsuperscript{173} Further, regulations permit Japanese pension funds to remain uninvested, which render them incapable of becoming a significant source of investment in venture capital funds anyway.\textsuperscript{174} Similarly, in Germany, pension funds are not a factor in the financial marketplace because German corporate pension funds are also largely unfunded.\textsuperscript{175}

B. The Impact of German and Japanese Laws on the Operation of a Venture Capital Fund

The reliance on bank loans and the lack of significant independent sources of funding affect the operations of venture capital funds in both Germany and Japan.\textsuperscript{176} In both countries, seed and early-stage venture financing is scarce because "the core businesses of banks... do not involve high-risk equity investments in start-up firms."\textsuperscript{177} Instead, banks opt to provide financing to later-stage expansion businesses that are close to public offerings or being acquired.\textsuperscript{178} Banks also favor traditional low-tech industries such as retail and real estate while eschewing new technology.\textsuperscript{179} As a result, some venture capital firms have begun to focus on high-tech and Internet investments,\textsuperscript{180} these investments tend to be small and scattered.\textsuperscript{181}

\textsuperscript{169} See id.
\textsuperscript{170} Black & Gibson, supra note 20, at 251.
\textsuperscript{171} Id at 316.
\textsuperscript{172} Midha, supra note 16, at 977.
\textsuperscript{173} Sibbitt, supra note 6, at 364.
\textsuperscript{174} See supra Part II.B.
\textsuperscript{175} Black & Gibson, supra note 20, at 251.
\textsuperscript{176} Roos, supra note 50, at 1031 (noting that "[j]udicial control can shape managerial entrepreneurship.")
\textsuperscript{177} Midha, supra note 16, at 163.
\textsuperscript{178} Black & Gibson, supra note 20, at 253.
\textsuperscript{179} Midha, supra note 16, at 162. see also Sibbitt, supra note 5, at 42.
\textsuperscript{180} A notable example is Softbank, founded by Masayoshi Son, considered by many in

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Government regulations also discourage investment in venture capital funds.\textsuperscript{182} For example, out of the desire to prevent the reemergence of family-controlled conglomerates\textsuperscript{183} that dominated the Japanese economy before World War II, the Japanese Anti-Monopoly Law was enacted after the war, prohibiting the formation of holding companies.\textsuperscript{184} In order to avoid being classified as a holding company, a venture fund must limit stock ownership in its portfolio companies.\textsuperscript{185} Such legal restrictions are one reason venture capital firms in Japan have taken significantly lower equity stakes in their portfolio companies than their U.S. counterparts.\textsuperscript{186} Until recently, venture capitalists also could not play a direct role in the management of their portfolio companies.\textsuperscript{187}

Additionally, stock options, so crucial to the growth of start-ups in the United States because of the upside incentives they provide to management and employees alike, have not been a useful tool in Germany and Japan.\textsuperscript{188} Existing Japanese law makes "the issuance of stock options so cumbersome as to be practically unworkable."\textsuperscript{189} Without stock options to compensate for the risk managers take by joining a startup, it becomes difficult to attract top talent.\textsuperscript{190} Similarly, in Germany there were numerous legal restrictions on the issuance of stock options until Japan to be an innovator for his doing entrepreneurship, who, perhaps not coincidentally, was educated at the University of California at Berkeley. See The Internet's Pioneer [Editorial], THE INTE,

182. See Midha, supra note 16, at 890.
183. These conglomerates, known as zaibatsu, engaged in monopolistic practices. Id.
184. Id.
185. Id. at 890.
186. Sibbitt, supra note 5, at 93. Another reason is that because of the bank-centered financial system, both Germany and Japan have historically favored debt financing over equity. See Jonathan R. Macey & Geoffrey P. Miller, Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States, 48 STAN. L. REV. 75, 85, 89 (1995). Japanese companies borrow $5.33 from banks for every dollar they raise in the capital markets, German companies borrow $4.29, and U.S. companies borrow only $1.05. See id.
188. Id.
189. Id.
190. See id. at 891-92.
May 1, 1998, when the Stock Corporations Act was amended\(^{191}\) to allow employee and management stock options, but only with shareholder approval.\(^{192}\)

