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

I. INTRODUCTION

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

1. Doug Wagner, *Netscape Communications Corporation*, JONES TELECOMMUNICATIONS & MULTIMEDIA ENCYCLOPEDIA, at <http://www.digitalcentury.com/encyclo/update/netscape.html> (last visited Nov. 25, 2000). An IPO is the offering of a company's securities to the public for the first time. See JAMES D. COX ET AL., *SECURITIES REGULATION, CASES AND MATERIALS* 2 (2d ed. 1997). A company engaged in the process of an IPO is also commonly referred to as "going public." See *id.*

2. Robert Seidman, *Netscape's IPO*, IN, AROUND AND ONLINE—ISSUE 2.32, <http://www.onlineinsider.com/html/archives/081195.html> (Aug. 11, 1995).

3. *Id.*

4. *Id.*

5. "NASDAQ" is an acronym for National Association of Securities Dealers Automated Quotron, the dominant over-the-counter (OTC) stock market in the United States. Eric C. Sibbitt, *Law, Venture Capital, and Entrepreneurism in Japan: A Microeconomic Perspective on the Impact of Law on the Generation and Financing of Venture Businesses*, 13 CONN. J. INT'L L. 61, 62 (1998).

6. Seidman, *supra* note 2.

7. Wagner, *supra* note 1.

The ripple effect of the Netscape IPO was felt throughout the world,⁸ especially in the People's Republic of China (China), where the government is keenly interested in developing venture capital to fuel the growth of its burgeoning high-tech industry.⁹ Even though China has attracted significant venture capital financing in the last decade,¹⁰ venture capital laws currently do not exist in China.¹¹ The Chinese government recently announced plans to draft venture capital laws in an effort to improve the investment environment and encourage venture capital financing of the high-tech sector.¹² The government acknowledged, however, that this would be a lengthy, multi-year process.¹³ Given China's unique political, economic, and financial structures, the Chinese government recognizes the need for comprehensive regulations.¹⁴

This Comment focuses not only on the types of laws required, but also on the larger institutional structure necessary for the development of a vibrant venture capital industry in China. Additionally, this Comment explores the role of law in the relationship between corporate governance¹⁵ and the growth of venture capital. Part II analyzes the U.S. venture capital industry in the context of the U.S. market-centered corporate governance model. Part III surveys the German and Japanese bank-centered model. Using these two contrasting models as a conceptual

8. See Sibbitt, *supra* note 5, at 69 (noting that the Netscape IPO "helped boost the Internet and the World Wide Web," and "promoted the funding of other ventures"). The author also notes that "Japan has yet to produce an IPO as successful as Netscape." *Id.* at 86.

9. See *High-Tech Sector Wants Money: Report*, XINHUA NEWS AGENCY, Aug. 30, 2000, LEXIS, News Library, Xinhua File.

10. See *Venture Capital in China: Enter at Your Own Risk*, CHINAONLINE, Jan. 7, 2000, LEXIS, News Library, Chinao File [hereinafter *Enter at Your Own Risk*] (reporting that over the last four years, China has attracted more overseas venture capital than any other developing country in southeast Asia).

11. *Id.*

12. See *China Seeking to Develop Venture Capital with New Laws*, AGENCE FRANCE PRESSE, Aug. 9, 1999, LEXIS, News Library, AFP File.

13. *Id.* (reporting that Cheng Siwei, the Vice Chairman of the National People's Congress, stated that the drafting process would take at least two years).

14. See discussion *infra* Part IV.

15. Corporate governance concerns the distribution of power among shareholders, officers, directors, and to a lesser extent, other constituencies such as employees and creditors of a corporation. See Arthur R. Pinto, *The United States*, in *THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS* 253, 262 (Arthur R. Pinto & Gustavo Visentini eds., 1998).

framework, Part IV examines the current institutional structure in China and discusses how China can utilize the lessons learned by the United States, Germany, and Japan. Finally, Part V concludes with recommendations for institutional reforms in order to develop venture capital in China.

II. THE U.S. MODEL

The venture capital industry has played a significant role in the growth of the U.S. economy.¹⁶ Particularly in the last decade, venture capital has been the engine that propelled the spectacular rise of the Internet economy and the high-tech sector.¹⁷ Stocks of “dot.coms” reached dizzying heights and created instant millionaires by the week.¹⁸ In 1999 alone, venture capital investment averaged \$2 billion per week, or more than \$100 billion per year, up 150% from the previous year.¹⁹ By most accounts the success of the U.S. venture capital industry is the envy of the world.²⁰

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

16. Curtis J. 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, 866 (1997) (citing a Congressional report finding “the venture capital community [to be] a vital link in the process of capital formation, technological changes, and economic growth.”); see also William A. Sahlman, *Insights from the Venture Capital Model of Project Governance*, BUS. ECON., July 1994, at 37 (crediting venture capital with creating some of the most successful companies in the United States).

17. See Milhaupt, *supra* note 16, at 870 (noting that venture capital is “almost an essential form of financing” for high-risk, high-tech companies).

18. See, e.g., Seidman, *supra* note 2.

19. See *Venture Capital Basics*, SALARY.COM, at 1, at http://www.vault.com/nr/main_article_detail.jsp?article_id=52583&ht_type=5 (Sept. 13, 2000) (quoting National Venture Capital Association statistics).

20. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 245 (1998); see also JOSEPH W. BARTLETT, *VENTURE CAPITAL: LAW, BUSINESS STRATEGIES, AND INVESTMENT PLANNING* 12 (1988) (commenting that venture capital “is the one technique our competitors in other industrial countries have yet to master.”).

21. See *infra* Part II.B–C.

venture capital.²² Legal commentators and economists alike largely attribute the unparalleled growth of the venture capital industry in the United States to the U.S. market-centered system.²³ They argue that a well-developed stock market is fundamental to the development of the venture capital industry.²⁴ This Comment expands on their theory by further positing that the U.S. venture capital industry owes its success in large measure to the operations of law at each stage of its development. Just as a corporation "operates under a series of legal rules, markets, and private ordering" and these legal rules "shape the basic structure of corporate organs, define the rights of corporate actors, and set the boundaries for private ordering,"²⁵ the venture capital industries in the United States, Germany, and Japan are similarly shaped by the operations of law.

A. A Primer on the Venture Capital Industry

Venture capital in the United States is perhaps best defined as "investment by specialized organizations . . . in high-growth, high-risk, often high-technology firms that need [capital] to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt."²⁶ Unlike banks, which lend money to the borrower, venture capitalists provide financing to a startup company²⁷ by acquiring part ownership in the company through equity investments.²⁸ The companies that receive venture capital funding are called "portfolio companies."²⁹

22. See, e.g., Milhaupt, *supra* note 16, at 879–81.

23. See, e.g., Black & Gilson, *supra* note 20, at 243–45.

24. *Id.*

25. Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 4 (1996).

26. Black & Gilson, *supra* note 20, at 245. Alternatively, venture capital has also been defined as "a professionally managed pool of capital that is invested in equity-linked securities of private ventures at various stages in their development." William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 473 (1990).

27. A startup is a newly formed company founded by an entrepreneur. JOSEPH W. BARTLETT, *EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS* 6 (2d ed. 1995).

28. *Venture Capital Basics*, *supra* note 19, at 2.

29. The term "portfolio company" denotes the fact that the company is but one in the venture capitalist's portfolio of companies. See BARTLETT, *supra* note 27, at 3, 4.

Along with the significant risk associated with the investment—the company could fail and render the venture capitalists' investment worthless—comes huge upside potential.³⁰ Venture capitalists expect that the company will take the infusion of cash to fund its growth, and create a business that is worth substantially more than before the venture capital investment.³¹ In exchange for their investment in the startup, the venture capitalists often obtain a significant stake in the company.³² Along with ownership comes the right to monitor management, whereby the venture capitalists are directly involved in corporate governance, including determining the company's business strategy, its products and services, its capital structure, its personnel, and even its name.³³ In addition, venture capitalists often receive annual management fees of approximately 2% to 2.5% of committed capital and a share of the company's profits.³⁴ The biggest financial payoff for venture capitalists occurs at the point of exit, usually three to five years after initial investment, when the venture capital fund "cashes out" of the company via an IPO or sale to another entity.³⁵

B. The Role of Law

The U.S. institutional structure—laws, business practices, and social norms—has been cited as the driving force of the U.S. venture capital market.³⁶ In particular, the success of the U.S. venture capital industry, to a large extent, is attributable to the existence of laws that govern all aspects of the venture capital investment process from formation, to entry, to exit.

30. *Venture Capital Basics*, *supra* note 19, at 2.

31. *Id.*

32. See Christopher B. Barry et al., *The Role of Venture Capital in the Creation of Public Companies*, 27 J. FIN. ECON. 447, 448 (1990) (noting that at the time of an IPO, the aggregate holdings by all the venture capitalists represent, on average, 34% of the outstanding shares of the portfolio company).

33. *Venture Capital Basics*, *supra* note 19, at 2; see also Sahlman, *supra* note 26, at 508.

