VENTURE CAPITAL IN CHINA: DEVELOPING A REGULATORY FRAMEWORK

CHRISTOPHER M. VAUGHN*

* Associate, Vinson & Elkins LLP, New York, New York; J.D., Tulane Law School; M.I.A., Columbia School of International and Public Affairs; B.A., Washington College. The author would like to thank Professor Guanghua Yu at the University of Hong Kong and Professor William Lovett at Tulane Law School.

I. INTRODUCTION

Venture capital[1] first appeared in China in 1985, when the Chinese government released *The Decision to Reform the Chinese Science and Technical System*, its first official document addressing the topic.[2] In Beijing that same year, the government sponsored China Venturetech Investment Corporation, China's first ever venture capital firm,[3] which specialized in high-tech venture investments and led the government's formation of similar investment entities in other provinces around China.[4] Yet the government, young to market economics and mired in ideological skepticism following Tiananmen Square, all but halted the nurturing of high-risk, high-return venture capital investments in 1989.[5] China's venture capital environment withered as a result. Nevertheless, the unpredictable game of private equity in China was underway.[6]

The 1990's witnessed a volatile resurrection of the industry,[7] and by the start of the 21st century, venture capital in China had reached a new level of prominence.[8] There are several explanations for venture capital's newfound attractiveness. First, to the venture capitalist, China's accession into the WTO means long-awaited liberalization in the

---

[1] *See* Anthony Aylward, TRENDS IN VENTURE CAPITAL FINANCE IN DEVELOPING COUNTRIES (Int'l Fin. Corp. Discussion Paper No. 36, 1998). Aylward defines venture capital as "intermediated external investment in small and medium sized companies that offers the prospect of above average earnings growth coupled with above average risk. The investment process consists of raising a fund, screening, selecting, structuring and monitoring investments. Finally the investment is sold and capital repaid to the investor."

[2] *See* Yu Ming, *Hidden Risks in China's Venture Capital Investment, at* http://www.ultrachina.com/english/doc.cfm?OID=89&MIDtoc=0&CIDtoc=42 (June 2, 2000).

[3] *See* Benjamin Yip, Venture Capital in Hong Kong: A Perspective Study and Recommendations 55 (1993) (unpublished M.B.A. thesis, University of Hong Kong) (on file with the University of Hong Kong Library).

[4] *See* Yu, *supra* note 2.

[5] *See id.*

[6] *See id.*

[7] *See* ASIAN VENTURE CAPITAL JOURNAL, THE 2000 GUIDE TO VENTURE CAPITAL IN ASIA 44-51 (2000). In 1992, venture capital again poured into China and rapidly increased through the middle of the decade. The venture capital pool spiked nine times in 1992 to US$878 million and continued upward towards its 1996 peak of US$3.6 billion. But an unstable regulatory environment coupled with reduced economic growth rates and lower than expected returns on investment from Asia's overarching financial crisis produced significant declines in the mid and late 1990's. In 1998 the pool fell to US$3.1 billion and new yearly investment outlays fell from 1995's high of US$678 million to a paltry US$234 million.

[8] *See* Paul H. Folta, *The Rise of Venture Capital in China*, CHINA BUS. REV., Nov.-Dec. 1999, at 6. Outlays in new funds began to rise again in 1998 with 66% of China's venture capital sources coming from outside of China, 35% of which came from non-Asian nations. *See* ASIAN VENTURE CAPITAL JOURNAL, *supra* note 7, at 47-48.

investment field.[9] China also has the world's fastest growing and most closely watched Internet market[10] and offers unprecedented governmental support in the high-tech field.[11] In light of Asia's 1997 financial crisis, venture capital provides China with longer-term, non-speculative investment that supports innovation and skill transfer, elements not found in the portfolio-type investments of the 1997 financial debacle.[12] At the same time, venture capital holds relief for China's tightening credit market.[13] Moreover, job growth associated with venture capital helps China stem its rising unemployment problems from sweeping state-

---

[9] *See* Yuan Jianan, *New Development in Regulations and Policies of the PRC Regarding Foreign Investment*, CHINA LAW UPDATE, May 2000 at 24. The State Council inaugurated a new liberalization campaign on Aug. 20, 1999 when it passed a nine-ministry, jointly formulated administrative regulation entitled *Opinion on Further Encouraging Foreign Investment.* Further clarification and liberalization took place on September 1, 2000 when MOFTEC and SAIC's *Provisional Regulations on Investment Inside China* went into effect. *See* Sally Harpole, *New Regulations Clear Path for Investment by FIE's*, CHINA LAW UPDATE, Sept. 2000, at 3. Lastly, legislators voted on October 31, 2000 to amend its foreign investment laws to equalize foreign opportunities in-line with pledges China made concerning WTO accession. *See* Hu Quhua and Saho Zongwei, *Bid to Level Playing-Field*, CHINA DAILY, Oct. 31, 2000, at 1.

[10] *See Sina.com Gets Nod to Go Public*, CHINA DAILY, Mar. 26, 2000. The number of Internet users in China doubles every eight months. *See* Yvonne Chan, *Web Wave to Break on Mainland Shores Under WTO Membership*, S. CHINA MORNING POST, Nov. 18, 1999. In the past two years the number of users increased fourteen fold. *See* James Kynge, *Firewall of China: Beijing is Proud of its Whizz-kids But Fears the Anarchy of the Internet*, FIN. TIMES, Jan. 27, 2000. In 1999 alone users jumped from 2 million to nearly 9 million. *See* R.J. Michaels, *New Medium, New Rules*, ASIAWEEK, Feb. 11, 2000. Projections forecast that users will reach 20 million by 2002 and 52 million by 2003. *See* Yvonne Chan, *supra; See also* Jim Erickson, *Dot-Com's High Rollers*, ASIAWEEK, July 23, 1999.

[11] *See* Sarah Tilton, *Technology*, ASIAN WALL STREET JOURNAL WEEKLY, May 31, 1999. With President Jiang Zemin and Premier Zhu Rongji openly supporting China's high-tech development, the State Council has mapped out several new policies to encourage investment in software and integrated circuit development using tax incentives. *See China Adopts New Policies to Boost IT Industry*, PEOPLE'S DAILY, July 12, 2000. Zhongguancun Science Park, Beijing's equivalent to Silicon Valley, already houses 4,830 hi-tech companies, of which 916 opened last year, 230 research and development centers, and China's top three computer makers. Production topped over US$2 billion in 1999. *See* Mark O'Neill, *Silicon Valley Dream Remote From Reality*, S. CHINA MORNING POST, Feb. 21, 2000, at 3.

[12] *See* William B. Sorabella, *Less Developed Country as Start-up Corporation: Adopting the Venture Capital Model for Development in Light of Global Capital Market Realities*, 31 LAW & POL'Y INT'L BUS. 517 (Jan. 1, 2000).

[13] *See Capitalizing on Chinese Financial Market Reforms*, THE BCA CHINA ANALYST, June 2000, at 27 ("First, alternative methods of financing are badly needed because the contraction of the traditional banking industry seems inevitable. Like many of its Asian counterparts, China's banking system is no longer a properly functioning financial intermediary."); *See also Credit Quality of China's Banks Falling, at* http://www.findarticles.com/cf_0/m0WDP/1998_July_6/50189036/p1/article.jhtml?term=credit+quality+of+china%27s+banks (July 6, 1998); *Exporters Faced Heightened Credit Risks in China,at* http://www.financeasia.com/articles/07032783-77C1-11D4-8C110008C72B383C.cfm (Aug. 22, 2000). Many of China's banks confront insolvency because of poor SOE loan performance, tight foreign exchange regulations, and deficiencies in the central bank's institutional regulations. An unwillingness to lend is reflected in a precipitous drop in loan growth since 1997.

owned enterprise reform.[14] The venture capital formula suits not only the high-risks of investing in former state-owned entities and other entities deficient in market operating experiences,[15] but also the government's recent push to develop western China.[16]

As well matched as China and venture capitalists might seem, however, significant obstacles stand in the way of further developments. Irrespective of China's recent Internet turmoil,[17] China's most pressing private equity dilemma is the absence of a regulatory framework to support a dynamic financing regime like venture capitalism.[18]

Section II of this paper details the modern history of China's financial structure and its ever-developing maturity towards sufficient need for and proper inclusion of a venture capital market. Section III describes China's present day venture capitalists, the difficulties they

[14] *See* Sangwon Suh and Richard Saludo, *Worried Giants*, ASIAWEEK, Nov. 21, 1997.

[15] *See* Curtis Milhaupt, *The Small Firm Financing Problem: Private Information and Public Policy*, 2 J. SMALL & EMERGING BUS. L. 177, 180 (1998) (noting that information asymmetries between the entrepreneur and investor, creating the high-risk, high-return formula, arise from the entrepreneur's absent track-record, but are overcome by the venture capitalist's tight monitoring through contractually imposed obligations placed on the entrepreneur).

