

An Introduction to the Venture Capital Market in China

1.1 The Engineering Problem

Venture capital (VC) is widely recognised as a powerful engine that can drive a nation's innovation, job creation, knowledge economy, and economic growth.¹ Governments around the world, such as Germany,² Australia,³ Japan,⁴ Israel,⁵ Chile,⁶ Taiwan,⁷ and Singapore,⁸ have tried to

¹ See J. Lerner, *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed – And What to Do About It* (New Jersey: Princeton University Press, 2009), Chapter 3. R. J. Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience', *Stanford Law Review*, 55(1067) (2003), 1068–1107. On the importance of VC, see generally P. A. Gomers and J. Lerner, *The Money of Invention: How Venture Capital Creates New Wealth* (Cambridge, MA: Harvard Business Review Press, 2001); Marco Da Rin et al., 'The Law and Finance of Venture Capital Financing in Europe: Findings from the RICAFE Research Project', *European Business Organisation Law Review*, 7 (2006), 525–547.

² See R. J. Gilson, *supra* note 1, at pp. 1094–1096.

³ See 'The Treasury and the Department of Industry, Innovation, Science, Research and Tertiary Education of Australia, Review of Venture Capital and Entrepreneurial Skills' (2012), available at <http://ict-industry-reports.com.au/wp-content/uploads/sites/4/2013/09/2012-Venture-Capital-and-Entrepreneurial-Skills-DIISRTE-Dec-2012.pdf>.

⁴ See Zenichi Shishido (2009) 'Why Japanese Entrepreneurs Don't Give Up Control to Venture Capitalists', online: SSRN, <http://bit.ly/2w8JrdA>.

⁵ See R. J. Gilson, *supra* note 1, at p. 109. See also J. Lerner, *supra* note 1. (New Jersey: Princeton University Press, 2009).

⁶ See R. J. Gilson, *ibid.*, at p. 1098.

⁷ Christopher J. Gulinello 'Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience', *George Washington International Law Review*, 37(4) (2005), 845–883.

⁸ L. Lin, 'Venture Capital in Singapore: The Way Forward', *Journal of Business Law*, 5 (2019), 363–387.

develop their VC markets.⁹ Empirical studies show that many government-led programmes have not been particularly successful.¹⁰ It is in this context that China's efforts stand out: over three decades, China has created the world's second largest VC market in terms of annual VC investment,¹¹ after the United States (US). Against the more moderate results achieved elsewhere, China's success is especially prominent considering that it has surpassed the US in terms of the amount of VC investments raised by start-ups¹² and number of unicorns,¹³ despite the relative youth of its market.

The key challenge for governments seeking to engineer a VC market is ensuring the simultaneous availability of three factors – a challenge that Gilson termed the 'simultaneity problem'.¹⁴ The first factor is investment capital. Venture capitalists provide a special type of capital for early-stage, high-growth, high-risk, and often technology firms that need capital to finance their development.¹⁵ Because of venture capitalists' appetite for high-risk, high-return investments and because of the managerial skills, technological background, and industrial connections that they can offer to start-ups, VC plays an important role in commercialising cutting-edge science and innovation.¹⁶

The second factor is the availability of specialised financial intermediaries that serve as the 'nexus of a set of sophisticated contracts' and that are able to incentivise the venture capitalists and entrepreneurs in a VC cycle.¹⁷ There are two major contracts that place financial intermediaries between venture capital and start-ups.¹⁸ The first contract arises at the

⁹ L. Lin, 'Engineering a Venture Capital Market: Lessons from China', *Columbia Journal of Asian Law*, 30(1) (2017), 160–220, at p. 162.

¹⁰ See generally J. Lerner, *supra* note 1. R. J. Gilson, *supra* note 1, at p. 1070.

