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JGBC JOURNAL FOR GLOBAL BUSINESS AND COMMUNITY
ISSN: 1934-4244

THE REGULATION OF CHINESE INNOVATION: HOW VENTURE CAPITAL MUST CHANGE IN THE NEXT CHINA

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ABSTRACT

This article examines both the Western venture capital investment model and the traditional Chinese venture capital model. It considers whether and how the former can be adapted to the Chinese context to fund private sector-led economic development.

INTRODUCTION

Startups and their proclivity for explosive yet seemingly random success have fixated the public eye on creating the "next big thing." As far as China is concerned, all eyes are focused on creating the "Next China." China's fate and startups, however, are closely intertwined. The success of Alibaba, JD, and Tencent have already shown that the nation's future will be built upon homegrown companies, and venture capital will be its tool. In this paper, I focus on the venture capital investment model and how it can best be used to create the Next China. First, I briefly describe the Western venture capital model and illustrate its significance with regards to China. I then evaluate the Chinese venture capital model and how it compares to the Western model while noting potential pitfalls. Following that, I outline improvements that should be made to China's venture model and the obstacles to implementing them. Finally, I summarize where China stands today relative to the suggested improvements and gauge its future outlook.

LITERATURE REVIEW

The Venture Capital Model: Why it Matters

The venture capital model is a powerful economic force on a global scale. The prominence and apparent ubiquity of venture-backed technology companies such as Google, Apple, and Microsoft only underscore the far-reaching influence of venture capital in terms of both societal and economic impact. Indeed, the global venture capital industry is booming, having risen from $35.6 billion invested in 2009 to $86.7 billion invested in 2014 (Ernst & Young, 2015). In the U.S. alone, venture-backed companies account for 18% of all public companies, collectively holding a market capitalization of $4.3 trillion, demonstrating the sheer scale at which they operate (Strebulaev & Gornall, 2015).

Venture capital is able to accomplish such a feat because of its investment model. Traditionally, in Western venture capital, investments are handled by venture capital firms that control pools of money, called funds, which are raised from limited partners (LPs) who act as investors in a venture capital firm by making capital commitments to a firm's fund. LPs are typically high net worth individuals or institutional investors such as pension funds, mutual funds, and other financial institutions. Once a fund is raised, venture capital firms focus on the financing of young, innovative, fast-growing companies, colloquially known as startups. A startup that meets a firm's investment criteria may receive a round of financing, while continued growth and good performance may warrant follow-up investments from the firm. Eventually, a venture-backed startup is expected to generate a return on investment for the firm through an "exit," usually an initial public offering (IPO) or a sale to another company, at which point returns are distributed to the firm and its LPs. Venture capital by nature is a risky asset class that often takes years to generate returns, but time has shown how those years can translate into major successes.

By focusing on startups, venture capital plays an integral role in promoting innovation in a country. Innovation, defined as the creation of an improved good or service from an idea or invention, can be classified as in-house innovation or external innovation (Zhang, 2015). In-house innovation refers to innovation by well-established firms and industries while external innovation is created by startups and entrepreneurs. Such external innovation is what can help China make the leap to the "Next China." As Stephen Roach (2014) outlines in his book, *Unbalanced*, China must become a services-led economy in order to combat sluggish employment growth borne from its current economic foundation of manufacturing and exports (p. 218). External innovation is the key to growing the Chinese services sector. According to Yang Xiaohui, Part Chief of Northeast Normal University, the average one-graduate startup is capable of creating 3.63 jobs, and an average startup company can create 16.72 (Zhou, 2015). While these numbers are relatively small, high-profile successes such as Facebook and Tesla-- former venture-backed companies that have a combined market cap of over $365 billion--serve as a constant reminder of what can be achieved through venture capital (Nasdaq, 2016). More significantly, Chinese-bred startups have already produced 18 "unicorns," startups valued at $1 billion or more, not to mention the astronomical success of Alibaba, which holds a public market cap of $200 billion. (Fannin, 2015; Nasdaq, 2016). Chinese companies such as these will be at the forefront of technology, providing skilled employment and wages as they grow with the help of venture capital.

Venture Capital in China: Regulations and Hurdles

While venture capital is very much present in China, government-imposed regulations on venture capital investment in China have molded domestic Chinese venture capital into a smaller, less functional version of its Western counterpart. Ultimately, the differences between Chinese and Western venture capital boil down to institutional and cultural components.