34. *Venture Capital Basics*, *supra* note 19, at 2; see also Sahlman, *supra* note 26, at 491.

35. See Black & Gilson, *supra* note 20, at 257.

36. Milhaupt, *supra* note 16, at 879–80.

1. The Venture Capital Fund and the Role of Law in Its Formation

Venture capitalists invest in startups through venture capital funds.³⁷ In the United States, a venture capital fund is generally organized as a limited partnership, where the partners are the capital providers.³⁸ At the inception of the venture capital fund, a limited partnership agreement between the fund and the capital providers is executed.³⁹ Like any limited partnership, the agreement sets forth the rights and obligations of the general partners and limited partners, the duration of the partnership, and dissolution procedures.⁴⁰

A limited partnership enjoys several advantages over corporations and general partnerships. First, unlike general partners who are personally liable for all of the debts and obligations of the partnership, a limited partner is only liable up to the extent of his or her capital contribution.⁴¹ In other words, a limited partner stands to lose only the capital contribution if the venture capital fund fails.⁴² Thus, the limited partner is shielded from exposure to liabilities incurred by the partnership.⁴³ The legislature designed this limited liability feature to encourage investment by a limited partner,⁴⁴ particularly the small individual investor, who does not wish to live in fear that his or her investment in a venture capital fund could result in losing the family home.

Second, like partnerships, a limited partnership enjoys favorable tax treatment because limited partnership income is not subject to taxation at the partnership level.⁴⁵ Limited partnerships are not taxed as separate entities; rather, the profits from the

37. See Sahlman, *supra* note 26, at 487.

38. Milhaupt, *supra* note 16, at 885. In a typical venture capital fund, the venture capitalists serve as general partners and other investors serve as limited partners. *Id.*

39. See Black & Gilson, *supra* note 20, at 256.

40. Typically, the maximum duration of the venture capital limited partnership is set at seven to ten years, after which the partnership must be liquidated and the proceeds distributed to the partners. *Id.* at 256.

41. *Evans v. Galardi*, 16 Cal. 3d 300, 305 (1976).

42. *Id.*

43. See, e.g., CAL. CORP. CODE § 15632 (Deering 1997); Milhaupt, *supra* note 16, at 885.

44. See, e.g., *Galardi*, 16 Cal. 3d at 306 (finding that the legislative recognition of limited partnership as business entity was to encourage investment).

45. I.R.C. § 701 (1988).

partnership “flow through” to the partners and are taxable to the partners as personal income only, thereby avoiding double taxation.⁴⁶ Thus, the law operates to encourage the formation of, as well as investment in, venture capital funds.

2. The Role of Law in Venture Capital Funding Sources

At its initial stage, a venture capital fund first needs to generate funding from investors.⁴⁷ Here, U.S. laws and regulations have not only spurred the investment in venture capital funds, but also fundamentally shaped the development of the funds' sources.⁴⁸

To begin, venture capital funds raise money from two types of investors: institutions and individuals.⁴⁹ Data compiled by researchers indicate that pension funds and insurance companies constitute the primary investors.⁵⁰ Pension funds contributed 40% of the capital raised by venture capital funds annually over the last decade, as a direct result of U.S. government regulations.⁵¹ In 1979, the Department of Labor expressly authorized pension funds to invest in venture capital funds.⁵² Previously, there had been virtually no pension fund investments in venture capital funds because the legality of such investments was in question.⁵³ The effect of this revised law is amply demonstrated by the flow of pension fund investment into venture capital funds, which began in 1979 and continues unabated to date.⁵⁴

46. See *id.* Double taxation is one of the primary drawbacks of a corporation. See ROBERT W. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS* 150 (6th ed. 1998). An individual pays personal income tax on income at a rate according to the level of taxable income. *Id.* Likewise, a corporation pays corporate income tax according to its level of taxable income. *Id.* When a corporation pays dividends to its shareholders, the corporation has already paid income tax on those dividends. *Id.* The dividends, however, are also taxable to the shareholder as personal income. *Id.* This concept is known as “double taxation.” *Id.*

47. See BARTLETT, *supra* note 27, at 6.

48. See discussion *infra* Part II.B.4.

49. See Sahlman, *supra* note 26, at 488.

50. See Black & Gilson, *supra* note 20, at 249.

51. For example, in 1992, 42% of venture capital contribution came from pension funds, 15% from insurance companies, and the remaining from individual investors and family. *Id.*

52. See Black & Gilson, *supra* note 20, at 269–70.

53. *Id.*

54. See *id.* at 270.

Additionally, unlike countries such as Germany and Japan, where a company's employee pension fund can remain unfunded, in the United States, the law requires companies to fund pension funds. For example, the Employee Retirement Income Security Act (ERISA)⁵⁵ established mandatory minimum funding levels in 1973.⁵⁶ Thus, many companies have pension funds with substantial assets and are able to make investments as they see fit.⁵⁷ Pension funds choose to invest in venture capital funds because of the high rate of return.⁵⁸

Conversely, U.S. laws have also operated to prevent certain sectors from investing in venture capital funds.⁵⁹ A primary example is the banking industry, where, through stock ownership and line of business restrictions, banking regulations prohibit banks from entering commerce.⁶⁰ Until it was recently abolished, the Glass-Steagall Act historically drew a line separating commercial banks from investment banks.⁶¹ Commercial banks were barred from conducting securities business or maintaining close affiliations with investment banks and, until recently, mutual funds.⁶² Glass-Steagall also prohibited banks from acquiring stocks themselves.⁶³ The Bank Holding Company Act further fine-tuned Glass-Steagall by prohibiting bank affiliation with non-banks (including insurers), yet allows passive ownership of no more than 5% of a non-bank's stock.⁶⁴

Indeed, one influential commentator has compared these laws to "the San Andreas fault line, . . . historically severing America's largest financial institutions from its largest industrial firms."⁶⁵ Consequently, it has been illegal for American banks to

55. Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. 1001-1461).

56. See Black & Gilson, *supra* note 20, at 270. An unfunded pension plan is treated as a liability in the company's financial statements. *Id.* It represents a company's future obligation to pay pensions to employees when they retire. *Id.*

57. *Id.*

58. See Milhaupt, *supra* note 16, at 880-81.

59. Mark J. Roe, *Some Differences of Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1949 (1993).

60. *Id.*

61. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. (1988)).

62. Roe, *supra* note 59, at 1949.

63. *Id.*

64. Bank Holding Company Act of 1956, ch. 240, § 4(a), 60 Stat. 133 (1956) (codified at 12 U.S.C. § 1843(a)(1) (1988)).

65. Roe, *supra* note 59, at 1930.

invest in venture capital funds, much less assume a significant role as do their counterparts in Germany and Japan.⁶⁶ Without the dominating presence of banks, U.S. venture capital developed other private funding sources and independently grew.⁶⁷

3. The Role of Law at the Point of Entry

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

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

66. See *id.* at 1948. Roe also argues that if U.S. banks tried to imitate German banks, they would run afoul of nearly every U.S. financial regulation. *Id.* at 1949. In addition to Glass-Steagall and the Bank Holding Company Act, the McFadden Act of 1927 allows national banks to open branches only if permitted by state law. *Id.* at 1948. Up until recently, state laws prohibited local branches. McFadden Act, ch. 191, § 1, 44 Stat. 1224 (1927) (codified as amended at 12 U.S.C. § 36 (1988)).

67. See Sahlman, *supra* note 26, at 488.

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

69. See Haksoo Ko & Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457, 466 (2000) (noting that at the early stage of a company's existence, equity financing is essential because the company's negative cash flow prevents it from obtaining debt financing).

70. See generally Sahlman, *supra* note 16, at 36.

71. Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 TENN. L. REV. 79, 103 (1997).

72. See Ko & Shin, *supra* note 69, at 460 (arguing that the particular venture capital contracting model that aligns the incentives of the various contracting parties is prevalent in the United States only).

73. Smith, *supra* note 71, at 104.

invariably include the following terms: board representation and restrictive covenants on management.⁷⁴

a. Representation on the Company's Board of Directors

"Venture capitalists often demand a significant voice on the board of directors."⁷⁵ They generally obtain at least enough actual representation to block important board actions.⁷⁶ "This is one of the most significant mechanisms through which venture capitalists exercise control over management of their portfolio companies."⁷⁷ As members of the board, venture capitalists are in a position to monitor management's activities.⁷⁸ Given the great risk venture capitalists face at this stage, one might rationalize that they would be inclined to actually assume full control of the portfolio company in order to minimize the risk of mismanagement.⁷⁹ The law, however, works to provide a disincentive to assuming control.

Venture capitalists generally avoid gaining actual control of the company by occupying less than half of the seats on the company's board of directors in order to avoid the regulatory consequences of gaining control over companies.⁸⁰ Among other things, being deemed a "controlling person" may expose an individual to liability to creditors and other investors.⁸¹ As one commentator notes, control entails legal responsibility.⁸² Because venture capital investment is already risky, taking on liability to creditors and other shareholders increases the risk exponentially.⁸³ Thus, the law provides a check on the venture capitalists as well.

74. *Id.*

75. *Id.* at 107.