¹¹ See Pitchbook Data, 'PitchBook Analyst Note: Venture Capital in China' (15 March 2019), online: Pitchbook, <https://pitchbook.com/news/reports/1q-2019-pitchbook-analyst-note-venture-capital-in-china>

¹² See Jason D. Rowley, 'Chinese Startups Lead US Rivals In 2018 Venture Race' (17 October 2018), online: Crunchbase, https://news.crunchbase.com/news/chinese-startups-lead-us-rivals-in-2018-venture-race/?utm_source=twitter&utm_medium=organic&utm_campaign=crunchbase-news&utm_content=chinese-startups-lead&fbclid=IwAR1Q-A_7GjPfSOdNAHEVo5nlsycThAMyTP1GiSt0VKmc0InxOTteV4mJ6mk

¹³ See Hurun Research Institute, 'Hurun Global Unicorn List 2019' (21 October 2019), online: Hurun Report, www.hurun.net/EN/Article/Details?num=A38B8285034B.

¹⁴ R. J. Gilson, *supra* note 1, at pp. 1076–1078 and 1093.

¹⁵ *Ibid.*, at p. 36.

¹⁶ *Ibid.*, at p. 1068. See also, J. Lerner, *supra* note 1, at pp. 181–182 (emphasising the importance of a large domestic market with investors willing to take risks with younger firms in the development of a VC market).

¹⁷ *Ibid.*, at pp. 1069 and 1093.

¹⁸ *Supra* note 9, at p. 166.

fundraising stage between the investor and the VC fund/venture capitalist, which is typically organised in the US and China as a limited partnership.¹⁹ This contract alleviates the agency costs between the investor and venture capitalists and incentivises the latter through mechanisms such as fixed-term, mandatory distributions, and structuring of the venture capitalists' compensation.²⁰ The second contract arises between the VC fund/venture capitalist and the portfolio company.²¹ This contract addresses the uncertainty, information asymmetry, and agency costs between the VC fund and entrepreneurs and incentivises both participants through mechanisms such as staged financing, allocation of control to the fund, structuring of the entrepreneur's compensation, and incentivised exit.²² The 'braiding' of the two contracts enhances the efficiency of both contracts in respect of incentivising exit of VC investments and constraining VC funds from engaging in opportunistic behaviour against entrepreneurs.²³

The third essential factor for creating a national VC market is the availability of entrepreneurs. Gilson assumes that the supply of entrepreneurs is the 'sole function' of the availability of capital and specialised financial intermediaries.²⁴ In his view, by providing *funding* through the right contractual *vehicle*, government can encourage a supply of *entrepreneurs*,²⁵ and increase the willingness of highly skilled managers and engineers to work in entrepreneurial environments.²⁶

These elements of the 'simultaneity problem' are not to be taken in isolation, but must emerge *simultaneously*. For example, if there is no capital available for high-risk businesses, entrepreneurs would not emerge to form such businesses, and intermediaries could not identify the best of those entrepreneurs and channel investment funds to them.²⁷ In addition, there are other determinants in engineering a VC market, including the fundamental technological innovation in the economy, the presence of liquid and competitive stock markets for VC to exit, the degree of protection provided to intellectual property rights, as well as the presence of 'agglomeration economies' in the region with the presence of professionals

¹⁹ Ibid.

²⁰ R. J. Gilson, *supra* note 1, at pp. 1087–1090.

²¹ *Supra* note 9, at p. 166.

²² R. J. Gilson, *supra* note 1, at pp. 1078–1087.

²³ Ibid., at pp. 1091–1092.

²⁴ *Supra* note 9, at p. 166.

²⁵ R. J. Gilson, *supra* note 1, at pp. 1102–1103.

²⁶ *Supra* note 9, at p. 167.