Most, if not all, of the dissimilarities between Chinese and Western venture capital can be attributed to the disparity between one country's capital market structure and regulatory system and that of the other. Pukthuanthong and Walker describe two common capital market structures that define the U.S. and China, respectively: a stock market-centered structure and a bank-centered structure (Pukthuanthong & Walker, 2007). A stock market-centered country like the U.S. tends to have many banks that are relatively small in comparison with large corporations; the stock markets in these countries are usually mature with corporate governance conducted through cross-holdings and board membership in corporations. In contrast, a bank-centered country like China has fewer, larger banks, but those banks invest considerably in the corporate sector and play a major role in corporate governance. Oftentimes, a nation's market structure is a product of its regulatory system (Bruton, Manigart, Fried, & Sapienza, 2002). In China, regulators promote a bank-centered market by encouraging banks to own equity in customer firms and sit on the boards of those firms. U.S. regulators have traditionally shied away from such practices. Furthermore, financial reporting in China is much less transparent than in the U.S., making it difficult for venture capitalists to oversee their investments. Chinese shareholders also hold weaker protections than U.S. shareholders, further hampering the development of the Chinese stock market. When combined, a bank-centered structure and complementary regulatory system can form a harsh environment for venture capital by impeding stock market mechanisms and strengthening older, entrenched financial institutions that restrict private sector growth.

A major drawback of Chinese venture capital is the limitation of domestic funding sources. This stems from regulations that prevent financial institutions such as insurance companies and social security funds from participating in venture capital investment (Pukthuanthong & Walker, 2007). In contrast, financial institutions constitute a large source of venture capital funding in the U.S. Meanwhile, a large fraction of Chinese venture capital investment is performed by the government. A study by the Chinese Venture Capital Institute (CVCI) estimated that government investments accounted for 48% of total venture capital investments in China in 2003, compared to just 8.3% in the U.S. (Pukthuanthong & Walker, 2007). Heavy government involvement coupled with no institutional involvement in venture capital investment limits the amount of funding available to Chinese startups and, more importantly, raises questions about government motives. Critics argue that government investment decisions are extremely bureaucratic and will stunt the growth of private sector investment as well as result in the subsidization of undeserving companies. In addition, many state-owned enterprises (SOEs) make venture capital investments, and critics are dubious of their ability to make independent investment decisions given their strong affiliation with the government (Ding & Zhang, 2009).

Chinese venture capital is also plagued by difficult exit options. As previously mentioned, venture capitalists generate returns on their investments through an exit, the most profitable exit of which is an IPO. An oft-cited 1988 study by Venture Economics reports that for every $1.00 invested in a firm that goes public, a $1.95 average cash return is realized over an average holding period of 4.2 years. In comparison, $1.00 invested in an acquired firm yields only $0.40 over a 3.7-year average holding period (Plagge, 2007). Western economies have streamlined the IPO process by creating well-developed, liquid capital markets accentuated by stock exchanges with laxer listing requirements that cater to startups. Chinese stock market regulations, however, greatly discourage domestic IPOs through stringent listing requirements. Listing is difficult even for successful firms—in the end, it is the government that has the final say over whether or not a firm is listed (Pukthuanthong & Walker, 2007). Listing overseas on a foreign stock exchange presents another set of challenges: domestic companies seeking listing outside China must gain the approval of the China Securities Regulatory Commission (CSRC), passing criteria that are stricter than those for domestic listing (Ding & Zhang, 2009). Without a path to IPO, investors must either find a strategic buyer or execute a stock buyback. The difficulty of realizing investment returns similar to those of Western markets makes Chinese venture capital less attractive to foreign investors.

Institutional differences aside, Chinese venture capital is also quite distinct from Western venture capital from a cultural and social standpoint. Given that cultural differences between East and West are so large, it should come as no surprise that they pervade business practices. Pukthuanthong and Walker cite the phenomenon of *guanxi*, a network of relationships maintained by a businessperson inside and outside his or her firm (Pukthuanthong & Walker, 2007). *Guanxi* can be used to call in favors and vice versa, and can also be leveraged to generate value for one's firm. In terms of venture capital, *guanxi* refers to venture capitalists and their connections with colleagues, LPs, and entrepreneurs. While Western deals and transactions are characterized by a rigid set of enforceable contracts, g*uanxi* affirms Chinese venture capital's social-minded aspect. Deals are not so much enforced by signed documents as they are bound by an unwritten social contract. Furthermore, while the amount of time Western venture capitalists spend with their investments varies proportionally with the investment's level of risk, *guanxi* requires that the entire network is maintained equally, regardless of priority. In this manner, Chinese venture capital injects a unique human element into its practices.