[16] *See Bridging the Gap*, CHINA ECON. REV., Oct. 2000, at 17; *See also Western Adventure*, CHINA ECON. REV., Aug. 2000, at 1. The "Go West" Campaign, kicked off by Zhu Rongji in early 1999, offers foreign investors tax holidays, investment opportunities in previously forbidden sectors like energy and telecoms, and relaxes price controls in transportation, education, and environmental protection.

[17] *See* David Porter, *China Must Keep the Door Open to Foreign Hi-Tech Investment*, ASIAN VENTURE CAPITAL JOURNAL, Oct. 1999, at 4. China's Information Industry Minister, Wu Jichuan, kicked off concerns regarding foreign investment in China's internet service providers, content providers, and other value-added services when commenting in September 1999 that such investments were illegal because they violated a 1993 ban on foreign involvement in Chinese telecommunications. In early 2000, a raft of new regulations from the State Council, the Ministry of Information Industry, and the State Bureau of Secrecy cracked down on internet providers, requiring registration of their encryption software, three ministry approvals before issuing domestic stock or floating shares overseas, and proclamations that the government would stop internet leakages of state secrets. *See* Mark Landler, *Rolling with China's Web Punches*, N.Y.TIMES, Jan. 31, 2000, at 10; *See also* James Kynge, *supra* note 11. Meanwhile, as government ministries struggled internally on how to reign in the Internet, the State Council continued to issue regulations. Document No. 292 requires Internet providers to re-register, threatening foreign investors with high levels of investment, and imposes legal responsibility for all politically sensitive information appearing on web sites. *See generally* Terry McCarthy, *Regulations: China's Net Commandments*, TIME, Feb. 25, 2000, at 26; *See also* Tom Mitchell, *Hi-Tech Development Finds Special Home in the Zone*, S. CHINA MORNING POST, Oct. 9, 2000, at 3. The State Council furnished its latest rules in October and November of 2000, requiring that portals apply for licensing and limit news postings to domestic news sources only. *See* Jamila Zhou and Raymond Li, *Internet Regulations a Blow to Commercial Portals*, S. CHINA MORNING POST, Nov. 8, 2000, at 8; *See also* Craig Smith, *Tough New Rules Don't Faze Chinese Internet Start-Ups*, N.Y. TIMES, Oct. 4, 2000, at 2. Eighty to ninety percent of China's Internet start-ups will fold or merge before year-end, in part because investors are unwilling to infuse second or third-tranche funding in light of recent restrictions. *See Capital Burn-Out*, CHINA ECON. REV., Oct. 2000, at 23.

[18] *See* Winston Yau, *Rules Revamp for WTO: Regulations to Ease Flows for Venture Capital and Set Guidelines for Foreign Players*, S. CHINA MORNING POST, Nov. 3, 2000 ("China has no comprehensive rules to govern this sector.").

have faced, and the legislative gaps that currently frustrate those operations. Section IV points out how Chinese legislators have attempted to fill those gaps, and Section V offers regulatory lessons from the United States, Japan, and Korea on how those gap-filling initiatives might be extended to encourage a fuller, more robust venture capital regime. In conclusion, Section VI notes that China's proposed venture capital regime is both timely and in keeping with promised financial liberalizations made to the WTO and the international community generally. China unquestionably stands to gain economically if it can foster the political will to incorporate the lessons of other venture capital jurisdictions.

II. CHINA'S SYSTEM OF FINANCE: A BRIEF HISTORY

A. The Pre-Communist and Communist Era

Prior to Communism, China's financial structure was composed primarily of native bankers in family groupings or clans, organized as proprietorships or small partnerships that accepted deposits, disbursed loans and handled remittances or money exchanges throughout the country.[19] While "[t]he native financial institutions of China appear to have been reasonably adequate to the functions which they had to discharge before the modern era, . . . they were not fitted for handling the international financial transactions that resulted from trade with Western countries."[20] As a result, in order to raise more capital for commercial enterprise operations at the turn of the 20th century, China broadened its financial capabilities and obtained financial services from a number of foreign banks[21] in conjunction with fund sourcing through a series of security exchanges in Shanghai, Beijing and Tianjin.[22]

That changed, however, when Mao Zedong's central government absorbed privately operated and Nationalist-run financial institutions in

---

[19] *See* FINANCIAL INSTITUTIONS AND MARKETS IN THE FAR EAST: A STUDY OF CHINA, HONG KONG, JAPAN, SOUTH KOREA AND TAIWAN 20 (Michael Skully ed., 1982).
[20] *Id.* at 3.
[21] *See* Xiaoping Xu, CHINA'S FINANCIAL SYSTEM UNDER TRANSITION 179 (1998) (detailing that the first foreign bank, Oriental Banking Corporation, came to Shanghai in 1848 and was followed by a proliferation of foreign banks handling loans to the Chinese government, investments in China's railway and mining operations, and customs and salt revenues). *See also* Skully, *supra* note 19, at 3 (listing HSBC, Standard Chartered, and others from Germany, Japan, Russia, France, Belgium, and America).
[22] *See* Cecil R. Dipchand et al., THE CHINESE FINANCIAL SYSTEM 147 (1994) (indicating that the local government in Shanghai established an exchange in 1914 and Beijing's government followed in 1918, as did Tianjin's in 1921). *See also* Skully, *supra* note 19, at 21 (stating that the 1940 Shanghai exchange lead by the Chinese Stock Promotion Committee, a committee composed of Shanghai banks and trust companies, traded shares in 76 different companies).

1949.[23] Mao brought banks and the informal lending sector under direct lending and borrowing controls of the People's Bank of China.[24] He abolished China's nascent securities markets and disbanded China's wealthy lending class.[25] His self-reliance doctrine also prompted the exodus of foreign banks, effectively ending foreign financing for China.[26] In essence, Mao modeled China's centrally controlled mono-banking system on the Soviet's state planning tradition.[27] China's central government unified enterprise expenditures under a state physical plan and to ensure that state enterprises met their state-required output quota the Ministry of Finance disbursed funds in the form of interest-free state grants via the central banking system.[28] Any profit overages were remitted back to central authorities.[29] This carried on for the next thirty years.[30]

B. *The 1978 Reforms*

Not until 1978, when the 11th Party Central Committee shifted its ideological focus from class struggle towards economic liberalization and development, did China's mono-banking system give way.[31] Significant revenue deficits burdened the central government following the high implementation and reconstruction costs of the Great Leap Forward and Cultural Revolution.[32] State-owned enterprises, which by 1976 accounted for 99.5% of state revenues,[33] also were becoming more and more inefficient and unable to absorb China's growing employable labor force.[34] Moreover, China's newly formed private enterprise sector was in desperate need of new capital.[35] China's desire for greater, more efficient

---

[23] *See* Skully, *supra* note 19, at 4. *See also* Dipchand, *supra* note 22, at 2. The country's seven largest financial institutions, run primarily by four Nationalist families, were brought under central control immediately. The other 3,500 provincial and municipal banks came under central control, albeit it more slowly, through the use of higher taxes and wage contracts that forced privately run institutions to close or sell out to the state.
[24] *See* Dipchand, *supra* note 22, at 2.
[25] *See id.* at 147.
[26] *See id.* at 9 (indicating that foreign loans in China's First Five Year Plan (1953-1957) accounted for only 3% of capital construction financing, most of which came from the Soviet Union until the two nations encountered political disagreements in 1960).
[27] *See id.* at 9; *see also* K. Matthew Wong, *Securities Regulations in China and Their Corporate Finance Implications on State Enterprise Reform*, 65 FORDHAM L. REV. 1221, 1227 (1996).
[28] *See id.*
[29] *See id.*
[30] *See* Skully, *supra* note 19, at 5.
[31] *See* Dipchand, *supra* note 22, at 15.
[32] *See id.* at 11.
[33] *See id.* at 13.
[34] *See id.* at 15 (indicating that some 20 million Chinese were unemployed in 1978).
[35] *See* discussion on ownership, *infra* page 9.

productivity required more diverse financing options and mandated that China change its banking, securities and foreign financing structures in conjunction with its privatization efforts.