**C. The Impact of Law at the Point of Exit**

Exit from an investment in a portfolio company is crucial to the success of venture capital.\(^{193}\) The most frequently used method of exit in the United States is the IPO.\(^{294}\) In both Germany and Japan, such an exit is rarely available.\(^{195}\) Government regulations have stifled growth of a public equity market, which in turn has resulted in a lack of liquidity for venture capitalists.\(^{196}\)

1. The Stock Markets Do Not Provide a Viable Means of Exit

"Japan's bank-centered system severely limits the potential for an exit through an IPO.\(^{197}\) The government's strict listing requirements involving profitability guidelines and minimum net asset requirements have made the barrier of listing the stock on the secondary market significantly high for Japanese start-ups, as these companies are generally not yet profitable and usually undercapitalized.\(^{198}\) Even after a company meets the formal listing standards, it must pass the informal but more stringent "practical listing standards" applied by the MOF.\(^{199}\) Not surprisingly, it takes a Japanese startup twenty to twenty-nine years to go from formation to IPO,\(^{200}\) while the average time in the United States is five to seven years.\(^{201}\) Given the average lifespan of a person, it is not difficult to imagine that waiting

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192. § 197(3)(3) Aktiengesetz (Stock Corporation Law).
194. See discussion supra Part II.B.4.
196. Id. at 604.
197. Id. at 604.
198. Id. at 604. Contrast this with the United States, where the NASDAQ does not impose profitability requirements for a company to be listed. Eddy, supra note 152, at CS-9.
200. Id.
201. Id.
202. Id. at 67.
203. Id.
204. Id.
205. Black & Blohm, supra note 26, at 251.
206. See Gordon, supra note 191, at 226.
207. Id. at 226.
208. Black & Blohm, supra note 26, at 251.
209. See Gordon, supra note 191, at 226.
210. Id.
211. See id.
212. For, supra note 113, at 115 n.1.
confidence in the German and Japanese stock markets.212 "Japan has a securities statute that closely parallels the Securities and Exchange Act of the United States.213 Enforcement of the statute, however, is virtually nonexistent as regulators emphasize "de facto screening" of issuers rather than full disclosure.214 In the last four decades, the MOF engaged in virtually no formal market monitoring or enforcement activity.215 For example, securities fraud and insider trading regulations, though long in existence, have not been enforced.216 An atmosphere of distrust prevails as financial corruption scandals (involving those at the highest levels of government) surfaced, to which regulators turned a blind eye.217

In Germany, disclosure rules of publicly traded companies are not nearly as comprehensive as those in the United States.218 For example, the scope of disclosure for issuance of stock options is primarily at the discretion of management,219 which means a company can choose not to disclose material financial information about itself. Germany also did not have any law banning insider trading until 1994, when it was forced to respond to the European Commission’s infringement proceedings.220 The Neuer Markt, the German equivalent of the NASDAQ, resisted tightening regulations until recently, when investors demanded changes amidst allegations of trading irregularities, insolvency, and unanticipated earnings announcements.221 This lack of transparency leaves investors in the dark about corporate governance and has caused investors to place less value on financial disclosures, even when such disclosures are made.222 Ultimately, the result of the German and Japanese bank-centered governance system is that the institutional structure and legal framework needed to support venture capital investments, if not already, are either not available or underdeveloped in both countries.223 Conversely, the laws that do exist in both countries operate to hinder the development of venture capital funds.

D. The Role of Culture

Japan’s cautious culture also handicaps the development of an active venture capital market.224 Historically, Japanese society has imposed and rewarded group conformity over individualism.225 "A Confucian moral order mitigates self interest and opportunism.226 Children learn from an early age to heed the teachings exemplified by the Japanese proverb, “the nail that sticks up gets hammered down” (geru kui ga utaruru).227 With individual creativity and individualism thus stifled, entrepreneurial spirit is hampered.228 One recent study found, not surprisingly, that when Americans and Japanese were asked whether starting a business was a respectable occupation, 91% of Americans said yes, whereas a meager 8% of Japanese agreed.229 Because conformity is prized, iconoclastic behavior becomes more costly, which renders individual risk-taking even more difficult.230 Not surprisingly, a culture of risk-aversion pervades Japanese society. This cultural trait, when translated to the financial arena, means that Japanese investors prefer to play it safe.231 Not only do they keep an "inordinately large" amount of