²⁷ R. J. Gilson, *supra* note 1, at p. 1093.

such as lawyers and accountants who are able to lower the transaction costs associated with forming and financing start-ups.²⁸ There is a cultural dimension as well – Japan, for example, has a shortage of young entrepreneurs, which is in part due to parental pressure.²⁹

Gilson attributes the success of the American VC market in solving the simultaneity problem to private ordering,³⁰ and explains that it was the ‘idiosyncratic’ history of the US VC market that encouraged the simultaneous emergence of entrepreneurs, investors, and financial intermediaries, which collectively incentivised all the parties in the VC cycle.³¹ However, his view of the development of the American VC market may be contrasted with other more government-centric accounts of how this market developed. Josh Lerner’s account of the development of the US VC market states that ‘the government played a critical role in shaping Silicon Valley’.³² ‘[P]ublic subsidies – particularly during the two world wars – catalysed growth in Silicon Valley and shaped its critical features.’³³ Mariana Mazzucato also found that ‘[P]revious mission-oriented policies were those driven by military or national security motives (such as those behind the origin of Defense Advanced Research Projects Agency (DARPA) in the US Department of Defense or NASA) . . .’³⁴ Government-led programmes in the US, such as the Small Business Innovation Research (SBIR) programme, have supported the development of tech firms by taking on capital-intensive risks long

²⁸ See Paul Alan Gompers and Joshua Lerner, *The Venture Capital Cycle* (Cambridge, MA: MIT Press 2004), at pp. 316–317.

²⁹ Elise Hu, ‘A Startup Scene That’s Not So Hot: Japan’s Entrepreneur Shortage’ (7 May 2015), online: NPR, www.npr.org/sections/alltechconsidered/2015/05/07/404376767/a-startup-scene-thats-not-so-hot-japans-entrepreneur-shortage. The cultural aspect is, by its very nature, multifaceted; suffice to say even foreign entrepreneurs find it difficult to set up businesses in Japan, due to the various hoops one has to jump through (i.e. in Japan the process of obtaining start-up visas or opening corporate bank accounts is complicated and multi-staged). See further in Masumi Koizumi, ‘Japan Wants Foreign Entrepreneurs, but What’s Missing?’ (25 November 2019), online: the Japan Times, www.japantimes.co.jp/news/2019/11/25/business/japan-foreign-entrepreneurs/#.Xl-4pagzbIU. However, it is difficult to offer a convincing cultural explanation without sufficient and reliable data, and this book will not address culture elements in detail.

³⁰ R. J. Gilson, *supra* note 1, at p. 1069 and p. 1093.

³¹ *Ibid.*

³² J. Lerner, *supra* note 1, at p. 34.

³³ *Ibid.*, at p. 41.

³⁴ Mazzucato and Penna, ‘Beyond Market Failures: The Market Creating and Shaping Roles of State Investment Banks’, Levy Economics Institute, Working Paper No. 831, at p. 43.

before they were viable businesses.³⁵ Some of America's most dynamic companies, including Apple, Intel, Chiron, and Compaq, have benefitted by the support of these federal programmes while they were privately held.³⁶

These competing accounts raise the question of whether it is possible for governments to successfully engineer VC markets. International experience reveals that resolving the simultaneity problem is not an easy task.³⁷ Some government programmes and policies in other jurisdictions that seek to provide capital to the VC market failed because they could not adequately respond to the three fundamental problems inherent in VC financing: uncertainty, information asymmetry, and agency cost.³⁸ For example, Germany's Deutsche Wagnisfinanzierungsgesellschaft (WFG)³⁹ was unable to effectively incentivise venture capitalists to invest. This was because the German government provided a guarantee and insured up to 75 per cent of WFG's losses and because profits were limited by the entrepreneur's call option.⁴⁰

Nevertheless, some government programmes such as the Israeli Yozma programme⁴¹ and New Zealand's Venture Investment Fund

³⁵ The SBIR programme provided over \$13 billion to small high-technology firms between 1983 and 2003. See *supra* note 28, at p. 309.