China first restructured and broadened its banking system.[36] Mao's mono-banking program was divided into two tiers, a tier one central bank that oversaw the tier two commercial banking elements.[37] The general focus for China was to commercialize its state banking operations.[38] These new specialized banks were now responsible for their own profits and losses and had to replace budgetary grants with interest-bearing loans.[39] In addition, newly formed comprehensive banks at the

[36] *See* Xu, *supra* note 21, at 30. Although China has greatly expanded its banking options, Xu's table on the structure of the banking system as of 1992 indicates that the majority of China's banking infrastructure still falls under the domain of China's four specialized banks:

Bank	**No. of Branches/Subsidiaries**	**No. of Employees**
People's Bank of China (Central Bank)	2,550	173,692
Specialized Banks		
Agricultural Bank	56,417	503,397
Bank of China	7,110	117,886
Industrial Bank	31,495	525,297
Construction Bank	28,139	280,214
Comprehensive Banks		
Bank of Communications	547	23,973
CITIC	11	600
Development Banks		
China Investment Bank	N/A	N/A
Credit Cooperatives		
Rural	5,937	563,169
Urban	3,518	77,382
Foreign Funded Banks		
Foreign Bank Branches	90	N/A
Foreign Joint Venture Banks	N/A	N/A
Foreign Bank Rep. Offices	215	N/A
Non-bank Financial Institutions		
Trust & Investment Companies	375	46,378
People's Insurance Company	4,237	105,638
Finance Companies	N/A	N/A
Financial Leasing Companies	N/A	N/A
Securities Companies	85	N/A

See also Simon Pritchard, *Strength Lies in Masses*, S. CHINA MORNING POST, May 10, 2001 at 12 (noting that Chinese banks account for 80% of corporate financing in China).

[37] *See* Xu, *supra* note 21, at 19.

[38] *See* Paul Heytens and Cem Karacadag, AN ATTEMPT TO PROFILE THE FINANCES OF CHINA'S ENTERPRISE SECTOR 4 (Int'l. Monetary Fund, Working Paper WP/01/182, Nov. 2001).

[39] *See id.*.at 23-26 (discussing the new responsibility of the Agricultural Bank of China, the Industrial and Commercial Bank of China, the Bank of China and the People's Construction Bank of China and indicating that bank lending increased from a tiny share of capital investment in 1979 to 80% by 1985).

national and local levels offered enterprises a second financing source.[40] These institutions were important because they attracted foreign capital again and focused investment into projects that introduced technology, equipment and management skills from overseas.[41] Urban and rural credit cooperatives also offered yet another, locally based opportunity for smaller businesses to acquire badly needed capital.[42]

In addition to these credit market improvements, China's government resurrected its long absent securities market to further extricate itself from state-owned enterprise losses and to better utilize China's large private savings base.[43] In 1986, securities trading recommenced in a limited number of select Chinese cities.[44] By 1990, China opened its first national exchange in Shanghai and a second six months later in Shenzhen.[45] Smaller regional exchanges also opened in Shenyang, Wuhan, Tianjin and Dalian.[46] These new securities markets meant that, for the first time, enterprises could utilize funds beyond the limitations of state appropriations.

Further diversifying its financial configuration, China's open-door policy encouraged the return of foreign financing through increased export earnings, foreign direct investment (FDI) and foreign capital inflows.[47] In China's first decade of liberalization, 80% of these foreign resources came from export earnings, 10% from foreign lending, of which most went to commercial lending, and 6% from FDI.[48] In the second decade, however, FDI became much more important, accounting for nearly 65% of all foreign capital inflows, while foreign lending fell to

---

[40] *See id.* at 26-27 (noting the Bank of Communications and the China International Trust and Investment Corporation (CITIC) existed at the national level while local operations included the Guangdong Development Bank, the Fujian Industrial Bank and the Shenzhen Development Bank).

[41] *See* Dipchand, *supra* note 22, at 73-94.

[42] *See* Xu, *supra* note 21, at 27.

[43] *See* Pritchard, *supra* note 36, at 12 (stating that China's citizens saved nearly US$ 1 billion in 2000 despite a 20% withholding tax and a 1.8% interest rate); *See also* Todd Kennith Ramey, *Socialism Embraces Capitalism? An Oxymoron for the Turn of the Century: A Study of the Restructuring of the Securities Markets and Banking Industry in the People's Republic of China in an Effort to Increase Investment Capital*, 20 HOUS. J. INT'L L. 451, 458 (Winter, 1998) (stating that China's 40% Savings-to-GDP ratio is double the 20% level found in the United States); *See generally* Wong, *supra* note 27.

[44] *See* Wong, *supra* note 27, at 1222.

[45] *See id.*

[46] *See* Ramey, *supra* note 43, at 468.

[47] *See* Kui-Wai Li, FINANCIAL REPRESSION AND ECONOMIC REFORM IN CHINA 60 (1994).

[48] *See id.* at 62-63. Li's *Table 2.22 Inflow of Foreign Resources* and *Table 2.23 Foreign Loans Used* give a nice breakdown of foreign resources utilized from 1980-1990.

about 28%.[49] The bulk of these funds came from Hong Kong and Macau.[50]

C. *The Need for Venture Capital in 2002*

Although the expansion of financing options in China has been impressive, it should not be overstated. China's booming private sector[51] still relies primarily on insufficient self-financing.[52] The private sector accounts for 27% of China's GDP, second only to the state sector,[53] and 35% of the nation's employment,[54] but it takes in only 1% of bank lending.[55] China's banking structure continues to hesitate in lending to the private sector.[56] The desire to reduce non-performing loans, an

---

[49] *See* Jun Fu, INSTITUTIONS AND INVESTMENTS: FOREIGN DIRECT INVESTMENT IN CHINA DURING AN ERA OF REFORM 121 (2000) (covering the period 1990-1998).

[50] *See id.* at 122 (graphing that nearly 60% of China's foreign funds come from Hong Kong and Macau, followed by Taiwan (11%), the United States (8%), and Japan (5%)).

[51] *See* Gary H. Jefferson and Thomas G. Rawski, *Ownership Change in Chinese Industry, in* ENTERPRISE REFORM IN CHINA: OWNERSHIP TRANSITION AND PERFORMANCE 23-25 (Gary H. Jefferson and Inderjit Singh eds., 1999) [hereinafter ENTERPRISE REFORM]. See the table below detailing the type and number of enterprises in thousands from 1980-1996. Note that the bulk are individual-owned:

Type of Enterprise	**1980**	**1985**	**1990**	**1995**	**1996**
State-Owned	83.4	93.7	104.4	118	113.8
Collective-Owned	293.5	367.8	1,668.5	1,475.0	1,591.8
Township-Owned	186.6	632.6	680.8	689.9	678.4
Village-Owned	---	741.7	596.6	371.6	518.6
Individual-Owned	---	3,347.8	6,176.0	5,688.2	6,210.7
Other	.4	1.7	8.8	60.3	70.2
Shareholding	---	---	---	5.9	8.3
Foreign-Funded	---	---	---	18	19.8
Overseas-Funded	---	-*--	---	26.9	24.5
Total	377.3	3,811.0	7,957.8	7,341.5	7,986.5

China divides enterprises into state-owned, collective-owned, individual-owned, and "other" ownership forms. Collective-owned enterprises include urban collectives, township enterprises, village enterprises, and cooperatives. Individual-owned firms are privately owned firms that employ seven workers or less. Private firms employing eight or more are labeled Privately Owned and fall under the "Other" category. "Other" includes domestic joint ventures, privately owned enterprises, foreign-funded joint ventures, overseas-funded joint ventures, foreign-funded wholly owned firms, overseas-funded wholly owned firms, foreign-funded cooperatives, overseas-funded cooperatives, and share-holding enterprises. Overseas ownership encompasses only Hong Kong, Macau and Taiwan where Foreign-funded ownership encompasses all other countries. *See id.*

[52] *See* Neil Gregory and Stoyan Tenev, *The Financing of Private Enterprise in China*, FINANCE AND DEVELOPMENT, Mar. 2001, at 14.

[53] *See id.*

[54] *See* Heytens and Karacadag, *supra* note 38, at 7.

[55] *See* Gregory and Tenev, *supra* note 52.

[56] *See id.* at 3-5. For a better impression of the private sector's importance see Jefferson and Rawski, *supra* note 51. For the limited interaction that the banking sector has with China's private sector see Gregory and Tenev, *supra* note 52.

inability to offset high risk through China's centrally controlled and artificially low interest rate system, and the traditional safety of lending to state-owned enterprises, backed by government financing in cases of failure, have contributed to the banking industry's risk-aversion. [57] Moreover, because of underdeveloped screening procedures and unclear market information, banks exclude small businesses from debt financing through prohibitively high collateral requirements.[58]

Likewise, the private sector accounts for only 1% of companies listed on China's securities markets.[59] Burdened with the government's struggle to balance socialist ownership against capitalist efficiency, China's private sector has suffered under the primitive nature of China's capital markets.[60] With stringent listing requirements prohibiting many interested companies from participating in the equities market,[61] a four-share system that distorts pricing and ensures state-controlled ownership,[62] and insufficient disclosure requirements—compounded by ill-defined corporate governance standards—domestic capital investment has funded only 3% of mainland GDP.[63]

Furthermore, with respect to foreign investment, while it boomed in the early 1990's and captured significant media attention, it is important to recognize that foreign funds have amounted to only 5 or 6% of China's fixed asset investment and only 9 to 10% of GDP. [64] Predictions indicate that foreign investment and lending figures will continue to grow following China's WTO admission,[65] but approval

---

[57] *See id.*

[58] *See id.*

[59] *See id.* at 62.