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212 See, e.g., Lily M. Li, World Watch: Europe, Wall St. J., Nov. 27, 2000, at A25 (reporting that a series of scandals in Germany’s New Markt “threw investor confidence.”).
213 Fox, supra note 113, at 113 n.1.
214 Id.
215 Milhaug, supra note 25, at 6.
216 Shiratori, supra note 5, at 89.
217 See, e.g., id. at 90 (describing the “Recruit” Scandal of 1990, where shares of selected companies were sold to executives of then Prime Minister Noboru Takeshita, Finance Minister Ichiro Miyazawa (who later became Prime Minister), and former Prime Minister Yasuhiro Nakasone). Immediately after the companies went public, recipients of these shares sold them for four times more than the original cost. Id.
218 Gordon, supra note 191, at 206.
219 Id.
220 Id.
222 Li, supra note 215, at A25.
capital in safer investments such as bank deposits, but they also invest less in stocks and bonds than the average American. Therefore, it is not a coincidence that even though Japanese personal financial assets exceed $10 trillion, there are no angel investors in Japan, and virtually no seed stage venture capital funding. Also, venture capital funding tends to focus on mature industries, which are less risky.

Additionally, while the United States has historically been "anti-big" (big banks or big corporations), in Japan "populist, anti-bank ethos is historically absent in Japan." This is partly due to the futility of such opinions because Japan did not become a democracy until after World War II. Likewise, in Germany, though dominance by German banks in its economic landscape is paramount, populist anti-bank sentiments have never been as fervent as in the United States. Germany has never known anything like the fear and resentment that monopoly once aroused in the United States. Partly due to the existence of codetermination, where employees have significant representation as board members of the largest corporations, interest groups are given a voice in corporate governance by law, thereby obviating much of the populist angst. Without the need to rail against the big and the mighty, would-be entrepreneurs in Germany and Japan are deprived of the impetus to strike out and challenge the establishment by pursuing alternative paths.

235. Id. at 84.
236. An angel investor is an individual who provides initial funding to a startup. See Venture Capital Demystified, supra note 15, at 5.
237. Id. at 877.
238. Id. at 894.
239. Some have commented that this anti-big posture has provided the gasoline for entrepreneurs in the United States. See Mark J. Roe, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 234, 279 (1994).
240. See, supra note 39, at 790.
241. Id.
242. Id. at 1989.
245. See Roe, supra note 39, at 790.
246. See Roe, supra note 39, at 799.

2001] Venture Capital Laws in China

The combination of social, economic, and cultural forces led to deep-rooted bank dominance of venture capital investment over individual investment in both Germany and Japan, and the related legal framework contributes to the lackluster stock markets. Because banks are not very effective in performing the venture capital role, both countries have failed to develop a strong venture capital industry as a result.

IV. PROPOSALS FOR A UNIQUE CHINESE MODEL

As discussed in Part II and Part III, in order to develop a vibrant venture capital industry, certain parameters must be in place: a market-centered corporate governance system, a highly regulated securities market which aims to protect investors, and a culture of risk taking—all backed by well-developed and rigorously enforced laws. Measured against this backdrop, China presently fails to meet almost all of the criteria.

A. The Present Institutional Structure in China

Since the founding of the People's Republic of China in 1949, the Chinese economy has operated under a central planning model borrowed from the Soviet Union. The twin pillars of the Soviet socialist model were central planning and state ownership. Unlike the economies of the United States, Germany, and Japan that function under the free market system, control of the Chinese economy is solely vested in the hands of the central government, which drafts five-year plans guiding China's economic growth. Until recently, private ownership of companies was outlawed in favor of exclusive state ownership.

247. See Gordon, supra note 191, at 220.
248. Id. at 220-21.
251. See id. at 5-6.
Therefore, China does not have a market-centered corporate governance system like the United States, and to the extent it has a governance system at all, the role of the Chinese government is somewhat analogous to that of the central banks in Germany and Japan.233

By the end of the Chinese Cultural Revolution (1966–1976), with the opening of China to the West, the realization struck many inside China that the ideological economic model had only led to the stagnation of the Chinese economy.234 In 1979, during a tour of the southern province of Guangdong, Paramount Leader Deng Xiaoping made the historic pronouncement that presaged the waning of the socialist dogma and the dawning of a Western-style, market-driven economy.235 Discussing the pros and cons of a socialist versus a capitalist system, Deng famously said: "black cat or white cat, it's a good cat if it catches mice.236 Deng's comments buoyed the spirits of the Chinese people (who began to pursue dreams of wealth for the first time since 1949) and ushered in an era of unprecedented economic growth in China.237