76. See Richard Testa et al., *Venture Capital Investment*, in VENTURE CAPITAL 1991: FORMING THE FUND AND FINANCING ISSUES 9, 12 (1991).

77. Smith, *supra* note 71, at 107.

78. Black & Gilson, *supra* note 20, at 253.

79. See, e.g., Smith, *supra* note 71, at 105.

80. *Id.* at 107.

81. 15 U.S.C. 77o (1994).

82. Smith, *supra* note 71, at 108-09.

83. See BARTLETT, *supra* note 27, at 4.

b. Restrictive Covenants that Constrain the Behavior of Managers

“In addition to representation on the board of directors, venture capitalists generally constrain the action of management by negotiating a number of different kinds of restrictive covenants to help protect their investment.”⁸⁴ These covenants prohibit self-dealing by the management, and prevent managers from “usurping corporate opportunities and competing with the firm.”⁸⁵ Some provisions even call for managers to cooperate with the company even after their departure.⁸⁶

Another significant form of managerial control is through compensation packages that emphasize stock options over present income so that managers have an incentive to maximize shareholder value.⁸⁷ Further, the stock options usually vest over a period of years so that if a manager leaves before the options are fully vested, he or she loses all of the unvested options.⁸⁸ This helps to ensure that the manager does not endeavor to maximize his or her own personal short-term profit at the expense of the company’s future.⁸⁹

Venture capital contracts also require periodic disclosures of financial information by management to the venture capitalists.⁹⁰ These include adherence to prescribed levels of current ratio, working capital, short and long-term debt, net worth, and restrictions against encumbrances of assets.⁹¹ Obviously, these terms assume the existence of generally accepted accounting principles (GAAP) so that the financial statements can be meaningfully interpreted and relied upon by the user, namely the venture capitalists.⁹²

4. The Role of Law at the Point of Exit

Perhaps the greatest benefit U.S. law provides to the venture capital industry is in the regulation of the U.S. stock market. As

84. Smith, *supra* note 71, at 110.

85. *Id.* at 113.

86. *Id.*

87. *Id.* at 114.

88. *Id.* at 115–16.

89. *See id.* at 116.

90. *Id.* at 117.

91. *Id.* at 120.

92. *See infra* Part II.B.4 (discussing the U.S. accounting system).

commentators note, without a stock market, a portfolio company cannot have an IPO, thereby foreclosing the primary avenue of exit for venture capital funds.⁹³

The importance of an IPO as a means to exit from (or cash out of) an investment cannot be underestimated. Beyond investors' obvious need for liquidity, an IPO serves as a measure of a venture capital fund's and the venture capitalists' performance.⁹⁴ Because venture capitalists contribute more than money to a portfolio company—they also provide “reputational capital” to the startup—there must exist an objective measure of this nonfinancial contribution.⁹⁵ Third parties such as customers, suppliers, managers, and underwriters rely on this benchmark for their own decisions on whether to transact business with the portfolio company.⁹⁶ Further, as a portfolio company grows and its management gains experience, the relative value of the venture capitalists' nonfinancial contribution declines, thereby making it more efficient for the venture capitalists to exit and invest in other early-stage companies, where their reputational capital would be of greater value.⁹⁷

Because an IPO is only possible through a stock market,⁹⁸ the existence of a healthy stock market is essential to the development of the venture capital industry. The U.S. venture capital industry has been the happy beneficiary of the efficiency and vitality of the U.S. stock market.⁹⁹ The growth of the U.S. stock market is, in turn, directly attributable to the operations of law, specifically securities regulation by the Securities and Exchange Commission (SEC).¹⁰⁰

The primary objectives of U.S. securities laws, as administered by the SEC, “are to protect investors and ensure

93. See Black & Gilson, *supra* note 20, at 245.

94. *Id.* at 255.

95. *Id.* at 252 (defining reputational capital as the reputation of a venture capital fund that enables it to engage various third parties, such as underwriters, and develop the portfolio company).

96. *Id.* at 254.

97. *Id.* at 255.

98. *Id.* at 245.

99. See *id.*

100. Roberta S. Karmel, *Stock Market and the Globalization of Retirement Savings—Implications of Privatization of Government Pensions for Securities Regulators*, 33 INT'L LAW. 955, 962 (1999).

that securities markets are fair, efficient, and transparent."¹⁰¹ The SEC performs its watchdog function primarily via the Securities Act of 1933 (1933 Act)¹⁰² and the Securities Exchange Act of 1934 (1934 Act).¹⁰³ The 1933 Act governs the public offering of securities; it provides that any such offering must be registered with the SEC before securities may be sold.¹⁰⁴

The hallmark of both the 1933 Act and the 1934 Act is disclosure.¹⁰⁵ The 1933 Act requires full and fair disclosure to be made in the registration statement that must be filed with the SEC as part of the company's public offering process.¹⁰⁶ The disclosure requirements are voluminous, ranging from information concerning the company's business to the background of management personnel and perceived risk factors of the offering.¹⁰⁷ The registration statement also requires audited financial statements.¹⁰⁸

The 1934 Act covers securities trading and requires periodic reporting by registered companies.¹⁰⁹ Companies whose stocks are listed on a national stock exchange, such as the New York Stock Exchange or the NASDAQ, are subject to the reporting requirements of the 1934 Act.¹¹⁰ These companies must file an annual report (10-K) with the SEC, including audited financial statements, and quarterly reports (10-Q) with unaudited financial statements.¹¹¹ Additionally, they must also report events of material importance soon after the events occur.¹¹²

These extensive reporting requirements, more stringent than those of any other country,¹¹³ serve to protect investors, provide transparency to the system, prevent fraud, and thereby promote investor confidence in the market.¹¹⁴ They are directly

101. *Id.*

102. *Id.* at 971.

103. *Id.*

104. Securities Act of 1933, ch. 38, 48 Stat. 74.

105. See Karmel, *supra* note 100, at 971.

106. 15 U.S.C. § 77e(c) (1994).

107. See *id.* § 77g.

108. See *id.* § 77e.

109. Securities Act of 1933, § 15 U.S.C. §§ 78i, 78m (1994).

110. *Id.* § 78i(g).

111. HAMILTON, *supra* note 46, at 334.

112. *Id.*

113. Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113, 113 n.1 (1999).

114. See Karmel, *supra* note 100, at 962.

responsible for making the U.S. stock market the success it is today.¹¹⁵ Additionally, a complex set of civil liability provisions supplements the SEC's enforcement of these regulations.¹¹⁶

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

115. See *id.*

116. See Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants*, 29 INT'L LAW. 875, 893-94 (1995).

117. See *id.* at 875; see also Karmel, *supra* note 100, at 962.

118. ERIC G. FLAMHOLTZ ET AL., FINANCIAL ACCOUNTING 8 (1986).

GAAP primarily come from pronouncements of the accounting profession's self-governing bodies such as the Financial Accounting Standards Board, other groups affiliated with the American Institute of Certified Public Accountants, and the SEC. *Id.*

119. *Id.*

120. ROGER H. HERMANSON ET AL., AUDITING THEORY AND PRACTICE 16 (4th ed. 1987).

121. Audited financial statements must include the balance sheet, the income statement, the retained earnings statement, and the cash flows statement. FLAMHOLTZ ET AL., *supra* note 118, at 10.

122. Statistical studies have demonstrated the value of U.S. GAAP to investors. For example, in a study published in the 1993 *Journal of Accounting Research*, researchers compared annual earnings and corresponding stock prices based on a sample of several thousand annual reports from seventeen countries from 1983 to 1990. Andrew Alford et al., *The Relative Informativeness of Accounting Disclosures in Different Countries*, 31 J. ACCT. RES. 183 (Supp. 1993). The study found a high degree of correlation between accounting measures and stock price/return, particularly in the United States, evidencing the relevancy of financial statement information to investment decisions. *Id.* A much lesser degree of correlation was found in Germany. *Id.*

123. See Black & Gilson, *supra* note 20, at 257

C. The Role of Culture

The popular perception is that the United States is a country of adventurous risk-takers.¹²⁴ Certainly, a society that produced twenty-something Wunderkinds such as Bill Gates, Steve Jobs, and Marc Andreessen cannot be said to frown upon risk-taking.¹²⁵ Entrepreneurial zeal alone, however, is insufficient to create sustained innovation; it is the institutional structure and related legal framework in the United States that has enabled entrepreneurs to succeed.¹²⁶ Venture capital epitomizes the synergistic combination of law, economics, and entrepreneurialism. Netscape, the brainchild of venture capitalist Jim Clark and programmer Marc Andreessen, provides a prime example of this synergy.¹²⁷

Andreessen was an undergraduate at the University of Illinois writing software code for \$6.85 an hour for the university's National Center for Supercomputing Applications when he came up with an Internet browser program called Mosaic.¹²⁸ Andreessen put the browser on the Internet for anyone to download for free.¹²⁹ The browser proved to be quite popular and frequently downloaded, but Andreessen could not figure out a way to make money from it.¹³⁰ Enter Clark, a seasoned venture capitalist who previously co-founded Silicon Graphics, Inc., a successful Silicon Valley computer company.¹³¹ Clark became aware of Andreessen's efforts through the Internet.¹³² In short order, the two met and Clark decided to invest in Andreessen's browser technology—a new company was born.¹³³ Andreessen's programming wizardry and Clark's business acumen combined to

124. Sibbitt, *supra* note 5, at 83.

125. Respectively the founders of Microsoft Corporation, Apple Computer, and Netscape, who each started his company while still in his early twenties. *Bill Gates' Web Site—Biography*, <http://www.microsoft.com/billgates/bio.asp> (Dec. 2000); *Steve Jobs Timeline*, <http://www.sfgate.com/net/projects/stevejobstimeline.html> (last visited July 6, 2001); Wagner, *supra* note 1.