[60] *See* Pritchard, *supra* note 36, at 12 (quoting Dai Xianglong, governor of the People's Bank of China, "The capital market in China is not a fully developed one."); *See also* Wong, *supra* note 27, at 1245.

[61] *See* Wong, *supra* note 27, at 1237 (noting that only profitable enterprises with significant book value are capable of garnering the government approval needed for listing).

[62] *See id.* at 1238 (explaining that state shares and legal person shares, which account for 75% of total common shares, require government approval for transfer. Individual shares, which make-up only 25% of the market, are further separated into A-shares for Chinese citizens and B-shares for foreign investors. Finally, H-shares are also available to foreign investors on overseas markets like Hong Kong. This unwieldy share structure undermines efficient pricing models expected in more advanced, purely capitalistic markets).

[63] *See* Pritchard, *supra* note 36.

[64] *See id.* at 5.

[65] *See China to Attract More Foreign Investment Next Year*, CHINAONLINE (Dec. 7, 2001) (noting that the expected amendments to the Foreign Investment Directory as per WTO requirements will open many more sectors to FDI); *See also Banking and Insurance*, at http://www.china.org.cn/e-china/banking/introduction.htm (n.d.). By the end of 1999, 177 commercial foreign financial organizations and 248 foreign bank agencies and had established operations in China. Once foreign-invested banks can operate in all major cities and offer yuan-denominated loans to Chinese enterprises as promised under WTO commitments, these figures and the amount of foreign lending

requirements, political considerations, and unpredictable enforcement of contract law have inhibited many foreign financiers and closed off this option for most domestic enterprises.

In 1999, 90% of China's start-up capital came from private sources like principle owners, start-up teams and families.[66] Post-start-up operations also relied heavily on private sources and retained earnings.[67] Considering the private sector's growth, the limits within China's debt and capital markets, and the private sector's increased need for external financing, internal financing alone is unsustainable.[68] Enter venture capital. Although accounting for only 0.75% of China's GDP,[69] venture capital's risk-taking structure seems the appropriate answer to China's current private sector financial crunch. Certainly, until China's banking structure liberalizes further and its securities markets mature, venture capital is the only market poised to grow with China's private enterprise sector.[70]

III. CHINA'S CURRENT VENTURE CAPITAL REGIME

A. *The Players and Their Current Form*

Although China operates without formal venture capital legislation, China's promising markets in medical services, software, wireless applications, and biotechnology have attracted a number of venture capitalists.[71] As of 1998 there were an estimated 3,112 venture capital funds managing roughly US$3.62 billion in China.[72] The majority of China's 300 registered venture capital institutions are organized as venture capital investment companies, of which 83% are limited liability

---

are expected to increase dramatically. *See China to Ease Rules on Foreign Banks on February 1*, BUSINESS DAILY UPDATE (Dec. 31, 2001).

[66] *See id.* (citing a 1999 International Finance Corporation survey). This is comparatively high when put next to percentages of internal funding found in advanced reforming countries like Estonia (33%), Poland (34%), and Lithuania (37%). *See id.* at 3.

[67] *See id.* at 1.

[68] *See id.*

[69] *See* Folta, *supra* note 8, at 9 (noting that this is a 1998 figure).

[70] *See id.* (indicating that from 1997 to 1998 the growth in Chinese venture capital investments outpaced GDP and FDI nearly two times. Venture capital grew an average of 15.5%, GDP 8.65% and FDI 3.7%. They also note that "venture capitalists increasingly get the initial call because they often appear more closely aligned with the local Chinese entrepreneur's immediate interests.").

[71] *See Entering the House of Pain-And Profit*, ASIAN VENTURE CAPITAL JOURNAL, Mar. 1999, at 22.

[72] *See* Folta, *supra* note 8, at 7; *See also Realized Venture Investment in China Only Accounts for US$ 145 Million*, CHINAONLINE, June 20, 2001; *See also Venture Capital in China: Regulations and Practices*, CHINA BUSINESS, Dec. 7, 2001.

companies under China's Company Law.[73] Most of these were formed in 1999 and concentrate in the coastal areas with the government holding equity in about 90% of them.[74] Of the total number of institutions, ownership breaks down as follows:[75]

	Wholly-State	*Government-Invested*	*Privately-Owned*[76]	*Foreign-Invested*[77]	*Other*[78]
Percent	19%	20%	44%	13%	4%

While the government's share of investment funds has fallen from 70% to 43%[79] and Chinese enterprises now account for 40%,[80] indicating a healthy diversification of domestic funding sources, it is important to recognize that 90% of total realized venture capital

[73] *See Organization and Ownership Structure,* CHINA BUSINESS, Dec. 7, 2001. Sixty-one percent of all capital investment institutions are venture capital investment companies. The others are organized as venture capital investment management companies or venture capital investment divisions under companies or enterprises.

[74] *See Realized Venture Investment, supra* note 72 (indicating that about 83% of China's venture capital investment companies were established in 1999); *See also Venture Capital in China: Regulations and Practices, supra* note 72. Shanghai, Beijing and Shenzhen each have more than 60 institutions. Nanjing, Hangzhou, Tianjin and Guangzhou each have about ten such firms. Dalian, Shenyang, Xi'an and Chengdu each have around five. On average, each provincial capital has one or two such venture capital institutions.

[75] *See Organization and Ownership Structure, supra* note 73.

[76] *See* Folta, *supra* note 8, at 7 (indicating that most of these funds are based in Hong Kong).

[77] *See* THE 2000 GUIDE TO VENTURE CAPITAL IN ASIA, *supra* note 7, at 45-46; *See also* Dennis Taylor, *U.S., China VCs Join Forces to Fund Projects,* THE BUS. J., June 2, 2000. Over fifty foreign funds operate in China backed by some 600 to 800 companies interested in Chinese start-ups. *See also See Entering the House of Pain-And Profit, supra* note 71, at 22. The Walden Group's China Walden Fund invested US$100 million in early-stage high-tech private enterprises. *See* Folta, *supra* note 8. Chase Capital Partners, an affiliate of Chase Manhattan Corporation, dedicated 50% of its US$100 million Asian portfolio to China and opened a US$521 million Asia Opportunities Fund with the World Bank's IFC. *See id.* Baring Capital Partners, through its US$75 million ING Beijing Fund, has invested in winners like Skyworth Digital, China's fourth largest color television manufacturer and listed on the Hong Kong Exchange. Skyworth also has paired up with Microsoft China Corporation to develop set-top Internet boxes. *See Reconfiguring The Portfolio,* ASIAN VENTURE CAPITAL JOURNAL, May 2000, at 11. Inter-Asia Venture Management Limited brought MacDonald's to China and corporate giants like IBM, Intel, and Lucent Technologies also are joining the fray. *See Entering the House of Pain, supra*; *See also* Sunray Liu, *Western Venture Capitalists Chase Tech Companies, Despite Debate Over Country's Trade Status–China Sees Too Many Investors, Too Few Startup,* ELEC. ENG'G TIMES, May 22, 2000. IBM will provide US$200 million in venture capital to local e-commerce start-ups and Intel has contributed to leading Chinese portals, e-commerce sites, and wireless telecommunications start-ups. *See id.*

[78] *See Organization and Ownership Structure, supra* note 73 (explaining the Other category as listed Chinese companies, large enterprises, research institutes, hi-tech development zones and securities houses).

[79] *See Government Funds Account for 43 % of Venture Capital Investment,* CHINA BUSINESS, Aug. 3, 2001.

[80] *See Organization and Ownership Structure, supra* note 73.

investments comes from overseas.[81] This makes a further analysis of foreign operations critical.

Operating with hampered investment independence under the costly and cumbersome governance of China's foreign invested enterprise (FIE) laws,[82] a foreign fund is typically structured as an equity or cooperative joint venture under Chinese Company law between a foreign venture capital firm,[83] a Chinese investee company, and the Chinese government, particularly municipalities.[84] The Chinese entrepreneur assigns assets and the Chinese government and foreign venture capitalist assign cash into a newly formed limited liability company, where the

[81] *See Realized Venture Investment*, *supra* note 72.