B. Existing Barriers to Developing a Vibrant Venture Capital Market in China

1. The Omnipotent Role of the Chinese Government

In spite of the flourishing of private enterprise in the last two decades, the Chinese economy remains largely state-owned and centralized.238 The state sector still accounts for one-third of industrial output, over one-half of total assets, and two-thirds of investment.239 The government controls every sector of the economy, from banking to telecommunications,240 from agriculture to infrastructure construction.241 Moreover, the government restricts the percentage of foreign ownership in certain industrial sectors.242 For example, foreign investment in telecommunications projects are limited to less than 50%, and to 70% in midral facilities and retailing.243 These seemingly arbitrary restrictions undoubtedly hamper the development of a venture capital industry.244 By limiting the shareholding of some of the most profitable areas of investment, the government has created a "less than favorable investment climate for venture capitalists.245

2. The State of Securities Regulation

The Chinese leadership’s deep ambivalence over the direction of the Chinese economy is most vividly illustrated by the government’s regulation of the Chinese securities industry.246 On one hand, China clearly sees the benefits of attracting foreign capital via a growing securities market.247 On the other hand, "the mentality associated with traditional central planning persists, and tight government control continues with a goal of striving to maintain the dominance of state ownership.248 Thus, the resulting securities laws are a hodgepodge of Western free-market tenets, mixed with principles of state control.249 Whether this

250 Id.
251 "The People's Bank of China is the central bank of the People's Republic of China. The People's Bank of China shall, under the leadership of the State Council, formulate and implement monetary policies and exercise supervision and control over the banking industry." L. TOOLEY & TINA RAYN, BANKING LAW IN CHINA 55 (1997)
252 See supra Part I.EA, discussing the role of German and Japanese banks in their economies and venture capital markets.
253 See supra Part I.EA, discussing the role of German and Japanese banks in their economies and venture capital markets.
254 See supra Part I.EA, discussing the role of German and Japanese banks in their economies and venture capital markets.
255 See supra note 245, at 129 n.16.
256 Id.
257 China’s Gross Domestic Product grew an average of 9% annually from 1978 to 1994. See Robert A. Kepp (President, United States-China Business Council), Two Thirty Years Before the Senate Foreign Relations Committee, in FIDN. NEWS SERV., Year 6, 1996, JEXLS, WORLD LIBRARY, Alfred P. Cl. China’s economy is ranked by the International Monetary Fund as the third largest in the world, behind the United States and Japan. Id.
259 Id.
framework is suitable to the development of a healthy venture capital industry is dubious.

a. The Development of the Securities Market in China

In the last decade, China has developed an active securities market, though China does not yet have its equivalent of a NASDAQ market. Since the founding of the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991, the Chinese securities market in the whole has emerged as a fairly large and integrated system in a short time. Ironically, the Chinese government provided the impetus for a securities market, for the fundamental function of the Chinese securities market has been to serve the economic goal of the state by extirpating the government from continuing to subsidize the deeply troubled state-owned enterprises (SOEs). As such, unlike the United States, Germany, and Japan, where the sole purpose of securities markets is to provide an efficient exchange mechanism for shareholders, the development of securities regulation in China has evolved around the protection of state interests rather than shareholder interests.

b. The Regulatory Framework

The Chinese government has tightly controlled the securities market since its inception. Initially, the People’s Bank of China was designated by the central government as the securities market authority. In 1993, the State Council Securities Regulatory Commission (SCSRC) was established, and replaced the People’s Bank of China as the regulatory authority.

On December 29, 1998, the Standing Committee of the National People’s Congress adopted China’s long-awaited formal securities legislation, the Securities Law of the People’s Republic of China (Securities Law). The Securities Law, which became effective on July 1, 1999, was in the drafting stage for six-and-a-half years. Prior to its passage, China had no comprehensive national securities law. Instead, the laws and regulations governing issuance and trading of securities were found in two separate pieces of legislation: the China Company Law (Company Law) and the Provisional Regulations on Stock Issuing and Trading of 1993 (Provisional Regulations).

i. The Company Law

The Company Law, promulgated by the Standing Committee of the Eighth National People’s Congress on December 29, 1993, and effective on July 1, 1994, provides a general framework for the establishment of shareholder-owned companies. The government’s motive of protecting state interests is distinctly demonstrated by the divided share trading structure. Stocks in a company may be offered in several share categories, each representing a different form of shareholding. In practice, four share types are the most prevalent: A, B, H, and N. The A shares are denominated in renminbi (RMB) and subscribed to by individual domestic investors. A shares trade on the domestic Shanghai and Shenzhen stock exchanges. The B shares are further divided into shares held by the state, such as an administrative agency, state-owned firms, and individual shareholders. Transfer of state shares are only allowed by approval from the particular government entity involved.