³⁶ See *Ibid.* See also Pierre Bienaimé, 'This Chart Shows How The US Military Is Responsible For Almost All The Technology in Your iPhone' (30 October 2014), online: Business Insider, <https://www.businessinsider.com/the-us-military-is-responsible-for-almost-all-the-technology-in-your-iphone-2014-10> (noting that there is little in Apple's devices, for example, that did not owe its existence in some way to the US Department of Defense).

³⁷ *Supra* note 9, at pp. 166–168.

³⁸ See J. Lerner, *supra* note 1.

³⁹ Deutsche Wagnisfinanzierungsgesellschaft translates roughly to 'German Venture Financing Fund'. R. J. Gilson, *supra* note 1, at p. 1094 N. 66, citing Ralf M. Becker and Thomas F. Hellmann. 'The Genesis of Venture Capital: Lessons from the German Experience', in Vesa Kannianen and Christian Keuschnigg (eds.), *Venture Capital, Entrepreneurship, and Public Policy* (Cambridge, MA: The MIT Press, 2004). Martin Selzer and Thomas Pruever (2015). 'Liquidity Meets Perspective: Venture Capital and Start-ups in Germany 2015', *VC Trends Initiative By EY*, online: EY, <https://go.ey.com/2tljvd8>. See also R. J. Gilson, *supra* note 1, at pp. 1094–1097. As of 2013, the average VC investment in Germany stands at merely €780,000, compared to €6,000,000 in America. See 'A Slow Climb', *The Economist*, 3 October 2013, online: <http://econ.st/1sYYdea>.

⁴⁰ WFG proved a failure due to the form of interference undertaken by the government: capital allocation was determined by WFG's board committee, which was largely composed of bureaucrats. Further, WFG personnel were not incentivised to provide technological or management assistance (that usually comes packaged with VC investment) to portfolio companies due to the restriction on profits accruing to WFG. See R. J. Gilson, *supra* note 1, at pp. 1094–1099.

⁴¹ See R. J. Gilson, *supra* note 1, at pp. 1097–1099.

(NZVIF)⁴² have achieved a certain degree of success.⁴³ This can be traced to differences in programme design. For example, unlike the WFG, the Israeli Yozma programme avoided making investment decisions, allowing these to be made by investors, and required no guarantee against loss.⁴⁴ Accordingly, investments were made by highly incentivised fund managers who bore the investment's risk and possessed the control rights to directly monitor the portfolio companies.⁴⁵

As this book will discuss, China has adopted a unique approach to address the simultaneity problem. China's VC market did not emerge from the interplay of market forces alone, but was, from its inception in the 1980s, a creature of governmental design. Specifically, the government issued various policies to facilitate the development of the VC market in order to encourage innovation and technological development, and to develop the country's labour-based economy into a knowledge-based economy.

The Chinese experience is valuable in helping to evaluate the potential of various regulatory approaches to the VC market. China offers a fascinating case study of how a VC market is developed, having nurtured one of the fastest developing and largest engineered markets in the world.⁴⁶ Before 1985, China did not have a VC market;⁴⁷ yet three decades of development has allowed China to rank as the second largest market in terms of annual global VC investment. As can be seen from Figure 1.1, the amount of newly raised VC as well as the number of new VC funds being established in China have been steadily increasing throughout the years from 2006 to 2018. Despite the fact that a decline in both the

⁴² J. Lerner, *supra* note 1, at pp. 132–133.

⁴³ World Bank studies have also confirmed the role of governmental intervention in igniting innovation in emerging markets in Europe and Central Asia, stating that 'the government plays a special role in promoting start-ups to generate new activities and support sustainable job creation because of the high risk that deters the entry of new ventures and the high failure rate once such ventures are established'. See Goldberg, Itzhak; Goddard, John Gabriel; Kuriakose, Smita; Racine, Jean-Louis, *Igniting Innovation: Rethinking the Role of Government in Emerging Europe and Central Asia*. World Bank, <https://openknowledge.worldbank.org/handle/10986/2358>, at p. 33.