[82] *See Views from Foreign Venture Capital Investors*, *at* http://virtualchina.org/archive/news/sep00/090600-vcap-jl-knf-c.html (n.d.). Because China's 1999 Company Law is quiet on whether foreign funds may invest directly into young Chinese companies, funds follow the traditional FIE investment formats of equity joint venture, cooperative joint venture, or wholly foreign owned entity. Article 18 of the Company Law suggests that limited liability companies with foreign investment are different from domestic limited liability companies as does MOFTEC's *Certain Questions on the Establishment of Foreign Investment Companies Limited by Shares* (Jan. 10, 1995) seem to suggest that companies limited by shares with foreign investment are different from domestic companies limited by shares. The Administration of Industry and Commerce has given mixed signals on the topic and liberal southern China localities, where limited direct investment is practiced, seems a result of discretionary local administrative acts that limit the investments to 25%. *See also* John Lo, *The Problem with Venture Capital in China*, *at* http://www.virtualchina.com/archive/laws/venture.html (n.d.).

[83] *See Venture Capital Investment in China in 2001 Expected to Exceed US$ 483 Million*, CHINA BUSINESS, Dec. 21, 2001 (indicating that the United States made up 40% of China's foreign venture capitalists and that only 19% of that figure were American companies).

[84] *See* Porter, *supra* note 17. The Bank of China initiated this practice when it joined with Hambrecht & Quist Asia Pacific to form the US$85 million China Dynamic Growth Fund In 1994. *See* Folta, *supra* note 8. In 1999, the Beijing Municipal Government's investment arm, Beijing Enterprises Holding Limited, joined with WI Harper Group and Hong Kong property giant Sun Hung Kai Group, along with Qinghua University Enterprise Group, in formation of the US$50 million Beijing Technology Development Fund which focuses on electronic commerce and wireless telecommunications. *See Bridging Beijing and Silicon Valley*, ASIAN VENTURE CAPITAL JOURNAL, July 1999, at 17. The Shenzhen government's investment arm, Shum Yip Holdings, responded shortly thereafter when it joined with Alta Capital in forming its own US$50 million fund. *See Hi-Tech Backbone*, ASIAN VENTURE CAPITAL JOURNAL, Jan. 1999, at 16. Shanghai was not far behind. Its Municipal Government's investment arm, Shanghai Venture Capital Corporation Limited, joined with Shanghai Industrial Holding Limited, another government controlled corporation to form a US$100 million fund. *See Shanghai Industrial Goes VC*, ASIAN VENTURE CAPITAL JOURNAL, Aug. 1999, at 13. Shanghai Industrial Holdings also teamed up with Temask, an investment arm of the Singapore government, and Vertex, a venture capital arm of the Singapore Technologies Group, in forming the SI Technology Fund. *See Technology*, ASIAN WALL STREET JOURNAL WEEKLY, Apr. 3, 2000. More recently, national ministries have been engaging in the industry. The Ministry of Information Industry joined forces with the International Digital Group (IDG) in a US$100 million fund. *See* Folta, *supra* note 8. IDG also has a cooperative memorandum with the Ministry of Science and Technology to invest some US$1 billion in high-tech Chinese enterprises. *See Less Risk for Venture Capital in China Than in US*, PEOPLE'S DAILY, Apr. 12, 2000. China's State Bureau of Machine-Building Industry, through its trading company CMEC, also has joined in the venture capital game, partnering with GE Capital Services in pre-IPO bridge financing managed through First Eastern Investment Group. *See* Folta, *supra* note 8.

venture capitalist is assigned equity.[85] The venture capitalist usually invests through an offshore holding entity, known in China as a Special Purpose Vehicle and incorporated somewhere like the United States, the Cayman Islands, or the British Virgin Islands, and protects its equity interests using convertible preferred shares, anti-dilution protection, and pre-emptive rights.[86] Considering the government's significant role in these complex arrangements, in addition to its 40% stake in total investment funds, the bulk of China's venture capital operations do not appear to be economically driven, giving rise to the claim that they are venture capital outfits in name only.[87]

B. *Problems with Entry: Structure and Control Issues*

This framework is problematic for a number of reasons. First, under China's 1999 Company Law, the limited equity or cooperative joint venture structural options afforded foreign venture capitalists do not include incentives like flow-through taxation as seen in the limited partnership structures in jurisdictions like the United States.[88] Moreover, because of exorbitantly expensive registered capital requirements imposed on the entrepreneur registering as a limited liability company or a company limited by shares, many good business start-up proposals fail to qualify for registration and consequently forego badly needed funding.[89] This is exacerbated by the law's 20% limitation on entrepreneurs registering intellectual property as initial equity.[90] The entrepreneur also may face prohibitive costs because the Company Law is

---

[85] *See* John Lo, *supra* note 82; *See also* Mark Landler, *Rolling with China's Web Punches*, N.Y.TIMES, Jan. 31, 2000, at 10.

[86] *See id.*; *See also* Shen Wei and Yuji Sun, *Chinese Regulatory Framework for Venture Capital Investment*, CHINA LAW UPDATE, June 2000, at 16. Wei and Sun discuss two other less frequently used investment structures. Foreign investors may utilize a wholly foreign owned Chinese holding company to do their investing, but many are excluded from this option because of the high capital requirements and intricate government approval process needed to qualify. Technically, investors also could try investing directly into domestic limited liability companies because the Company Law is quiet on the subject, but the authors do not recommend the approach because MOFTEC does not encourage such practice.

[87] *See* Justin Doebele, *Let a Million Companies Bloom*, FORBES, June 12, 2000, at 160.

[88] *See* Peggy Fu, *Developing Venture Capital Laws in China: Lessons Learned from the United States, Germany, and Japan*, 23 LOY. L.A. INT'L & COMP. L. REV. 487, 522 (May 2001).

[89] *See* Lo, *supra* note 85. To qualify as a limited liability company, Article 23 of The Company Law of the People's Republic of China requires a minimum capital contribution of RMB 100,000 for technology ventures up to a maximum RMB 500,000 for production ventures. To qualify as a company limited by shares, Article 78 requires a minimum contribution of RMB 10,000,000. On a RMB 2,000 monthly salary, these steep figures prevent great numbers of capable Chinese businessmen from registering for funding.

[90] *See id.* Article 24 of the Company Law states that intellectual property in the form of a patent, copyright, or trade secret may not exceed 20% of initial registered capital.

silent on whether companies may legally offer stock option plans to employees as an alternative to cash payments.[91]

Second, while the private enterprise-to-government union has brought significant modifications to Chinese regulations regarding areas of foreign investment, including sensitive areas like aviation,[92] telecommunications,[93] and insurance,[94] China's imposition of this joint structure infringes on the venture capitalist's economically driven decision-making independence[95] and inefficiently channels investments towards politically important companies rather than economically promising prospects.[96] This is underpinned by China's FIE regulations. Ownership levels are capped in certain economic sectors, thereby inhibiting the venture capitalist's governance capabilities, or the venture capitalist is prohibited from investing in certain sectors altogether because of state sensitivity considerations.[97] Even if venture capitalists try to by-pass these equity regulations by offering entrepreneurs debt instruments

---

[91] *See id.* Some engage in the practice, but those instances are rare. Interview with Dr. Guanghua Yu, Professor of Company and Securities Law in the PRC, University of Hong Kong, in Hong Kong, China (Dec. 1, 2000).

[92] *See* Folta, *supra* note 8. In 1996, George Soros reportedly purchased 25% of Hainan Airlines from the Chinese government, despite laws prohibiting such purchases. In addition, the government raised the aviation foreign ownership level to 35% at the time of the deal and has suggested it may yet raise it to forty.

[93] *See id.* The first broadband integrated services digital network in Guangzhou was financed by SC & M International Limited and Brooks Telecommunications, two U.S. firms, in conjunction with the Guangzhou City Government.

[94] *See Priming the PRC Pump*, ASIAN VENTURE CAPITAL JOURNAL, Nov. 1999, at 14; *see also Well-Covered in China*, ASIAN VENTURE CAPITAL JOURNAL, May 1999, at 10. In a race to get hold of insurance operating licenses from the Chinese government to profit on China's estimated US$30 billion insurance market, CGU, the UK's largest insurance group, formed a joint venture upon Jiang Zemin's visit to the UK. They joined with the Commonwealth Development Corporation, an entity partially funded by the UK government, to invest US$100 million in China's small and medium-sized enterprises. This was a response to Swiss Life Insurance and Pension, Switzerland's largest insurer, launching its US$66 million Swiss Life Private Equity China Fund just six months earlier when Jiang visited Switzerland.

[95] *See* Curtis Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 870 (1997). Milhaupt lists five key components to a successful venture capital environment. In addition to liquidity, incentives, labor mobility, and risk tolerance, he notes that venture capital funds must be detached from special interests of government, banks, or institutional investors to ensure that venture capitalists can seek out and nurture the most promising, innovative firms in-line with their high-risk, high-return approach.

[96] *See* Doebele, *supra* note 87.