In contrast, B shares are also traded on the two exchanges but are...
reserved solely for foreign investors. Additionally, B shares are traded in U.S. dollars on the Shanghai Stock Exchange, and in Hong Kong dollars on the Shenzhen stock exchange.

To attract foreign investment, the Chinese government encourages state-owned Chinese companies to issue shares directly on international markets. Consequently, H and N shares were created, and are held only by foreign investors. H shares are listed on the Hong Kong Stock Exchange, and N shares are listed on the New York Stock Exchange. Even though A and B shareholders ostensibly have the same rights, the de facto inequity is obvious, giving "the unequal access to information, unequal liquidity, unequal prices, and unequal formalities of transfer." In essence, the trading of domestic A shares is limited to shares owned by private investors, which represents only 20% of total common stock issued.

Such a share trading structure has dire implications for a venture capital industry. If a domestic venture capital fund invests in a domestic Chinese startup, the fund's only avenue of exit would be listing on either the Shanghai or Shenzhen Stock Exchange and issuing A shares. This option severely limits the available market for the shares, and thus most likely will restrict the stock's upside potential.

On the other hand, if a foreign venture capital fund invests in a domestic startup, it is faced with a similar dilemma. Other than going through the expensive and time consuming process of listing on an overseas stock exchange such as the New York Stock Exchange, with its attendant regulatory requirements, the only viable option is to issue B shares on a domestic stock exchange. This option automatically renders the stock off limits to all Chinese citizens, not exactly the outcome any venture capitalist would desire.
chilling because the quota system drastically impacts the liquidity of the market by limiting the total stock offered at any given time. Instead of being able to go public according to its own timetable and market conditions, a company would have to wait for a quota allocation, thereby possibly missing its window of opportunity in the marketplace altogether.

iii. Securities Law

The recently enacted Securities Law makes explicit any listed company's legal duty of continuous disclosure. A listed company is required to file an annual report, and an audited annual report with CSRC and the exchange. In addition, Article 62 requires a company to file and publish a special report when any major event occurs that may have an impact on the price of its stock but of which the public is not aware. Moreover, Article 59 clearly states that a listed company is responsible for the truthfulness, accuracy, and completeness of its issuing and listing documents and shall ensure there is no false record, misleading statement, or significant omission. Because the hallmark of securities law disclosure, these disclosure requirements appear to be a step in the right direction in protecting investors. Experiences in the last decade, however, tell a far different story. To begin, proper disclosure is enabled by accounting rules. For example, as discussed in Part II, in the United States, publicly-traded companies must file quarterly (10-Q) and annual (10-K) reports with the SEC. These reports must be prepared in accordance with GAAP, a formidable body of accounting rules that form the foundation of financial statement preparation by U.S. companies, whether or not publicly-traded.

311. Id at 425.
313. Securities Law art. 60; Zang, supra note 260, at 904.
314. Securities Law art. 62; Zang, supra note 260, at 904.
315. Securities Law art. 63; Zang, supra note 260, at 904-905.
316. See supra Part II.B.4.
318. See discussion supra Part II.B.3.
319. See supra notes 218-23 and accompanying text (discussing U.S. GAAP).

In contrast, accounting regulations in China are in their infancy. The General Accounting Law was adopted by the National People's Congress in January 1985, but was not widely followed until amended in December 1993. The law is applicable to government agencies, state-owned enterprises, and institutions only. Laws regarding accounting for private enterprises only became effective in July 1993, when the State Council approved the Standards of Conduct of Enterprise Accounting. The law provides that companies shall adopt the credit and debit (double entry) accounting method and maintain a book of accounts. The law also endorses the principle of income and expense matching, one of the fundamental concepts of GAAP.