126. See *supra* Part II.B.

127. See Wagner, *supra* note 1.

128. See *id.*

129. *Id.*

130. See Tom Steinert-Threlkeld, *Can You Work in Netscape Time?*, FAST CO., Nov. 1995, at 86, available at <http://www.fastcompany.com/online/01/netscape.html> (last visited Nov. 25, 2000).

131. *Id.*

132. See *id.*

133. See *id.*

make Netscape one of the most successful Internet companies of the 1990s.¹³⁴

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

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

Shareholders are also protected by the U.S. legal system.¹⁴⁰ For example, an investor bilked by fraud or misrepresentation in an IPO has a myriad of legal options available to him or her.¹⁴¹ The investor can sue the company's management, its board of directors, its accountants, its underwriters, and even its lawyers,

134. *Id.*

135. In fact, Clark subsequently used the money he made from the Netscape investment to establish another company, Healtheon Corp. Larry Kanter, *Jim Clark, SALON.COM*, at <http://www.salon.com/people/bc/1999/11/24/clark/print.html> (Nov. 24, 1999).

136. See Wagner, *supra* note 1.

137. *Id.*

138. *Id.*

139. Andreessen still harbors some resentment over the actions taken by his former employer; he claims that the National Center for Supercomputing Applications was trying to shut down his young company. *Id.*

140. COX ET AL., *supra* note 1, at 590.

141. See *id.* at 589.

both individually and derivatively.¹⁴² Should the shareholder prevail in a court of law, the defendants can be held jointly and severally liable for monetary damages.¹⁴³ Additionally, such an investor does not lack access to legal representation, as there is one lawyer for every 300 people in the United States.¹⁴⁴ Contingency fee arrangements also make legal representation affordable to the average investor.¹⁴⁵ Legal recourse has served as a check on corporate management's execution of its duties and continues to bolster investor confidence.¹⁴⁶

III. THE GERMAN AND JAPANESE MODELS

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

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

142. *Id.* at 591. A shareholder derivative suit is maintained by the shareholder of a company on behalf of, and for the benefit of the company and other shareholders. See Sibbitt, *supra* note 5, at 91.

143. COX ET AL., *supra* note 1, at 611, 616.

144. Sibbitt, *supra* note 5, at 90.

145. *See id.*

146. Indeed, the proliferation of shareholder derivative suits has led some to argue that the balance of legal protection is weighed too much in favor of the shareholder. *See, e.g.*, Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

147. *See, e.g.*, Black & Gilson, *supra* note 20, at 251.

148. Milhaupt, *supra* note 16, at 875; *see also* Black & Gilson, *supra* note 20, at 251 (noting that the German venture capital industry is a fraction of the size of its U.S. counterpart).

149. Sibbitt, *supra* note 5, at 62.

150. *Id.*

151. Milhaupt, *supra* note 16, at 875.

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

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

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

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

152. Sibbitt, *supra* note 5, at 62. OTC refers to the secondary stock market where stocks of smaller companies are often traded, as compared to the primary stock market, such as the Tokyo Stock Market in Japan or the New York Stock Exchange in the United States, where stocks of more established companies are traded. Kate Kelly, *E*Trade's Switch to Big Board Leaves Nasdaq With Bad Taste*, WALL ST. J., Feb. 13, 2001, at C19.

153. Sibbitt, *supra* note 5, at 62.

154. Black & Gilson, *supra* note 20, at 266.

155. See, e.g., *id.* at 883.

156. Milhaupt, *supra* note 16, at 869.

157. *Id.* at 877.

158. See Roe, *supra* note 59, at 1937-39 (noting, for example, that the three largest German banks together own over 32% of the stock of Siemens, and over 60% of Daimler-Benz prior to its merger with Chrysler). Likewise in Japan, the five largest financial institutions have historically owned over 21% of Toyota Motors, and almost 20% of Matsushita. *Id.* at 1940.

159. Sibbitt, *supra* note 5, at 105.

1. The Formation of a Venture Capital Fund

Laws present legal barriers to venture capital fund formation in Japan.¹⁶⁰ To begin, unlike venture capital funds organized as limited partnerships in the United States, “[n]o available organizational form in Japan offers venture capital providers both flow-through tax treatment and limited liability.”¹⁶¹ Though a Japanese limited partnership entity (*tokumei kumiai*) technically exists,¹⁶² tax regulations make it meaningless to venture capitalists in practice.¹⁶³ The Japanese Ministry of Finance (MOF) imposes a withholding tax where there are ten or more limited partners, which renders a limited partnership effectively off-limits to venture capital funds, as such funds generally have large pools of investors.¹⁶⁴

The most commonly used entity in Japan for institutional investment in venture capital is the “partnership for investment purposes [*toshi jigyo kumiai*],” which is a hybrid of the U.S. general partnership and limited partnership.¹⁶⁵ Unlike the limited partnership in the United States, this type of partnership offers the benefit of no double taxation but lacks limited liability protection to all its members.¹⁶⁶ Thus, unlike the United States, the Japanese legal structure impedes the formation of venture capital funds.

2. Sources of Funding

While in the United States investment in venture capital funds comes from pension funds, insurance companies, and individuals, in Japan it comes primarily from banks (24%) and corporations (33%).¹⁶⁷ The banks’ contributions are made in the form of loans, not equity.¹⁶⁸ Japanese startups, therefore, must use precious capital to repay the bank loans, instead of channeling the money toward growing the business, thus increasing the risk of

160. See Milhaupt, *supra* note 16, at 888.

161. *Id.*

162. Hideki Kanda, *Japan*, in *THE LEGAL BASIS OF CORPORATE GOVERNANCE IN PUBLICLY HELD CORPORATIONS* 111 (Arthur R. Pinto & Gustavo Viscentini eds., 1998).

163. See Milhaupt, *supra* note 16, at 888.

164. *Id.*

165. See *id.*

166. *Id.*

167. *Id.* at 877.

168. *Id.* at 882.

business failure.¹⁶⁹ Likewise in Germany, over 50% of the money comes from banks, and slightly less than 10% comes from the German government.¹⁷⁰

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

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

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

169. *See id.*

170. Black & Gilson, *supra* note 20, at 251.

171. *Id.* at 269.

172. Milhaupt, *supra* note 16, at 877.

173. Sibbitt, *supra* note 5, at 105.

174. *See supra* Part II.B.2.

175. Black & Gilson, *supra* note 20, at 251.

176. Roe, *supra* note 59, at 1931 (noting that "[i]nstitutional ownership discourages entrepreneurial leadership").

177. Milhaupt, *supra* note 16, at 881.

178. Black & Gilson, *supra* note 20, at 250.

179. Milhaupt, *supra* note 16, at 882; *see also* Sibbitt, *supra* note 5, at 62.

180. A notable example is Softbank, founded by Masayoshi Son, considered by many in

Government regulations also discourage investment in venture capital funds.¹⁸² For example, out of the desire to prevent the reemergence of family-controlled conglomerates¹⁸³ that dominated the Japanese economy before World War II, the Japanese Anti-Monopoly Law was enacted after the war, prohibiting the formation of holding companies.¹⁸⁴ In order to avoid being classified as a holding company, a venture fund must limit stock ownership in its portfolio companies.¹⁸⁵ Such legal restrictions are one reason venture capital firms in Japan have taken significantly lower equity stakes in their portfolio companies than their U.S. counterparts.¹⁸⁶ Until recently, venture capitalists also could not play a direct role in the management of their portfolio companies.¹⁸⁷

Additionally, stock options, so crucial to the growth of startups in the United States because of the upside incentives they provide to management and employees alike, have not been a useful tool in Germany and Japan.¹⁸⁸ Existing Japanese law makes "the issuance of stock options so cumbersome as to be practically unworkable."¹⁸⁹ Without stock options to compensate for the risk managers take by joining a startup, it becomes difficult to attract top talent.¹⁹⁰ Similarly, in Germany there were numerous legal restrictions on the issuance of stock options until

Japan to be an iconoclast for his daring entrepreneurialism, who, perhaps not coincidentally, was educated at the University of California at Berkeley. See *The Internet's Financier* [sic], TIME DIGITAL 50, at <http://www.time.com/time/digital/digital50/21.html> (last visited Feb. 26, 2001); see also Robert A. Guth, *The Rainmaker, Masayoshi Son's Role As Internet Kingpin In Japan Is Shrinking*, WALL ST. J., Mar. 29, 2001, at A1.