[97] *See id. The Foreign Industrial Guidance Catalogue (Revised)* (Jan. 1, 1998) lists encouraged, permitted, restricted, and prohibited sectors of investment, but the catalogue is vague and, in some instances, inconsistent. The uncertainty delays, even destroys, funding opportunities where timing and efficiency are critical.

like convertible notes, they confront significant foreign lending restrictions.[98]

Lastly, from an administrative standpoint, the procedural requirements to structure these joint entities appear unnecessarily rigid. Most venture capital investments are placed into pre-registered, expanding companies in China.[99] Nevertheless, there is a required re-registering process which means that the pre-existing business and the venture capitalist must bear an unnecessary and time-consuming MOFTEC approval process in conjunction with a long period for feasibility studies of what amounts to a repackaging of a pre-existing, continuing undertaking.[100] It also means inefficient and seemingly unnecessary asset reassignments of permits, licenses, and contracts back into the pre-existing entity.[101]

C. *Problems with Exit: The Cashing Out Issue*

Even if the entrepreneur and the venture capitalist successfully pair up in spite of these challenges, exits[102] pose yet another problem for venture capitalists in China.[103] Strict listing requirements make it impossible for not-yet-profitable businesses to issue on the domestic markets of Shanghai or Shenzhen and listing approval tends to require political favor few private companies can garner.[104] "[A]lmost all ...

---

[98] *See* Lo, *supra* note 85. Article 7 of *The Administration of Taking Out of International Commercial Loans by Organizations in China Procedures* (Jan. 1, 1998), promulgated by the State Administration of Foreign Exchange, states that the investee must be an approved foreign trade operator engaging in an encouraged business line with three previous consecutive years of profits.

[99] *See* THE 2000 GUIDE TO VENTURE CAPITAL IN ASIA, *supra* note 7,at 44. Forty-one percent of investments went into expansion financing.

[100] *See* Lo, *supra* note 85.

[101] *See id.*

[102] *See* Milhaupt, *supra* note 95. As one of his five elements, Milhaupt notes that liquidity, otherwise known as exit, is crucial to the operation of the venture capital market. Exit options consist of the venture capitalist cashing out through an IPO, the companies' repurchasing of shares, or transferring its shares to a third party. These exits rely on a liquid stock market, reasonable listing requirements, liberalized foreign ownership, and a developed mergers and acquisitions market. For other considerations on exits *see* Nicholas Jelf and Ruth Markland, *Exit Issues – Securing An Exit, in* THE BARCLAYS CAPITAL GUIDE TO PRIVATE EQUITY IN ASIA 61 (Asian Law and Practice, 1998).

[103] *See One Country, Two Investment Environments*, ASIAN VENTURE CAPITAL JOURNAL, Dec. 1999, at 10.

[104] *See* Craig Smith, A *Dot-Com Revolution in China: Venture Capital Backs Talented Young Entrepreneurs*, N.Y. Times, July 15, 2000, at 1. Article 152 of the Company Law requires that a company issuing public shares must have China Securities Regulatory Commission approval, RMB 50,000,000 in share capital, and three years of profitability with a minimum 1,000 shareholders receiving 25% of the total amount of the company shares.

listed companies [in China] are transformed ... SOE's."[105] Even if the China Securities Regulatory Commission (CSRC) decides to list a new firm, practice dictates that legal person shares, those typically held by venture capitalists, cannot be traded on the stock exchange or over-the-counter.[106] Most recently, the Chinese government also decided to delay the launching of a third bourse modeled on the NASDAQ, a setback for most venture capitalists.[107] In addition, the CSRC adheres to a strict securities quota allocation system and limits businesses from listing overseas, noting concerns over foreign control of sensitive industrial sectors.[108] Furthermore, China's mergers and acquisitions market is considerably underdeveloped, effectively closing off the exit potential of selling shares to third parties.[109]

IV. THE DEVELOPING REGULATORY FRAMEWORK

A. *Four Documents and National Legislation*

China's National People's Congress (NPC) recognizes that venture capitalists in China face significant entry and exit problems and recently declared that legislative efforts to address these concerns are underway.[110] In the meantime, private funds rely on four vague documents: the NPC's 1985 *Decision to Reform the Chinese Science and Technical System*, the Chinese Communist Party Central Committee and the State Council's 1999 *Decisions Concerning Technology Innovations, Development of High-Technology and Realization of Industrialisation*,[111]

---

[105] *See* Peggy Fu, *supra* note 88, at 23 (citing Xian Chu Zhang, The *Old Problems, the New Law, and the Developing Market – A Preliminary Examination of the First Securities Law of the People's Republic of China,* 333 INT'L LAW 983, 986 (1999)).

[106] *See* Lo, *supra* note 85.

[107] *See Government Funds Account for 43 % of Venture Capital Investment,* supra note 79.

[108] There are numerous regulations on listing overseas which include the 1998 *PRC Securities Law, Special Regulations of the State Council Concerning Floating and Listing of Shares Overseas by Companies Limited by Shares (1994), The Essential Clauses of the Articles of Association for Companies Seeking Listing of Shares Outside the PRC (1994), Notice of the State Council on Further Strengthening the Administration of Shares Issues and Listings Overseas (1997),* and the *Opinion on Further Standardising Operations and Reform of Companies Listed Outside China (1999).*

[109] *See* Nicholas Jelf and Ruth Markland, *Exit Issues–Securing An Exit, in* THE BARCLAYS CAPITAL GUIDE TO PRIVATE EQUITY IN ASIA 64 (Asian Law and Practice, 1998). M&A markets are underdeveloped throughout the Asian region.

[110] *See* Yau, *supra* note 18. The national government announced that it would submit draft venture capital regulations to the NPC before the end of 2000 and would institute the new rules within two years. The drafting committee is made up of banking and securities professionals, an economics professor from Peking University, and former senior officials from the Industrial & Commercial Bank of China and the CSRC.

[111] *See* Wei and Sun, *supra* note 86, at 24. These decisions mentioned the establishment of a venture capital mechanism, venture capital companies, and venture capital funds.

the government's most significant regulatory contribution issued in November of 1999, the *Several Opinions on the Establishment of the Venture Capital Mechanism,* [112] and the recently published *Interim Regulations on the Establishment of Venture Capital Investment Enterprise by Overseas Investors.*[113]

Although the *Several Opinions* limit venture capital to the high-tech sector, they offer a positive venture capital framework that encourages private participation over government intervention.[114] The *Several Opinions* promote stock option formulations for the first time, which may help improve employee motivation at cash-strapped start-ups having difficulties meeting monthly pay rolls.[115] The three exits of public listing, share repurchasing, and share transfer to third parties also are mentioned in the *Opinions.*[116]

More importantly, the *Several Opinions* create two new investment entities for the venture capital market, the Venture Capital Company (VCC) and the Venture Capital Fund (VCF).[117] While both forms are limited to the technology field, VCC's may invest in high and new technology companies in addition to mid and small-scale technology related enterprises.[118] VCC's also may invest all of their capital, an exemption to Article 12 of the Company Law which limits company investment in other companies to 50% of net assets.[119] The *Several Opinions* are silent as to limitations for either entity regarding foreign investment.[120] Many suspect a maximum foreign ratio in-line with the FIE laws will top out at 49 or 50%.[121] VCC's also may provide management support to their investee companies where the *Opinions* do not explicitly grant such power to VCF's.[122]

The recently released *Interim Regulations* allow foreign entities to make direct risk investments for the first time in China.[123] These

---

[112] *See The Birth of a Venture Capital System for China*, CHINA LAW & PRACTICE, Apr. 2000, at 18. The Ministry of Science and Technology, the State Planning Development Commission, the State Economic and Trade Commission, the Ministry of Finance, the People's Bank of China, the State Administration of Taxation, and the China Securities Regulatory Commission issued the Several Opinions.

[113] *See Rules Hammered Out Approving Direct Foreign Venture Capital Investment in China*, CHINA BUSINESS, Sept. 21, 2001.

[114] *See The Birth of a Venture Capital System for China*, *supra* note 112, at 18.

[115] *See id.*

[116] *See id.*

[117] *See id.* at 25.

[118] *See id.*

[119] *See id.* at 19.

[120] *See The Birth of a Venture Capital System for China*, *supra* note 112, at 20.