Other than these rudimentary requirements, the accounting laws provide little guidance in terms of the types of financial statements to be prepared, the extent of disclosure, and the timing of revenue and expense recognition. As a result, practices differ widely from U.S. standards, which significantly decreases the reliability value of the financial statements. Furthermore, inadequate financial statement disclosure leads to lack of transparency, limits investor access to information, and affects the quality of information available—of which do not bolster a venture capitalist's confidence in the stock market.

321. Id.
322. Id.
323. Id.
324. Id note 16.
325. See id note 16.
326. See supra Part II.B.3 (noting that in the United States, per FASB guidelines, financial statements include, at a minimum, an income statement, a balance sheet, and a statement of cash flows).
327. See Trierer at Your Own Risk, supra note 10.
328. Even these rudimentary requirements are not always followed, leading many in the investment community to question whether the numbers are really what they represent. See Mick Maguire, China's Stock Market on Bumpy Road, L.A. Times, Jan. 9, 2000, at Cl.
329. Indeed, the investment environment is so fraught with peril, "marked by insider trading, fancy numbers, one-way regulators" that some have likened it to horse racing or "jai ping." Id.
iv. Weak Regulatory Enforcement

No matter how complete rules and regulations governing the stock markets are, they are rendered toothless without enforcement. In this regard, the lack of regulatory enforcement by the Chinese government echoes that of Germany and Japan and is similarly detrimental to the growth of venture capital.330 Even though China has adopted securities regulations, enforcement issues are prevalent as regulators are stuck in a perpetual state of paralysis because of bureaucratic infighting.332 For example, many listed companies failed to submit financial reports to the China Securities Regulatory Commission (CSRC), the executive arm of the SCRC,334 and no sanctions were levied by the CSRC.334 Just like in Germany and Japan, where regulators have failed to enforce the rules, this inadequate regulation of the securities market in China has also led to loss of investor confidence and hinders investment in the market.335

c. Other Significant Barriers

Apart from the existence of administrative stock market regulations that primarily function to serve the interests of the government, a myriad of other laws also present obstacles to the growth a healthy venture capital industry in China. To begin, unlike the United States, China does not recognize a limited partnership.336 A venture capital fund, organized as a partnership, is subject to double taxation,337 which provides a disincentive to venture capital investors. Foreign investors are particularly disadvantaged, as there is no assurance of the consistent 330. Compare supra Part IID.4 (discussing SEC enforcement of securities regulations) with supra Part III.2C (discussing German and Japanese regulations’ lack of enforcement).
332. See id.
333. See id. at 627–28 (explaining that even though the CSRC is the equivalent of the U.S. SEC, its supervisory and regulatory powers are much more limited because securities regulation in China is also controlled by various other governmental entities at both local and national levels).
335. See Zheng, supra note 330, at 639.
336. TOOLEY & RAYN, supra note 282, at 3.
337. See Enter at Your Own Risk, supra note 10; see also supra note 46 and accompanying text (providing an explanation of double taxation).

application of tax laws and adherence to international tax treaties.338 Moreover, the availability of an exit, via an IPO, the pivotal element of the success of the U.S. venture capital industry and the stagnation of that in Germany and Japan, is largely nonexistent in China because of the restrictive shareholding structure and quota system.339 As with Germany and Japan, the lack of liquidity significantly limits the financial prospects of a portfolio company.340 Additionally, in certain cases an investor must obtain approval from the government in order to dispose of his or her interest in a company—a vivid example of the particular risks associated with venture capital investing in China.341

Finally, the role of the Chinese government in venture capital development cannot be underestimated. The State Council allocated over $800 million to set up venture capital funds in many high-growth Chinese cities such as Beijing, Shanghai, and Shenzhen.342 The Chinese government as a significant venture capital funding source is remiss in the role of the central banks in Germany and Japan,343 only the former wields even more power.

To be sure, one can argue that without the Chinese government, there would be no venture capital in China today. But the government as investor has many drawbacks. Just as the banks in Germany and Japan prefer to invest in lower risk late-stage companies in traditional industries such as retail and real estate,344 to does the Chinese government. In 1997 alone, more than 50% of venture capital was invested in existing established companies, while only 25% was invested in new companies.345 Not surprisingly, “construction projects, consumer goods and