181. See Lark Park, *Venturing Around the World*, INDUSTRY STANDARD, Nov. 20, 2000, at 142.

182. See Milhaupt, *supra* note 16, at 889.

183. These conglomerates, known as *zaibatsu*, engaged in monopolistic practices. *Id.*

184. *Id.*

185. *Id.* at 890.

186. Sibbitt, *supra* note 5, at 93. Another reason is that because of the bank-centered financial system, both Germany and Japan have historically favored debt financing over equity. See Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 85, 89 (1995). Japanese companies borrow \$5.33 from banks for every dollar they raise in the capital markets, German companies borrow \$4.20, and U.S. companies borrow only \$0.85. See *id.*

187. Milhaupt, *supra* note 16, at 890.

188. *Id.*

189. *Id.*

190. See *id.* at 891-92.

May 1, 1998, when the Stock Corporations Act was amended¹⁹¹ to allow employee and management stock options, but only with shareholder approval.¹⁹²

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

Exit from an investment in a portfolio company is crucial to the success of venture capital.¹⁹³ The most frequently used method of exit in the United States is the IPO.¹⁹⁴ In both Germany and Japan, such an exit is rarely available.¹⁹⁵ Government regulations have stifled growth of a public equity market, which in turn has resulted in a lack of liquidity for venture capitalists.¹⁹⁶

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

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

191. Jeffrey N. Gordon, *Corporate Governance: Pathways to Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219, 236 (1999).

192. § 192(1)(3) Aktiengesetz (Stock Corporation Law).

193. Milhaupt, *supra* note 16, at 883; see discussion *supra* Part II.B.4.

194. See discussion *supra* Part II.B.4.

195. Milhaupt, *supra* note 16, at 883.

196. *Id.* at 884.

197. *Id.* at 883.

198. *Id.* at 884. Contrast this with the United States, where the NASDAQ does not impose profitability requirements for a company to be listed. Kelly, *supra* note 152, at C19.

199. Milhaupt, *supra* note 16, at 884.

200. Sibbitt, *supra* note 5, at 62.

201. *Id.*

almost thirty years to reap the benefits of one's investment hardly provides an incentive to invest in a venture fund.

Incredible as it may seem, from 1992 to 1995, the MOF administered a queue for IPOs, limiting them to five per week.²⁰² This quota system resulted in a backlog of over 120 companies waiting for regulatory approval,²⁰³ and in part accounts for the huge disparity between the average 637 listings per year on the NASDAQ market and the forty-four listings per year on the Japanese OTC market.²⁰⁴

The German stock markets are notoriously illiquid; exits through the stock market are largely unavailable.²⁰⁵ IPOs historically have been rare in Germany.²⁰⁶ For example, there were only ten IPOs in all of 1994.²⁰⁷ Additionally, out of the twelve IPOs in 1995, only one was on the German stock market; the rest were on overseas markets.²⁰⁸ Obviously, venture capitalists do not perceive the German stock market as providing a viable means of exit.²⁰⁹ Commentators, including the German government, attribute this lack of breadth of the German stock market to the bank-dominated financial system, which hinders the development of a shareholder culture.²¹⁰ Given the dominance of banks over corporate financing, there has been no urgent need to develop other sources of funding, such as through the stock market.²¹¹

2. Inadequate Disclosure Laws and Lack of Enforcement Undermine Investor Confidence

The most critical factor in the success of the U.S. stock market is securities regulation and the principle of full disclosure.²¹² Inadequate disclosure requirements and enforcement in Germany and Japan have led to investors' lack of

202. *Id.* at 67.

203. *Id.*

204. *Id.*

205. Black & Gilson, *supra* note 20, at 251.

206. See Gordon, *supra* note 191, at 220.

207. *Id.* at 220.

208. Black & Gilson, *supra* note 20, at 251.

209. See Gordon, *supra* note 191, at 220.

210. *Id.*

211. See *id.*

212. Fox, *supra* note 113, at 113 n.1.

confidence in the German and Japanese stock markets.²¹³ "Japan has a securities statute that closely parallels the Securities and Exchange Act of the United States."²¹⁴ Enforcement of the statute, however, is virtually nonexistent as regulators emphasize "de facto screening" of issuers rather than full disclosure.²¹⁵

In the last four decades, the MOF engaged in virtually no formal market monitoring or enforcement activity.²¹⁶ For example, securities fraud and insider trading regulations, though long in existence, have not been enforced.²¹⁷ An atmosphere of distrust prevails as financial corruption scandals (involving those at the highest levels of government) surfaced, to which regulators turned a blind eye.²¹⁸

In Germany, disclosure rules of publicly traded companies are not nearly as comprehensive as those in the United States.²¹⁹ For example, the scope of disclosure for issuance of stock options is primarily at the discretion of management,²²⁰ which means a company can choose not to disclose material financial information about itself. Germany also did not have any law banning insider trading until 1994, when it was forced to respond to the European Commission's infringement proceedings.²²¹ The Neuer Markt, the German equivalent of the NASDAQ, resisted tightening regulations until recently, when investors demanded changes amidst allegations of trading irregularities, insolvency, and unanticipated earnings announcements.²²² This lack of transparency leaves investors in the dark about corporate

213. See, e.g., Lily H. Li, *World Watch: Europe*, WALL ST. J., Nov. 27, 2000, at A25 (reporting that a series of incidents on Germany's *Neur Markt* "rocked investor confidence.").

214. Fox, *supra* note 113, at 113 n.1.

215. *Id.*

216. Milhaupt, *supra* note 25, at 60.

217. Sibbitt, *supra* note 5, at 89.

218. See, e.g., *id.* at 90 (describing the "Recruit" Scandal of 1989, where shares of unlisted companies were sold to associates of then Prime Minister Noboru Takeshita, Finance Minister Kiichi Miyazawa (who later became Prime Minister), and former Prime Minister Yasuhiro Nakasone). Immediately after the companies went public, recipients of these shares sold them for four times more than the original cost. *Id.*

219. Gordon, *supra* note 191, at 236.

220. *Id.*

221. See Ursula C. Pfeil, Comment, *Finanzplatz Deutschland: Germany Enacts Insider Trading Legislation*, 11 AM. U. J. INT'L L. & POL'Y 137, 137 (1996).

222. Li, *supra* note 213, at A25.

governance²²³ and has caused investors to place less value on financial disclosures, even when such disclosures are made.²²⁴

Ultimately, the result of the German and Japanese bank-centered governance system is that the institutional structure and legal framework needed to support venture capital investments are either not available or underdeveloped in both countries.²²⁵ Conversely, the laws that do exist in both countries operate to hinder the development of venture capital funds.

D. The Role of Culture

Japan's cautious culture also handicaps the development of an active venture capital market.²²⁶ Historically, Japanese society has imposed and rewarded group conformity over individualism.²²⁷ "A Confucian moral order mitigates self interest and opportunism."²²⁸ Children learn from an early age to heed the teachings exemplified by the Japanese proverb, "the nail that sticks up gets hammered down" (*deru kui ga uttareru*).²²⁹ With individual creativity and individualism thus stifled, entrepreneurial spirit is hampered.²³⁰ One recent study found, not surprisingly, that when Americans and Japanese were asked whether starting a business was a respectful occupation, 91% of Americans said yes, whereas a meager 8% of Japanese agreed.²³¹

Because conformity is prized, iconoclastic behavior becomes more costly, which renders individual risk-taking even more difficult.²³² Not surprisingly, a culture of risk-aversity pervades Japanese society.²³³ This cultural trait, when translated to the financial arena, means that Japanese investors prefer to play it safe.²³⁴ Not only do they keep an "inordinately large" amount of

223. Gordon, *supra* note 191, at 236.

224. See Alford et al., *supra* note 122, at 204 (citing the results of a statistical study showing that investors considered U.S. financial disclosures to be more relevant than those required by German stock exchanges).

225. Milhaupt, *supra* note 16, at 869.

226. *Id.* at 894.

227. See Sibbitt, *supra* note 5, at 70, 77, 81.

228. Milhaupt, *supra* note 25, at 6.

229. Sibbitt, *supra* note 5, at 81.

230. See *id.* at 77-78.

231. Evelyn Iritani, *Japan Giving Its Start-Ups a U.S. Education, With Limited Success*, L.A. TIMES, Sept. 10, 2000, at C1.