As a product of a strict capital and regulatory environment, the Chinese venture capital model does not compare favorably with its Western counterpart. In order to fully realize venture capital's potential in China as a driver of services and innovation, major changes involving market access must take place both within China's market structure and government role while preserving the social stability of *guanxi*.

Changing the Model: Methods and Challenges

The objective of changing the Chinese venture capital model is to create an environment conducive to private investment and startup growth within China's borders. The methods suggested here aim to create a sustainable, accessible, and effective venture capital model that will foster Chinese innovation.

In light of the strict regulations of the CSRC that complicate venture capitalists' exit options in China, foreign investors and Chinese firms have utilized offshore investment structures since the 1990s to circumvent unfavorable regulations. Figure 1 provided by Jing Li shows this in detail (2012). At its most basic, an offshore investment structure has three components: a foreign investor (VC), an offshore holding company, and a subsidiary that operates within China (referred to here as P.R.C. for People's Republic of China). To begin, if a Chinese firm is seeking investment and wishes to raise money from foreign sources, the firm can set up a holding company that is based outside of China and use the holding company to acquire a controlling equity stake in the original firm based inside China. The original firm is thereby converted into a subsidiary of the offshore company. A foreign venture capitalist can then invest in the offshore company freely.

The second, more complicated structure shown below applies to restricted industries in China where foreign investors are not allowed to hold controlling stakes (Li, 2012). In this case, the Chinese firm again establishes an offshore holding company and uses the offshore company to provide assets to employees outside the firm to acquire a separate business entity within China that will then acquire the necessary government licenses and approvals for operation. This business will serve as the *de facto* operating entity for the firm. At the same time, the offshore company also establishes a subsidiary in China. The subsidiary and operating entity then enter into agreements that give the subsidiary control over the operating entity. With this method, the offshore company is able to control the operating entity without having direct ownership and is then able to receive foreign investment outside of China.

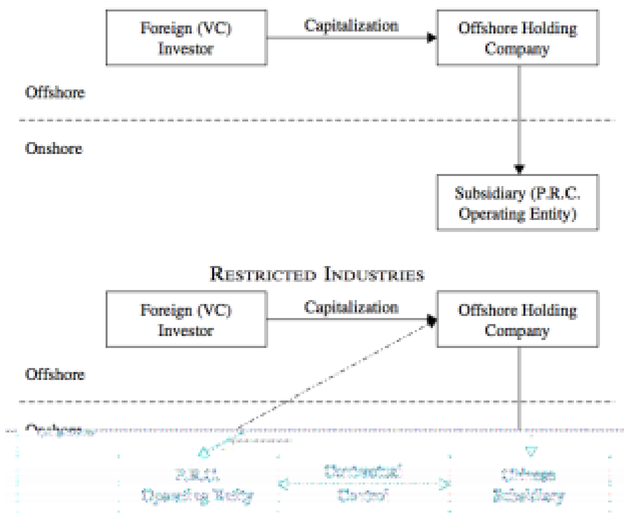

Figure 1: Offshore Investment Structures

Offshore investment structures, while convoluted, serve two purposes. First, they allow Chinese firms and foreign investors to operate outside the bounds of Chinese business regulations, giving the firm access to more efficient legal tools wherever the offshore company is based. Second, the foreign investor now has the option of exiting through an IPO without needing to deal with CSRC requirements. While offshore investment structures, also known as “red-chip structures,” served foreign investors well in the 1990s, they should only be viewed as a temporary solution to illiquid Chinese markets (Ding & Zhang, 2009). For venture capital to take off in China, a more permanent solution is necessary.

As previously discussed, the Chinese market structure suffers from weak protection policies, low financial transparency, and harmfully strict market regulations. As a whole, these flaws act to drive away potential investors and prevent domestic companies from achieving their full potential. The most effective solution to China’s venture capital shortcomings is a full legal framework dedicated to protecting intellectual property, expediting access to financial information, and introducing policies encouraging private investment.

A strong system of patent law that protects the intellectual property rights of individuals would not only encourage budding Chinese entrepreneurs but also safeguard the rights of foreign trade partners and companies. In a 2011 report, the U.S. Patent and Trademark Office examined the state of patent enforcement in China and found, based on a survey of U.S. rights holders, that Chinese patent law underperformed with regards to transparency, administrative enforcement, monetary damages, and more. A revamped Chinese patent law system would provide a safe haven for Chinese entrepreneurs who may only own patents and trademarks and allow them to act on their ideas without fearing infringement by a third party. Additionally, strong patent law would ease the concerns of venture capital firms that have shied away from investing in the Chinese high-tech industry because of the increased risk of weak property rights (Pukthuanthong & Walker, 2007). By making all parties more comfortable with sharing ideas in China, China can become a knowledge economy focused on producing ideas instead of manufactured goods.