⁴⁴ See R. J. Gilson, *supra* note 1, at p. 1097.

⁴⁵ *Ibid.*

⁴⁶ Anette Jönsson, 'Venture Capital Continues to Flow into Chinese Startups', *The Wall Street Journal*, 28 April 2015, online: www.wsj.com/articles/venture-capital-continues-to-flow-into-chinese-startups-1430244889. 'Venture Capital Soars and Investor Expectations Follow', *Nikkei Asian Review*, 18 February 2016, online: [Nikkei, http://asia.nikkei.com/Politics-Economy/Economy/Venture-capital-soars-and-investor-expectations-follow](http://asia.nikkei.com/Politics-Economy/Economy/Venture-capital-soars-and-investor-expectations-follow); Lucinda Shen, 'China is the Biggest Venture Capital Firm in the World', *Fortune*, 9 March 2016, online: <http://for.tn/2tZyM0S>.

⁴⁷ *Supra* note 9, at pp. 160–161.

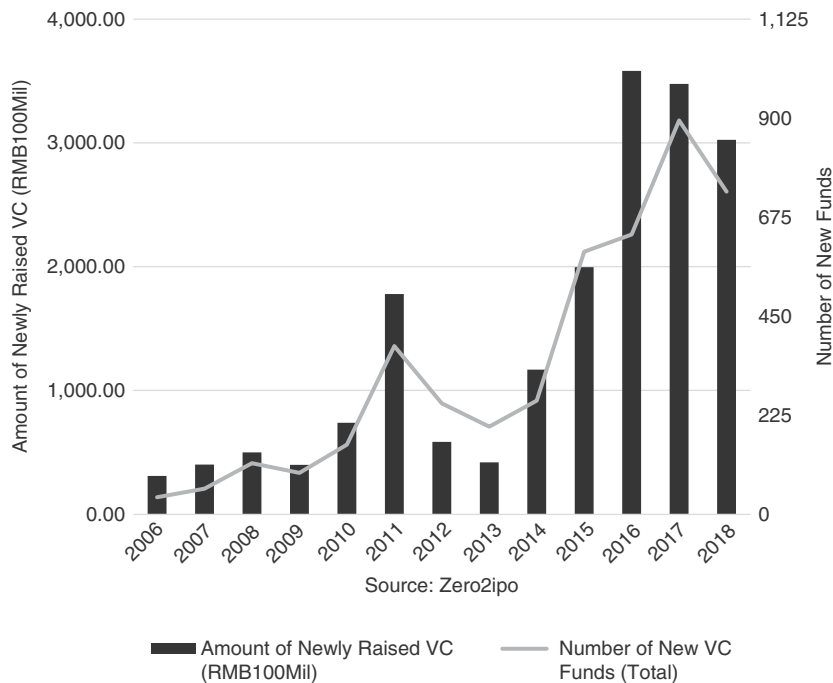


Figure 1.1 New VC commitments against new VC funds 2006–2018 (RMB 100 million)

number of funds and the volume of fundraising was experienced in the period of 2012 to 2013, and more recently in 2018, this does not detract from the clear upward trend.⁴⁸ These successes come despite the ineffectiveness of private ordering in China,⁴⁹ as demonstrated by weak investor protection⁵⁰ and lack of judicial

⁴⁸ The declines in 2012–2013 and 2018 could have been due to macro factors such as the economic slowdown in China (during 2012–2013), the US–China trade war (which has been ongoing since 2018), and the tightened regulations on fundraising in China.

⁴⁹ See generally Jiangyu Wang, ‘China: Legal Reform in an Emerging Socialist Market Economy’, in E. Ann Black and Gary F. Bell (eds.), *Law and Legal Institutions of Asia: Traditions, Adaptations and Innovations* (Singapore: Cambridge University Press, 2011); Donald Clarke, Peter Murrell and Susan Whiting, ‘The Role of Law in China’s Economic Development’, in Loren Brandt and Thomas G. Rawski (eds.), *China’s Great Economic Transformation* (Cambridge, England: Cambridge University Press, 2008).