330. See Enter at Your Own Risk, supra note 10.
332. See id.
333. See id. at 627–28 (explaining that even though the CSRC is the equivalent of the U.S. SEC, its supervisory and regulatory powers are much more limited because securities regulation in China is also controlled by various other governmental entities at both local and national levels).
335. See Zheng, supra note 330, at 639.
336. TOOLEY & RAYN, supra note 282, at 3.
337. See Enter at Your Own Risk, supra note 10; see also supra note 46 and accompanying text (providing an explanation of double taxation).
338. See Enter at Your Own Risk, supra note 10.
339. See id.
340. See supra Part III.B.
341. See id.
342. See supra Part III.B.
343. See id.
344. See Enter at Your Own Risk, supra note 10.
345. See Enter at Your Own Risk, supra note 10.
industrial projects have long accounted for 50.4% of China’s venture capital, while high-tech industries such as computers, electronics and biotechnology account for only 7.3% as a direct result of the Chinese government’s focus on infrastructure building in the last ten years.

This investment pattern seems to suggest that the focus on venture capital can only be changed by a shift in the government’s economic growth strategies. At a minimum, the reliance on government funding hinders the growth of private investment in venture capital. China’s government-driven system has led some commentators to observe that “securities markets in China do not remove enterprises from state control, or promote capitalism in a Western sense. Their effect and purpose is to preserve and enhance the socialist order.”

C. The Role of Culture

Just as culture plays an important role in the success of the U.S. venture capital industry and the lack thereof in Germany and Japan, culture will inevitably be a major factor in the development of the Chinese venture capital industry. In this regard, China shares similar traits with Japan, based on a common Confucian social philosophy that encourages conformity, obedience, and adherence to the status quo. Therefore, venture capital growth in China will be similarly adversely impacted.

Given the risk involved in venture capital, those who are willing to invest must be risk-takers, and those who are willing to start a company from nothing must be innovative and resourceful.

346. Id.
347. See Roe, supra note 59, at 1055 (arguing that if U.S. banks had been allowed to invest in securities markets, as is the case in Germany and Japan, it would have led to a weak U.S. securities market).
349. Compare supra Part II C (discussing the role of U.S. culture in developing venture capital) with supra Part III D (discussing the role of culture in Japanese and German venture capital industries).
351. See Venture Capital 1: Basics, supra note 19, at 5 (setting research indicating that historically 15% to 30% of portfolio companies fail).

On both counts, China, like Japan, suffers from a culture that discourages risk taking and entrepreneurialism.

Just as Japanese children are taught “dearu ku ga uitateku” (the nail that sticks up gets hammered down), Chinese children are familiar with the saying “shuda xiaotongfeng” (the bigger the tree, the more likely to be blown by the wind). So from an early age, Chinese culture tends to suppress individual initiative and often tames the spirit of the most resourceful and superior individuals, rather than encouraging the sometimes erratic fire of creativity. Thus, there is no history and tradition of venture capital in China, unlike the experience in the West.

Additionally, Chinese culture fosters a fundamental distrust of outsiders with one’s own money. This is manifested by the prevalence of family-owned Chinese businesses, where direct family members or those related by marriage hold key positions, even though they may not be the most qualified people available. This inability to trust significantly affects the future of venture capital in China, as the would-be Chinese provider of capital to venture capital funds agonizes over the fate of his or her money once invested in a venture capital fund in the hands of “strangers.” The Chinese venture capitalist entertains similar misgivings about whether a portfolio company’s management can be entrusted with the operations of the business.

Finally, the concept of “face” and the crucial role it plays in Chinese society cannot be underestimated. “Having face” means you are viewed by your peers, superiors, and subordinates as one in harmony with the prevailing disposition of society; you’ve done nothing to violate conformity. Failure brings shame to oneself and one’s family and causes the ultimate loss of
law. As China prepares to join the World Trade Organization, these objectives take on new dimensions, with even deeper resonance, because their successful implementation will largely determine whether China is ultimately ready to become an indispensable player in the global economic community.

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CPA (New York State). I would like to thank Professors Dan S. Schechter, Theresa H.
Maynard, and Susan Smith Eschbach, all of whose profound dedication to teaching
inspired me. In particular, I thank Professor Maynard for her insightful suggestions on
a draft of this Comment. I also thank Professor Eschbach for her continued encouragement
and support. Finally, I am grateful to Professor Schechter for mentoring, in his
immediate fashion, “law to think like a lawyer.” I dedicate this Comment to the loving memory of
my grandparents, whose deep personalized honor and integrity and who, by their own
example, taught me the joy and value of intellectual pursuit.