232. Sibbitt, *supra* note 5, at 82.

233. See *id.* at 84.

234. See *id.*

capital in safer investments such as bank deposits, but they also invest less in stocks and bonds than the average American.²³⁵ Therefore, it is not a coincidence that even though Japanese personal financial assets exceed \$10 trillion, there are no angel investors in Japan,²³⁶ and virtually no seed stage venture capital funding.²³⁷ Also, venture capital funding tends to focus on mature industries, which are less risky.²³⁸

Additionally, while the United States has historically been "anti-big" (big banks or big corporations),²³⁹ "[a] populist, anti-bank ethos is historically absent in Japan."²⁴⁰ This is partly due to the futility of such opinions because Japan did not become a democracy until after World War II.²⁴¹ Likewise, in Germany, though dominance by German banks in its economic landscape is paramount, populist anti-bank sentiments have never been as fervent as in the United States.²⁴² "Germany has never known anything like the fear and resentment that monopoly used to arouse in the United States."²⁴³ Partly due to the existence of codetermination, where employees have significant representation as board members of the largest corporations, interest groups are given a voice in corporate governance by law,²⁴⁴ thereby obviating much of the populist angst.²⁴⁵ Without the need to rail against the big and the mighty, would-be entrepreneurs in Germany and Japan are deprived of the impetus to strike out and challenge the establishment by pursuing alternative paths.²⁴⁶

235. *Id.* at 84.

236. An angel investor is an individual who provides initial financing to a startup. See *Venture Capital Basics*, *supra* note 19, at 5.

237. Milhaupt, *supra* note 16, at 877.

238. *Id.* at 894.

239. Some have commented that this anti-big posture has provided the genesis for entrepreneurialism in the United States. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 258, 279 (1994).

240. Roe, *supra* note 59, at 1976.

241. *Id.*

242. *Id.* at 1969.

243. HENRY C. WALLICH, *MAINSPRINGS OF THE GERMAN REVIVAL* 136 (1955).

244. See Roe, *supra* note 59, at 1970. German law requires an equal number of shareholder and worker representatives on a company's supervisory board. David Wessel, *U.S. v. Them, American Economy Offers a Model Others Both Envy and Fear*, *WALL ST. J.*, Jan. 18, 2001, at A1.

245. See Roe, *supra* note 59, at 1970.

246. See ROE, *supra* note 239, at 279.

The combination of social, economic, and cultural forces led to deep-rooted bank dominance of venture capital investment over individual investment in both Germany and Japan, and the related legal framework contributes to the lackluster stock markets.²⁴⁷ Because banks are not very effective in performing the venture capital role,²⁴⁸ both countries have failed to develop a strong venture capital industry as a result.

IV. PROPOSALS FOR A UNIQUE CHINESE MODEL

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

A. *The Present Institutional Structure in China*

Since the founding of the People's Republic of China in 1949, the Chinese economy has operated under a central planning model borrowed from the Soviet Union.²⁴⁹ The twin pillars of the Soviet socialist model were central planning and state ownership.²⁵⁰ Unlike the economies of the United States, Germany, and Japan that function under the free market system, control of the Chinese economy is solely vested in the hands of the central government, which drafts five-year plans guiding China's economic growth.²⁵¹ Until recently, private ownership of companies was outlawed in favor of exclusive state ownership.²⁵²

247. See Gordon, *supra* note 191, at 220.

248. *Id.* at 220–21.

249. See generally Lan Cao, *The Cat That Catches Mice: China's Challenge to the Dominant Privatization Model*, 21 BROOK. J. INT'L L. 97, 108–09 (1995).

250. See Zongling Shen & Jianbo Lou, *The Contemporary Socialist Market Economy and the Law of the People's Republic of China*, in FINANCIAL REGULATION IN THE GREATER CHINA AREA: MAINLAND CHINA, TAIWAN AND HONG KONG SAR 5 (Joseph L. Norton et al. eds., 2000).

251. See *id.* at 3–5.

252. The recent amendment to China's Constitution finally recognized private ownership and elevated the status of private economy from "complement to the socialist public economy" to "an important component of the socialist market economy." Compare XIANFA art. 11 (1993), translated in Lehman, Lee & Xu, *Constitution of the People's Republic of China—1993*, <http://www.chinalaw.cc/lib/general/01.htm> (last visited

Therefore, China does not have a market-centered corporate governance system like the United States, and to the extent it has a governance system at all, the role of the Chinese government is somewhat analogous to that of the central banks in Germany and Japan.²⁵³

By the end of the Chinese Cultural Revolution (1966–1976), with the opening of China to the West, the realization struck many inside China that the rigid socialist economic model had only led to the stagnation of the Chinese economy.²⁵⁴ In 1979, during a tour of the southern province of Guangdong, Paramount Leader Deng Xiaoping made the historic pronouncement that presaged the waning of the socialist dogma and the dawning of a Western-style, market-driven economy.²⁵⁵ Discussing the pros and cons of a socialist versus a capitalist system, Deng famously said: “black cat or white cat, it’s a good cat if it catches mice.”²⁵⁶ Deng’s comments buoyed the spirits of the Chinese people (who began to pursue dreams of wealth for the first time since 1949) and ushered in an era of unprecedented economic growth in China.²⁵⁷

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

1. The Omnipotent Role of the Chinese Government

In spite of the flourishing of private enterprise in the last two decades, the Chinese economy remains largely state-owned and centralized.²⁵⁸ The state sector still accounts for one-third of industrial output, over one-half of total assets, and two-thirds of

Mar. 1, 2001), with XIANFA art. 11, (amended by art. 16 on Mar. 15, 1999), translated in Constance A. Johnson, *People’s Republic of CHINA*, in CHINA: CONSTITUTIONS OF THE COUNTRIES OF THE WORLD 2 (Gisbert H. Flanz ed., Supp. 1999).

253. See *supra* Part III.A. (discussing the role of German and Japanese banks in their economies and venture capital markets).

254. See XIANFA art. 11 (amended Mar. 15, 1999).

255. See Cao, *supra* note 249, at 108 n.16.

256. *Id.*

257. China’s Gross Domestic Product grew an average of 9% annually from 1978 to 1994. See Robert A. Kapp (President, United States-China Business Council), Testimony Before the Senate Foreign Relations Committee, in FED. NEWS SERV., June 6, 1996, LEXIS, World Library, Allwld File. China’s economy is ranked by the International Monetary Fund as the third largest in the world, behind the United States and Japan. *Id.*

258. See World Bank Report No. 16265-CHA, *China’s Management of Enterprise Assets: The State as Shareholder*, June 5, 1999, at 9 (on file with the Loyola of Los Angeles International and Comparative Law Review).

investment.²⁵⁹ The government controls every sector of the economy, from banking to telecommunications,²⁶⁰ from agriculture to infrastructure construction.²⁶¹

Moreover, the government restricts the percentage of foreign ownership in certain industrial sectors.²⁶² For example, foreign investment in telecommunications projects are limited to less than 50%, and to 70% in medical facilities and retailing.²⁶³ These seemingly arbitrary restrictions undoubtedly hamper the development of a venture capital industry.²⁶⁴ By limiting the shareholding of some of the most profitable areas of investment, the government has created a less than favorable investment climate for venture capitalists.²⁶⁵

2. The State of Securities Regulation

The Chinese leadership's deep ambivalence over the direction of the Chinese economy is most vividly illustrated by the government's regulation of the Chinese securities industry.²⁶⁶ On one hand, China clearly sees the benefits of attracting foreign capital via a growing securities market.²⁶⁷ On the other hand, "the mentality associated with traditional central planning persists, and tight government control continues with a goal of striving to maintain the dominance of state ownership."²⁶⁸ Thus, the resulting securities laws are a hodgepodge of Western free-market tenets, mixed with principles of state control.²⁶⁹ Whether this

259. *Id.*

260. "The People's Bank of China is the central bank of the People's Republic of China. The People's Bank of China shall, under the leadership of the State Council, formulate and implement monetary policies and exercise supervision and control over the banking industry." I.A. TOKLEY & TINA RAVN, *BANKING LAW IN CHINA* 55 (1997) (citing Law of the People's Republic of China on the People's Bank of China, art. 2 (1995)).

261. *See Enter at Your Own Risk*, *supra* note 10.

262. *See id.*

263. *See id.*

264. *Id.*

265. *See id.*

266. *See Jay Zhe Zhang*, Comment, *Securities Markets and Securities Regulations in China*, 22 N.C. J. INT'L L. & COM. REG. 557, 560 (1997).

267. *See id.* at 620.

268. *Id.*

269. *See 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, 988, 1013 (1999).

framework is suitable to the development of a healthy venture capital industry is dubious.

a. The Development of the Securities Market in China

In the last decade, China has developed an active securities market, though China does not yet have its equivalent of a NASDAQ market.²⁷⁰ Since the founding of the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991, the Chinese securities industry as a whole has emerged as a fairly large and integrated system in a short time.²⁷¹ Ironically, the Chinese government provided the impetus for a securities market, for "the fundamental function of the Chinese securities market has been to serve the economic goal of the state by extricating the government from continuing to subsidize the deeply troubled state owned enterprises (SOEs)."²⁷² As such, unlike the United States, Germany, and Japan, where the sole purpose of securities markets is to provide an efficient exchange mechanism for shareholders, the development of securities regulation in China has evolved around the protection of state interests rather than shareholder interests.²⁷³

b. The Regulatory Framework

The Chinese government has tightly controlled the securities market since its inception.²⁷⁴ Initially, the People's Bank of China was designated by the central government as the securities market authority.²⁷⁵ In 1993, the State Council Securities Regulatory Commission (SCRC) was established, and replaced the People's Bank of China as the regulatory authority.²⁷⁶

On December 29, 1998, the Standing Committee of the National People's Congress adopted China's long-awaited formal securities legislation, the Securities Law of the People's Republic of China (Securities Law).²⁷⁷ The Securities Law, which became

270. See Zhang, *supra* note 266, at 563.

271. See *id.* at 559.

272. Zhang, *supra* note 269, at 985.

273. See *id.* at 988 (commenting that the security markets in China have the "effect and purposes . . . to preserve and enhance the socialist order").