⁵⁰ See generally Nicholas C. Howson and Vikramaditya S. Khanna, ‘The Development of Modern Corporate Governance in China and India’, in Muthucumarasawamy Sornarajah and Jiangyu Wang (eds.), *China, India, and the International Economic Order* (Singapore: Cambridge University Press, 2010) (on investor protection).

independence.⁵¹ As of February 2020, a total of 28,681 private equity (PE) funds and 8,269 VC funds have registered with the Asset Management Association of China (AMAC), the asset under management by all registered VC funds has reached a total value of RMB 1,217.071 billion,⁵² and a total of 14,937 PE and VC fund managers have been registered with AMAC.⁵³

Although VC is increasingly regarded as an important component of the Chinese economic landscape, little is known about the regulatory and policy measures employed by China and the real impact of such regulatory and policy measures. This book will explore the engineering of China's national VC market from the legal perspective, consider the current concerns about the continued growth of the market, and illustrate the lessons, which may be extracted from this crucial but as yet incompletely studied experience. In particular, the book will answer the following key questions:

1. *How did China create the world's second largest VC market within such a short period of time?*
2. *Are there any lessons of general applicability which may be extracted from China's VC story?*
3. *What are the ways forward for China's VC market?*

1.2 The Concept of 'Venture Capital' in the Context of China

The concept of VC was first debated in China in 1985, in the central government's *Decision to Reform the Science and Technology System*.⁵⁴ The term 'venture capital' was initially reflected as 'risk capital (*fengxian touzi*)' in the official documents to reflect the 'high-risk' nature of this

⁵¹ See generally Jianfu Chen, *Chinese Law: Context and Transformation* (Netherlands: Martinus Nijhoff Publishers, 2008), Chapter 4, at pp. 147–170.

⁵² AMAC Data, '私募基金行业数据' (Data on the Private Equity Industry), February 2020, online: AMAC, <https://www.amac.org.cn/researchstatistics/datastatistics/privategrafe fundindustrydata/>.

⁵³ Ibid.

⁵⁴ CPC Central Committee, 13 March 1985, '关于科学技术体制改革的决定' (*The Decision to Reform the Science and Technology Systems*) (No. 6 [1985] of the CPC Central Committee) (China). Prior to these developments and before the launch of the open-door policy and economic reform (*gaige kaifang*) in 1978, the legacy of the planned economy was such that all decisions regarding production and investment were embodied in a plan formulated by the government. Consequently, there were no private enterprises in China, let alone start-ups, entrepreneurship, or venture capital.

investment method. In order to encourage entrepreneurship and innovation, several government agencies, including the National Development and Reform Commission (NDRC) and the Ministry of Science and Technology, began instead to use the term ‘entrepreneurial capital (*chuangye touzi*)’ in the text of their regulations.⁵⁵

Today, most Chinese professionals understand ‘VC’ to be a subset of PE, and this understanding is consistent with international practice.⁵⁶ VC usually refers to investment in high-growth, high-risk, and often high-technology firms that need capital (in the form of equity instead of debt) to finance product development or growth.⁵⁷ It usually entails heavy involvement in advising the management of each company which is invested in, while most of these companies are not profitable in the short term. Although VC and PE share many similarities (e.g. similar legal structures, incentive schemes, and investors), there are major differences in the behaviour of firms involved in the respective activities, among other things. For instance, VC and PE invest in different types and sizes of companies. While VC generally focusses on early-stage, high-risk, and high-technology companies, PE invests in virtually every industry, especially later-stage companies.⁵⁸ VC generally does not include restructuring or leveraged buyout financing whereas it is more common for PE firms to acquire an existing or mature firm from its current owners.⁵⁹

These differences are sometimes glossed over in the Chinese market. Due to the youth of the Chinese VC industry and the lack of differentiation between VC and PE in Chinese regulations, the understanding of VC amongst investors remains limited. As a result, the term ‘venture capital’ is commonly confused with ‘private equity’.⁶⁰

⁵⁵ Li Junchen, ‘感悟涅槃：中国风险投资和非公开权益资本的崛起’ (*The Rise of China’s Venture Capital and Private Equity*) (Beijing: Tsinghua University Publisher, 2007), Chapter 1(2).