[121] *See id.*

[122] *See id.*

[123] *See Rules Hammered Out Approving Direct Foreign Venture Capital Investment in China*, *supra* note 113.

regulations allow venture capital firms to invest directly into China-based foreign-invested firms.[124] They still may not invest in securities, options, futures and other financial derivatives, but they are allowed all major exit options, including share sales after listing, share repurchases by the investee company, and equity transfers to third parties.[125]

B. *Improved Entry: Amendments to the Company Law and FIE Laws*

In addition to these documents and recent legislative efforts, the government has been working to amend a number of laws relevant to venture capital.[126] The State Council has been working to amend the Company Law to remove minimum capital requirements for establishing a corporate entity along with ending limitations on intellectual property assignments.[127] The Council also may allow foreign direct investment in domestic LLC's and trading in legal person shares.[128] This would boost exit liquidity significantly. Moreover, the Council is liberalizing laws concerning foreign joint ventures, foreign cooperatives and solely foreign-funded ventures to meet WTO investment liberalization obligations.[129] Of particular interest to venture capitalists is the permission granted to FIE's to invest directly in other existing and newly formed FIE companies as seen in the *Interim Regulations* mentioned earlier.[130]

C. *Improved Exits: Streamlining Securities*

Although recently delayed, the Chinese government is still pushing to launch a second exchange board, geared towards small and medium-sized companies, in order to help China increase exit

---

[124] *See id.*
[125] *See id.*
[126] *See* John Lo, *Venture Capital and the E-Sector in China*, *at* http://virtualchina.org/archive/finance/index.html (Sept. 6, 2000).
[127] *See id.*
[128] *See id.*
[129] *See China Amends Laws on Foreign Investment*, ASIA PULSE, Oct. 24, 2000; *see also* Hu Qihua and Shao Zongwei, *Bid to Level Playing Field*, CHINA DAILY, Oct., 31, 2000, at 1; Yuan Jianan, *New Development in Regulations and Policies of the PRC Regarding Foreign Investment*, CHINA LAW UPDATE, May 2000, at 24; Sally Harpole, *New Regulations Clear the Path for Investments by FIE's*, CHINA LAW UPDATE, Sept. 2000, at 1. These articles discuss the *Opinion on Further Encouraging Foreign Investment* (Aug. 20, 1999) and the *Provisional Regulations on Investment Inside China by FIE's* (Sept. 1, 2000). They focus on taxation benefits, financial support, lifting investment restrictions, and improving the foreign investment administration.
[130] *See* Harpole, *supra* note 129, at 1.

opportunities.[131] The board may allow sales of company shares before the companies are profitable and permit companies to float all of their shares.[132] Some have even suggested the birth of an Asian Regional Exchange in which China might participate.[133] China also recently allowed foreign investors to trade their B-shares on the hard currency markets after holding them for three years if they qualified as founding investors.[134] Non-founders also can trade with CSRC approval.[135] Moreover, foreign investors may be able to list their shares on the A-shares market.[136] Foreign investors might even see the two classes of shares merge, which would greatly increase liquidity and improve exit options further.[137]

D. *Local Efforts*

In addition to national efforts, local legislators have been aggressive in trying to attract funds into their own high-tech areas. Shenzhen, home to more than thirty venture capital investors, has the country's first ever set of rules directly addressing venture capital, the *Interim Regulations on Venture Capital Investment in High-Tech Industries*.[138] In addition to the VCC format set out at the national level in the *Several Opinions*, these regulations are the first to provide specific provisions regarding the establishment of a VCC by foreign investors.[139] Shanghai also has passed the *Regulations for Encouraging the Assimilation and Renovation of Imported Technology*, offering financing

---

[131] *See* Smith, *supra* note 104, at 1; *See also Dotcoms Enamored with Second Board*, PEOPLE'S DAILY, Nov. 13, 2000.

[132] *See id.*; *See also* Yu, *supra* note 2.

[133] *See Asian Regional Exchange: Politically Difficult-Financially Imperative*, ASIAN VENTURE CAPITAL JOURNAL, Jan. 1999, at 21.

[134] *See China Gives Foreign Partners B-Shares an Exit*, *at* http://latelinenews.com/ll/english/1024411.shtml (Dec. 1, 2000).

[135] *See id.*

[136] *See China Takes Tentative Step Towards Open Capital Market*, ASIA PULSE, Aug. 3, 2000.

[137] *See Shanghai B-Shares Surge 3.8 Percent on Renewed Hope of Merger*, *at* http://latelinenews.com/ll/english/1014761.shtml (Nov. 3, 2000).

[138] *See China - Shenzhen Issue First Venture Capital Regulations*, CHINAONLINE, Oct. 17, 2000. Passed by the Shenzhen Municipal Government on October 14, 2000, the Shenzhen Association of Venture Capital Investors, a fifty-five-member board, will provide oversight and discipline to the project. Lower entry requirements, clearly listed qualification procedures, and preferential treatment offered to high-tech enterprises is granted to venture capital firms when they take a 70% or more stake in start-up companies. Venture capitalists incorporated as limited liability companies must have US$3.6 million in registered capital and joint stock companies must have US$6.04 million. The regulations also provide for a venture capital management company, which requires only US$120,000 in registered capital. The rules ban venture capitalists from the banking trade.

[139] *See* Joachim Glatter et al., *Shenzhen Leads the Way in Venture Capital*, CHINA LAW & PRACTICE 54, Nov. 2000 (noting that Article 8 of the *Interim Regulations* recognize Wholly-Foreign Owned VCCs and Equity Joint Venture VCCs).

alternatives and government support to venture capitalists.[140] Xi'an has added itself to the regional efforts list as well, enacting preferential venture capital policies that provide for reduced capital investment requirements to establish a limited liability company, streamlined registration procedures, and tax incentives.[141] About ten other provincial governments have passed their own similar legislation as well.[142]

V. LESSONS FROM ABROAD

A. *The United States*

Venture capital thrives in the United States because of five prevalent elements.[143] With regard to capital formation, the U.S. has large amounts of pension funding invested in interests independent from government and corporate concerns thanks to loosened regulations under the Employee Retirement Income Security Act (ERISA).[144] As for entry, incentives include flow-through taxation structures like partnerships, LLCs and reduced capital gains tax.[145] Contractual arrangements that are unique to venture capital and minimize risk[146] are also available and

---

[140] *See* Wei and Sun, *supra* note 86, at 15.

[141] *See Threshold for Venture Capital Investment Lowered in Xi'an*, CHINAONLINE, Jan. 10, 2001. Total investment need only be around US$60,000 to establish an LLC. This is significantly lower than the thresholds of US$1.2 million for domestic investors and US$30 million for foreign investors found in other parts of China. If more than half of the venture capitalists' income comes from investments the venture capitalist is exempt from enterprise income tax for two years following its first profitable year.

[142] Interview with Dr. Guanghua Yu, Professor of Company and Securities Law in the PRC, University of Hong Kong, in Hong Kong, China (Dec. 1, 2000).

[143] *See generally* Milhaupt, *supra* note 95. The five elements are as follows: large, independent amounts of capital, liquidity, incentives, labor mobility, and risk tolerance.

[144] *See id.* at 881-882.

[145] *See* Fu, *supra* note 88, at 519 (May 2001). The 1952 Small Business Investment Company Program, the 1978 Revenue Act, 1979 ERISA "Prudent Man" Rule, 1980 Small Business Investment Incentive Act, 1980 ERISA "Safe Harbor" Regulation, and the 1981 Economic Recovery Tax Act reduced tax rates, reduced fiduciary duties on venture capitalists, and resulted in a tenfold increase in the size of the US venture capital pool. Similar results from similar regulatory efforts also are evident in the United Kingdom where easing tax liabilities attracted an increase in venture capital throughout the 1980's. *See* Colin Mason and Richard Harrison, *Venture Capital, The Equity Gap and The 'North-South Divide' in the United Kingdom*, *in* VENTURE CAPITAL: INTERNATIONAL COMPARISONS 202, 209 (Milford B. Green ed., 1991); *Cf.* Milhaupt, *supra* note 15, at 186 (discussing the U.S. government's regulatory role in venture capital and noting that public policy offers venture capitalists inefficient support, although programs like ACE-Net successfully facilitate information sharing and link investors with potential entrepreneurs). For more detail on the U.S. regulatory framework *see* Lee R. Petillon, *Designed to Scale: The Ability of Small Companies to Raise Capital Has Been Dramatically Eased by Federal and State Securities Rules*, 19 LOS ANGELES LAWYER 31 (1997).

[146] *See generally* Douglas G. Smith, *The Venture Capital Company: A Contractuarian Rebuttal to the Political Theory of American Corporate Finance*, 65 TENN. L. REV. 79 (1997) (listing most of the types of provisions that venture capitalists include in their contractual arrangements). The basic

consistently enforced.[147] More important, exits are well established in the U.S. under a market-centered corporate governance structure that fosters an active, disciplined mergers and acquisitions regime[148] and a stock market that allows for an active IPO culture.[149] Labor mobility, tolerance of high risk, and a well trained workforce further contribute to the vibrant quality of the U.S. venture capital market.[150]

China's government needs to make improvements in each one of these fields. First, China needs to encourage the use of more institutional money and less government funding. Diversified, private financing tends to allocate resources more efficiently.[151] Amendments to the Banking and Insurance Law would be appropriate in this regard. With regard to entry, China needs to incorporate more incentives like the U.S.'s flow-through taxation vehicles. China also needs to open up investment sectors by repealing the limitations set out in the FIE laws and the *Several Opinions*, which unnecessarily limit venture capitalists to the high-tech field. China's WTO obligations over the next five years should help in this regard. Furthermore, China needs to further cultivate the idea of contractual sanctity and ensure predictable contractual enforcement of the detailed, control-granting contracts associated with venture capitalists.[152] Guaranteeing the contractual enforcement of economically driven investments into China's most profitable areas, such as telecommunications and Internet development, will surely capture more venture capitalist interest.