274. *Id.* at 985.

275. Zhang, *supra* note 266, at 561.

276. *Id.* at 562.

277. See Zhang, *supra* note 269, at 983.

effective on July 1, 1999, was in the drafting stage for six-and-a-half years.²⁷⁸ Prior to its passage, China had no comprehensive national securities law.²⁷⁹ Instead, the laws and regulations governing issuance and trading of securities were found in two separate pieces of legislation: the China Company Law (Company Law)²⁸⁰ and the Provisional Regulations on Stock Issuing and Trading of 1993 (Provisional Regulations).²⁸¹

i. The Company Law

The Company Law, promulgated by the Standing Committee of the Eighth National People's Congress on December 29, 1993, and effective on July 1, 1994, provides a general framework for the establishment of shareholder-owned companies.²⁸² The government's motive of protecting state interests is amply demonstrated by the divided share trading structure.²⁸³ Stocks in a company may be offered in several share categories, each representing a different form of shareholding.²⁸⁴ In practice, four share types are the most prevalent: A, B, H, and N.²⁸⁵ The A shares are denominated in renminbi (RMB)²⁸⁶ and subscribed to by individual domestic investors. A shares trade on the domestic Shanghai and Shenzhen stock exchanges.²⁸⁷ The A shares are further divided into shares held by the state, such as an administrative agency, state-owned firms, and individual shareholders.²⁸⁸ Transfer of state shares are only allowed by approval from the particular government entity involved.²⁸⁹ In contrast, B shares are also traded on the two exchanges but are

278. *Id.*

279. *See id.*

280. Zhang, *supra* note 269, at 984–85.

281. The Securities Law codified the relevant provisions of Company Law and Provisional Regulations. *See id.* at 985.

282. Zhang, *supra* note 266, at 560. The Company Law permits the establishment of two types of companies: joint stock company and limited liability company. I.A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA 5 (1998). This Comment addresses the joint stock company only.

283. *See* Zhang, *supra* note 269, at 987.

284. Zhang, *supra* note 266, at 570.

285. *Id.* at 571.

286. RMB is China's official currency, also known as yuan. TOKLEY & RAVN, *supra* note 260, at 57.

287. *See* Zhang, *supra* note 266, at 571.

288. *Id.* at 570.

289. *See id.*

reserved solely for foreign investors.²⁹⁰ Additionally, *B* shares are traded in U.S. dollars on the Shanghai Stock Exchange, and in Hong Kong dollars on the Shenzhen stock exchange.²⁹¹

To attract foreign investment, the Chinese government encourages state-owned Chinese companies to issue shares directly on international markets.²⁹² Consequently, *H* and *N* shares were created, and are held only by foreign investors.²⁹³ *H* shares are listed on the Hong Kong Stock Exchange, and *N* shares are listed on the New York Stock Exchange.²⁹⁴

Even though *A* and *B* shareholders ostensibly have the same rights, the de facto inequity is obvious, given "the unequal access to information, unequal liquidity, unequal prices, and unequal formalities of transfer."²⁹⁵ In essence, the trading of domestic *A* shares is limited to shares owned by private investors, which represents only 20% of total common stock issued.²⁹⁶

Such a share trading structure has dire implications for a venture capital industry. If a domestic venture capital fund invests in a domestic Chinese startup, the fund's only avenue of exit would be listing on either the Shanghai or Shenzhen Stock Exchange and issuing *A* shares.²⁹⁷ This option severely limits the available market for the shares, and thus most likely will restrict the stock's upside potential.

On the other hand, if a foreign venture capital fund invests in a domestic startup, it is faced with a similar dilemma. Other than going through the expensive and time consuming process of listing on an overseas stock exchange such as the New York Stock Exchange, with its attendant regulatory requirements, the only viable option is to issue *B* shares on a domestic stock exchange. This option automatically renders the stock off limits to all Chinese citizens, not exactly the outcome any venture capitalist would desire.

290. *Id.* at 571.

291. *See id.*

292. *Id.*

293. *See id.*

294. *See id.*

295. Zhang, *supra* note 269, at 987.

296. *Id.* at 989.

297. *See id.*

ii. Provisional Regulations

In addition to the Company Law, the State Council also promulgated Provisional Regulations in May 1993.²⁹⁸ These regulations apply to “any issuance and trading of securities and other related activities” within China (i.e., A shares).²⁹⁹ Among the conditions that must be met for listing on the two exchanges, the company must have paid-in registered capital of RMB ten million,³⁰⁰ and after-issue capitalization of at least RMB fifty million.³⁰¹ In addition, the company must have been profitable for at least three years.³⁰² These requirements favor state owned companies and eliminate all but the largest private enterprises from having access to securities markets.³⁰³ “It is not surprising that almost all the listed companies are transformed from SOEs.”³⁰⁴

The clearest indication of a government that is struggling to reconcile its socialist ideology with a stock market derived purely from capitalism is the quota system that has existed since the inception of the Chinese securities market.³⁰⁵ The central government sets a fixed amount of stock to be issued during the year and allocates the quota to provincial governments, which in turn allocate the quota among companies under their control.³⁰⁶ Without a quota, a company cannot issue shares to the public.³⁰⁷

This scheme is stunningly similar to that used by the MOF in Japan, with the same detrimental results.³⁰⁸ Quotas are a major barrier to companies entering the stock market.³⁰⁹ The quota system essentially replaces the supply and demand mechanism of a free market, thus depriving the market of efficient allocation of resources.³¹⁰ From a venture capital perspective, the effects are

298. Zhang, *supra* note 266, at 569.

299. *See id.*

300. TOKLEY & RAVN, *supra* note 282, at 147.

301. After-issue capitalization is the total value of issued stock. Zhang, *supra* note 266, at 574.

302. *Id.* at 572.

303. *See* Zhang, *supra* note 269, at 987.

304. *Id.* at 986.

305. *See* Zhang, *supra* note 266, at 624.

306. *Id.* at 572.

307. *Id.* at 572–73.

308. *See supra* Part III.C.1.

309. *See* Zhang, *supra* note 266, at 624.

310. *Id.* at 624–25.

chilling because the quota system drastically impacts the liquidity of the market by limiting the total stock offered at any given time.³¹¹ Instead of being able to go public according to its own timetable and market conditions, a company would have to wait for a quota allocation, thereby very possibly missing its window of opportunity in the marketplace altogether.

iii. Securities Law

The recently enacted Securities Law makes explicit any listed company's legal duty of continuous disclosure.³¹² A listed company is required to file an unaudited half-year report, and an audited annual report with CSRC and the exchange.³¹³ In addition, Article 62 requires a company to file and publish a special report when any major event occurs that may have an impact on the price of its stock but of which the public is not aware.³¹⁴ Moreover, Article 59 clearly states that a listed company is responsible for the truthfulness, accuracy, and completeness of its issuing and listing documents and shall ensure there is no false record, misleading statement, or significant omission.³¹⁵

Because the hallmark of securities law is disclosure,³¹⁶ these disclosure requirements appear to be a step in the right direction in protecting investors. Experiences in the last decade, however, tell a far different story. To begin, proper disclosure is enabled by accounting rules.³¹⁷ For example, as discussed in Part II, in the United States, publicly-traded companies must file quarterly (10-Q) and annual (10-K) reports with the SEC.³¹⁸ These reports must be prepared in accordance with GAAP, a formidable body of accounting rules that form the foundation of financial statement preparation by U.S. companies,³¹⁹ whether or not publicly-traded.

311. *Id.* at 625.

312. Zhang, *supra* note 269, at 993; Securities Law art. 60 (1998), available at http://www.chinaonline.com/refer/legal/Mmeyer_laws/pdf/pdf_e/securitylaw_a4.pdf.

313. Securities Law art. 60; Zhang, *supra* note 269, at 994.

314. Securities Law art. 62; Zhang, *supra* note 269, at 994.

315. Securities Law art. 59; Zhang, *supra* note 269, at 994.

316. *See supra* Part II.B.4.

317. *See* Karmel, *supra* note 100, at 962. *See generally* Sherbet, *supra* note 116, at 894 (discussing the role of the U.S. accounting standards in U.S. securities regulation).

318. *See* discussion *supra* Part II.B.3.

319. *See supra* notes 118–20 and accompanying text (discussing U.S. GAAP).