Going hand-in-hand with patent law is the push for financial transparency. Venture capital firms cannot make informed investment decisions without having access to financial information. In a 2013 study conducted by Transparency International, 33 Chinese multinationals scored an average of 2 out of 10 on a transparency survey administered to 100 companies, claiming 8 of the lowest 10 scores (Kowalczyk-Hoyer & Cote-Freeman, 2013). A lack of transparency also bodes poorly for China's efforts to combat anticorruption, allowing violators to act under the radar and undermine markets. For venture capital to be effective in China and be able to allocate funds to the most deserving companies, financial information must be readily available through reputable sources.

Finally, China must implement policies that allow venture capital firms (and other foreign investors) to easily access and operate within Chinese markets. Some policies include easing listing requirements for stock exchanges, shifting away from a bank-centric market structure, and lowering minimum required venture capital fund sizes. By applying policies that facilitate venture capital access into its markets, China not only provides its domestic startups with a new source of funding but also promotes the formation of partnerships between foreign and Chinese venture firms that benefit all parties. For example, U.S. firms that partner with Chinese venture firms and startups can help shape the Chinese venture industry by offering their industry expertise and technology while growing their Chinese networks. Likewise, Chinese firms that partner with U.S firms offer domestic market access to growing commercial technology and Internet-based markets while also gaining access to the U.S. venture market.

China's Outlook

Although there remains much to be done in improving venture capital in China, the government has taken meaningful steps that demonstrate its commitment to cultivating venture capital as a valuable economic vehicle. Despite this, investors looking to enter China should expect a gradual rather than sudden reversal in venture capital-focused reform.

March 2009 marked a step forward for Chinese venture capital and startups with the CSRC's publication of "Interim Measures for Initial Public Offerings and Listings on the Growth Enterprise Market." A key measure created the Growth Enterprise Market (GEM) that sits on the Shenzhen Stock Exchange (SSE) (Ding & Zhang, 2009). Because the GEM has less stringent listing requirements than the main SSE, small, private Chinese enterprises will be able to file IPOs more easily, creating another exit channel for venture capitalists. Additionally, while wait times for IPO approval to the GEM have varied, an analysis found that the quality of GEM stocks was just as high as that of SSE stocks, marking GEM as a viable alternative listing venue for high-growth firms (Cheung & Liu, 2014).

China has also been proactive in reforming its stance on regulation of foreign investments. The Foreign Investment Law (FIL), proposed in January 2015, is intended to simplify the rules and regulations surrounding foreign investments (Ye, Duan, & Chang, 2015). Under the proposed law, foreign investments would no longer require pre-investment approval; investors need only file an information report within 30 days after the completion of an investment. Pre-investment approval, however, is required for investing in an industry placed on the “negative” list. Industries on the negative list will either be prohibited from receiving investment or will have certain thresholds of investment that cannot be exceeded. Despite the lifting of pre-investment approval for some Chinese industries, FIL can only be considered a small improvement over the current policy, which evaluates foreign investments on a case-by-case basis. By retaining control over certain markets on the negative list, China shows that it is unprepared to fully hand over the reins to the market.

Lastly, while China has shown its willingness to alter old economic regulations, the announcement of a government-run venture capital fund sends mixed signals at best.
In January 2015, the State Council announced the establishment of a fund worth $6.5 billion, almost equaling the total amount of venture capital raised in China in the first half of 2014 (Jianxin & Sweeney, 2015). Such a move underscores the government’s commitment to venture capital but also highlights its unwillingness to vacate its position of market authority. Although the government will be able to use the money to foster emerging industries, the fund still reflects an unwillingness to vacate its position of market authority.

CONCLUSION

Innovation is what will drive China’s transition from a manufacturing and export economy to a services-led economy, and venture capital will be the catalyst. In order to place venture capital in a position to succeed, however China must focus on molding a national economic environment that encourages entrepreneurship and investment. This is possible through the implementation a legal framework with strong patent law, economic transparency, and market access policies that will allow venture capital in China to emulate venture capital in the West. As we have observed, China has indeed taken a variety of regulatory steps to nurture venture capital and address concerns with its current model. Nevertheless, China’s actions do not suggest any intentions of making a sudden transition towards a more economically beneficial venture capital model. In the long term, however, based on trends in Chinese policy, it is reasonable to expect that China will progressively adjust its course and secure a future of innovation.

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