⁵⁶ My interviews with lawyers, legal counsels, and venture capitalists indicate that their understanding on venture capital is consistent with the international definition of venture capital (on file with author).

⁵⁷ Tom Nicholas stresses (i) there is heavy involvement and advising of each invested company, (ii) most investments are not profitable, but (iii) a few produce ‘long-tail’ or ‘hockey stick’ -shaped returns making the activity profitable. See Tom Nicholas, *VC: An American History* (Cambridge, MA: Harvard University Press, 2019).

⁵⁸ Ibid.

⁵⁹ See R. J. Gilson, *supra* note 1; see also Becker and Hellmann, *supra* note 39.

⁶⁰ My interviews with lawyers, legal counsels, and venture capitalists indicate that individual investors do not have a clear idea on the difference between PE and VC (on file with author).

The number of VC firms which strictly invest in the VC sector but not the PE sector is much smaller than reported.⁶¹ Many existing Chinese VC firms arose with the boom of the capital market and have limited experience in the VC industry.⁶² A large number of local venture capitalists were investment bankers prior to entering the VC market and hence do not possess sufficient engineering expertise or market track records relative to their counterparts in the US.⁶³ Local individual investors also tend to be more conservative than American investors in making investments. Some of these Chinese investors are more inclined to make investments in later-stage portfolio companies in traditional industries to achieve quicker returns, rather than take chances with high-risk and potentially long-term investments into start-ups.⁶⁴ Further, unlike a typical VC cycle in the US, which usually lasts for seven to ten years, the average cycle in some Chinese VC firms is shorter at about five to seven years.⁶⁵

In recent times, the boundary between VC and PE has become increasingly blurred. Many VC firms that used to invest in early-stage start-ups, having had to cope simultaneously with fundraising difficulties following the 2008 global financial crisis as well as investors' expectations for higher returns, have become more inclined to invest in later-stage matured companies, especially pre-initial public offering (IPO) companies, to gain quick returns.⁶⁶ Meanwhile, recent government efforts in building up a multi-layered capital market framework, coupled with the rapid development of the mobile internet industry, have motivated traditional PE firms to shift their investment preferences from later-stage and pre-IPO companies to early-stage companies.⁶⁷ Significantly, the phrase used to reflect the industry trend in China has changed from 'quanmin PE' (meaning 'everyone invests in the PE industry' particularly in

⁶¹ Telephone interview with Mr A (anonymity requested), Vice President, Chengwei Capital, on 12 November 2015. For the number of registered PE funds and VC funds in China, visit AMAC website: www.amac.org.cn/researchstatistics/datastatistics/privategravefundindustrydata/

⁶² Ibid.

⁶³ L. Lin, 'The Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners', *Journal of Corporate Law Studies*, 13(1) (2013), 185–217, at p. 200.

⁶⁴ Ibid., at pp. 187 and 192.

⁶⁵ The cycle for RMB funds is generally shorter than that of USD funds. Telephone interview with Mr Tian, Partner, iVision Ventures, on 20 June 2020.

⁶⁶ See Zhou Ming, 'PE与VC投资双双后移' (PE and VC investments both shift to later stages), *China Securities Journal*, 17 March 2008.

⁶⁷ See '新三板持续火爆的PE/VC大举进入掘金' (The Booming of the New Third Board), *China Securities Journal*, (17 January 2015).