On the entrepreneurial side, the government needs to amend the Company Law's prohibitively high capital requirements for newly formed

---

document, the stock purchase agreement, typically gives venture capitalists majority-like control with minority-like obligations. These contracts are critically important in overcoming the information asymmetry between the investor and businessperson. What is most unique about them is that they create a concentrated ownership effect which runs counter to the widespread ownership ensured in the States under the 1956 Bank Holding Company Act, the Glass-Steagall Act, regulations governing proxy solicitation, and the McFadden Act. *See id.* at 94.

[147] *See* Milhaupt, *supra* note 95, at 886.

[148] *See id.* at 884.

[149] *See id.*

[150] *See id.* at 891 (explaining that individuals in the U.S. often are willing to move from stable employment into newly established ventures for the attractive potential of high pay-offs).

[151] *See generally* Matt P. McClorey, *Are State-Sponsored Venture Capital Funds Necessary for the Development and Growth of the Kansas Economy*, 7 KAN. J.L. & PUB. POL'Y 152 (1998), (detailing the failure of the state-sponsored Kansas Technology Enterprise Corporation because there was not a market failure requiring state intervention and there was not more efficient state-allocation of capital resources relative to the private sector); *See also* Milhaupt, *supra* note 15 (discussing the inefficiencies of government intervention regarding small firm funding).

[152] *See Paradise Postponed?*, ASIAN VENTURE CAPITAL JOURNAL at 19, Dec. 1999 ("Only on a handful of occasions have foreigners been able to actually collect a monetary judgment against a Chinese company in a People's Court. This points to fundamentally different views on the sanctity of contracts between Chinese and their western counterparts.").

corporations. An amendment legally endorsing stock options also would help encourage greater entrepreneurial activity. In addition, China's government needs to wean labor from its "iron rice bowl" outlook and expand opportunities for greater labor mobility and risk taking.[153]

As for exits, China needs to reform its Securities Law to reduce corporate listing requirements for purposes of enabling a more vibrant IPO market, and continue with efforts to create a third securities board modeled on the eased NASDAQ listing requirements. In conjunction with those efforts, China should further encourage the development of its mergers and acquisitions market through amendments to its Company Law.

B. Japan

Japan approaches venture capital through its tight banking structure and long-term, closely-knit system of corporate paternalism.[154] With the Ministry of Finance overseeing banking and more than half of Japan's venture capital firms operating as subsidiaries of banks, securities firms, or insurance companies,[155] venture capitalists are highly manipulated to serve conservative banking interests.[156] More than half of venture capital disbursements are loans, not equity investments, and most go to safer, intermediate-stage corporations removed from technology development.[157] Funds focus on manufacturing, wholesale, and retail in-line with larger parent corporation interests, crippling the ability of funds to support innovation.[158] To further tighten the banking sector's control, Japan also has been unwilling to provide private venture capitalists with flow-through tax structures or limited liability.[159] Japan's labor force also exhibits preference for risk-averse, longer-term employment that seems to come at the expense of innovative labor mobility.[160]

In addition to Japan's entry and entrepreneurial limitations, Japan's close corporate relations have hindered exit strategies. Acquisitions are virtually non-existent in Japan's cross-shareholding

---

[153] *See* David Holt, *A Comparative Study of Values Among Chinese and U.S. Entrepreneurs: Pragmatic Convergence Between Contrasting Cultures*, 12 J. OF BUS. VENTURING 483 (1997). Chinese entrepreneurs from Tian He High-and-New Technology Industrial Development Zone in Guangzhou scored very high on *Openness to Change*, indicating a proclivity towards risk-taking.

[154] *See* Milhaupt, *supra* note 95.

[155] *See id.*

[156] *See id.*

[157] *See id.* at 878.

[158] *See id.* at 879.

[159] *See id.*

[160] *See* Milhaupt, *supra* note 95, at 888-889.

environment.[161] The Ministry's stringent listing requirements also shut out burgeoning companies because they are unable to attract venture capital with promises of IPO fortunes, although the recently launched JOSDAQ should alleviate that somewhat.[162] And lastly, prohibitions against companies repurchasing their shares, except in a few Ministry-approved scenarios, shut out the repurchasing option.[163]

The Japanese example shows that weak incentives inhibit equity investment. China, therefore, needs to strengthen structural formats, increase liability protection, and offer tax breaks for its VCC and VCF investment vehicles. Japan's sedentary labor pool also proves that China needs to improve its human capital liquidity and heighten its risk tolerance in order to avoid a static investment environment.[164] Furthermore, to better enable the development of knowledge intensive fields, China must avoid the government and banking strategy of Japan. If anything, Japan shows that without an independent investment approach a venture capital market is unable to engage in riskier investments that support younger companies engaged in innovative, dynamic entrepreneurship.

With regard to exits, China should follow Japan's JOSDAQ and establish loosened listing requirements for its third board. Fostering a better mergers and acquisitions market and allowing for a corporate buy-back system are important too though, especially since Japan provides evidence that a second board alone does not offer a sufficient number of exit opportunities. More diverse options are required.

C. *South Korea*

Korea's strong governmental involvement in its venture capital markets might attract China's attention, but China should understand the limitations of Korea's approach. Korea's government employs the 1997 *Special Law to Promote Venture Capital Companies* (SLPVCC) and three underlying statutes to actively control Korea's venture capital market.[165] Korea's laws limit venture capital to certain high-tech fields, restrict investments to companies no older than seven years, and dictate levels of investment, research, and development.[166] The laws leave ultimate discretion with the Ministry of Commerce, Industry, and Energy in

---

[161] *See id.* at 884-885.
[162] *See id.*
[163] *See id.*
[164] *See* Holt, *supra* note 153.
[165] *See* Haksoo Ko and Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457 (2000).
[166] *See id.* at 471-472.

determining who qualifies for venture capital status.[167] To increase liquidity Korea opened KOSDAQ, a second board of exchange but faces a shortage of exits because banking and government control over corporations limit merger and acquisition activities. In terms of incentives, Korea perhaps goes too far, ensuring both job security and tax breaks for risk-seeking entrepreneurs.[168] As in Japan, however, the labor market in Korea is relatively immobile and fairly risk-averse.[169]

Despite China's proclivity towards an administrative governing model, China should take a more critical look at Korea's formula of government control. Korea's nurturing of special interests over pure market performers has impaired venture capitalists, their returns, and their investments in innovative entrepreneurship. The Korean example also shows that China's desire to restrict venture investment to technology means unnecessarily overlooking potential successes like future Federal Expresses or Starbucks Coffees.[170] China's inclination to imitate Korea's exaggerated entrepreneurial incentives also seems a bad idea.[171] It attracts entrepreneurs unequipped to bear high-risk costs and needlessly floods the market with an overabundance of business debacles.[172] On exits, Korea and its second board's lackluster performance indicates that China should continue improving its mergers and acquisitions market in addition to adding a second bourse that is well publicized and publicly accepted. Lastly, as seen in Japan and Korea, China would be best served if it promoted a more liquid, risk-seeking human capital pool.

VI. CONCLUSION

The conditions for venture capital in China are improving, as much has changed since 1985. Although China still needs to take several additional steps to ensure the development of a stable venture capital framework, its efforts thus far have been significant. As it continues to move forward in this area, China should heed the important lessons learned from other countries' experiences. In particular, when measured against Japan's banking-centered system and Korea's government-centered arrangement, the U.S.'s market-centered approach seems best suited for developing venture capital further in China. Even if China's legislation ultimately blends elements of each of those jurisdictions'

---

[167] *See id.* at 473.
[168] *See id.*
[169] *See id.*
[170] *See id.*
[171] *See Venture Capital in China: Enter at Your Own Risk*, *at* http://www.chinaonline.com/industry/financial/NewsArchive/ cs-protected/2000/January/B200010322-SS.asp (Jan. 1, 1999).
[172] *See id.*

policies, however, it still promises to be yet another positive economic step for China. In keeping with its transformative approach, WTO liberalization obligations, and its general market-orientation, China stands to gain considerably from encouraging the development of a more vibrant venture capital market.