In contrast, accounting regulations in China are in their infancy.³²⁰ The General Accounting Law was adopted by the National People's Congress in January 1985, but was not widely followed until amended in December 1993.³²¹ The law is applicable to government agencies, state-owned enterprises, and institutions only.³²² Laws regarding accounting for private enterprises only became effective in July 1993, when the State Council approved the Standards of Conduct of Enterprise Accounting.³²³ The law provides that companies shall adopt the credit and debit (double entry) accounting method and maintain a book of accounts.³²⁴ The law also endorsed the principle of income and expense matching, one of the fundamental concepts of GAAP.³²⁵

Other than these rudimentary requirements, the accounting laws provide little guidance in terms of the types of financial statements to be prepared,³²⁶ the extent of disclosure, and the timing of revenue and expense recognition. As a result, practices differ widely from U.S. standards,³²⁷ which significantly decreases the reliance value of the financial statements.³²⁸ Furthermore, inadequate financial statement disclosure leads to lack of transparency, limits investor access to information, and affects the quality of information available—all of which do not bolster a venture capitalist's confidence in the stock market.³²⁹

320. See Martindale-Hubbell, *People's Republic of China Law Digest: Accounting* (2000), LEXIS, Marhub Library, ASDIG File.

321. *Id.*

322. *Id.*

323. *Id.*

324. *Id.* arts. 4, 16.

325. See *id.* art. 17.

326. See *supra* Part II.B.3 (noting that in the United States, per FASB guidelines, financial statements include, at a minimum, an income statement, a balance sheet, and a statement of cash flows).

327. See *Enter at Your Own Risk*, *supra* note 10.

328. Even these rudimentary requirements are not always followed, leading many in the investment community to question whether the numbers are really what they represent. See Mark Magnier, *China's Stock Market on Bumpy Road*, L.A. TIMES, Jan. 9, 2000, at C1.

329. Indeed, the investment environment is so fraught with peril, "marked by insider trading, funny numbers, one-eyed regulators" that some have likened it to horse racing or mah-jong. *Id.*

iv. Weak Regulatory Enforcement

No matter how complete rules and regulations governing the stock markets are, they are rendered toothless without enforcement. In this regard, the lack of regulatory enforcement by the Chinese government echoes that of Germany and Japan and is similarly detrimental to the growth of venture capital.³³⁰

Even though China has adopted securities regulations, enforcement is ineffective.³³¹ Violations are prevalent as regulators are stuck in a perpetual state of paralysis because of bureaucratic infighting.³³² For example, many listed companies failed to submit financial reports to the China Securities Regulatory Commission (CSRC), the executive arm of the SCRC,³³³ and no sanctions were levied by the CSRC.³³⁴ Just like in Germany and Japan, where regulators have failed to enforce the rules, this inadequate regulation of the securities market in China has also led to loss of investor confidence and hinders investment in the market.³³⁵

c. Other Significant Barriers

Apart from the existence of administrative stock market regulations that primarily function to serve the interests of the government, a myriad of other laws also present obstacles to the growth a healthy venture capital industry in China. To begin, unlike the United States, China does not recognize a limited partnership.³³⁶ A venture capital fund, organized as a partnership, is subject to double taxation,³³⁷ which provides a disincentive to venture capital investors. Foreign investors are particularly disadvantaged, as there is no assurance of the consistent

330. Compare *supra* Part II.B.4 (discussing SEC enforcement of securities regulations) with *supra* Part III.C.2 (discussing German and Japanese regulators' lack of enforcement).

331. See Zhang, *supra* note 266, at 626, 627-28.

332. See *id.*

333. See *id.* at 627-28 (explaining that even though the CRSC is the equivalent of the U.S. SEC, its supervisory and regulatory powers are much more limited because securities regulation is also controlled by various other governmental entities at both local and national levels).

334. See, e.g., Sophie Roell, *Survey—China 1996: The Watchdogs Bark*, FIN. TIMES (London), June 27, 1996, LEXIS, News Library, Fintme File.

335. See Zhang, *supra* note 266, at 629.

336. TOKLEY & RAVN, *supra* note 282, at 3.

337. See *Enter at Your Own Risk*, *supra* note 10; see also *supra* note 46 and accompanying text (providing an explanation of double taxation).

application of tax laws and adherence to international tax treaties.³³⁸

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

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

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

338. See *Enter at Your Own Risk*, *supra* note 10.

339. Compare discussion *supra* Part IV.B.2 (regarding China) with *supra* Part II (regarding the United States) and *supra* Part III (regarding Germany and Japan).

340. Absent an IPO, the only other option available to U.S. investors is the sale of the company to another entity—not a viable means of exit in China due to the operations of the Company Law. See Zhang, *supra* note 266, at 568. An in-depth discussion of the Company Law provisions governing the formation of a private enterprise in China is beyond the scope of this Comment.

341. See *Enter at Your Own Risk*, *supra* note 10.

342. See *id.*

343. See *supra* Part III.B.

344. See *id.*

345. See *Enter at Your Own Risk*, *supra* note 10.

industrial projects have long accounted for 50.4% of China's venture capital, while high-tech industries such as computers, electronics and biotechnology account for only 7.3%" as a direct result of the Chinese government's focus on infrastructure building in the last ten years.³⁴⁶

This investment pattern seems to suggest that the focus on venture capital can only be changed by a shift in the government's economic growth agenda. At a minimum, the reliance on government funding hinders the growth of private investment in venture capital.³⁴⁷ China's government-driven system has led some commentators to observe that "securities markets in China do not remove enterprises from state control, or promote capitalism in a Western sense. Their effect and purpose is to preserve and enhance the socialist order"³⁴⁸

C. The Role of Culture

Just as culture plays an important role in the success of the U.S. venture capital industry and the lack thereof in Germany and Japan,³⁴⁹ culture will inevitably be a major factor in the development of the Chinese venture capital market. In this regard, China shares similar traits with Japan, based on a common Confucian social philosophy that encourages conformity, obedience, and adherence to the status quo.³⁵⁰ Therefore, venture capital growth in China will be similarly adversely impacted.

Given the risk involved in venture capital,³⁵¹ those who are willing to invest must be risk-takers, and those who are willing to start a company from nothing must be innovative and resourceful.

346. *Id.*

347. See Roe, *supra* note 59, at 1955 (arguing that if U.S. banks had been allowed to invest in securities markets, as is the case in Germany and Japan, it would have led to a weak U.S. securities market).

348. Minkang Gu & Robert C. Art, *Securitization of State Ownership: Chinese Securities Law*, 18 MICH. J. INT'L L. 115, 125 (1996).

349. Compare *supra* Part II.C (discussing the role of U.S. culture in developing venture capital) with *supra* Part III.D (discussing the role of culture in Japanese and German venture capital industries).

350. See MICHAEL HARRIS BOND, *BEYOND THE CHINESE FACE: INSIGHTS FROM PSYCHOLOGY* 69-71 (1991).

351. See *Venture Capital Basics*, *supra* note 19, at 3 (citing research indicating that historically 15% to 20% of portfolio companies fail).

On both counts, China, like Japan, suffers from a culture that discourages risk taking and entrepreneurialism.³⁵²

Just as Japanese children are taught “*deru kui ga uttaretu*” (the nail that sticks up gets hammered down),³⁵³ Chinese children are familiar with the saying “*shuda zhaofeng*” (the bigger the tree, the more likely to be blown by the wind).³⁵⁴ So from an early age, “Chinese culture tends to suppress individual initiative and often tames the spirit of the most resourceful and superior individuals, rather than encouraging the sometimes erratic fire of creativity.”³⁵⁵ Thus, there is no history and tradition of venture capital in China, unlike the experience in the West.³⁵⁶

Additionally, Chinese culture fosters a fundamental distrust of outsiders with one’s own money.³⁵⁷ This is manifested by the prevalence of family-owned Chinese businesses, where direct family members or those related by marriage hold key positions, even though they may not be the most qualified people available.³⁵⁸ This inability to trust significantly affects the future of venture capital in China, as the would-be Chinese provider of capital to venture capital funds agonizes over the fate of his or her money once invested in a venture capital fund in the hands of “strangers,” and the Chinese venture capitalist entertains similar misgivings about whether a portfolio company’s management can be entrusted with the operations of the business.³⁵⁹

Finally, the concept of “face” and the crucial role it plays in Chinese society cannot be underestimated.³⁶⁰ “Having ‘face’ means you are viewed by your peers, superiors, and subordinates as one in harmony with the prevailing disposition of society; you’ve done nothing to violate conformity.”³⁶¹ Failure brings shame to oneself and one’s family and causes the ultimate loss of

352. BOND, *supra* note 350, at 24.

353. Sibbitt, *supra* note 5, at 81.

354. Author’s own translation.

355. CHIN-NING CHU, *THE ASIAN MIND GAME: UNLOCKING THE HIDDEN AGENDA OF THE ASIAN BUSINESS CULTURE—A WESTERNER’S SURVIVAL MANUAL* 190 (1991).

356. For a brief history of venture capital in Europe, see Milhaupt, *supra* note 16, at 865.

357. See BOND, *supra* note 350, at 75.

358. *Id.* at 76.

359. See *id.* at 75.

360. ARNE J. DE KEIJZER, *CHINA: BUSINESS STRATEGIES FOR THE ’90s* 216 (1992).

361. *Id.*

face.³⁶² From this perspective, the inherent riskiness of venture capital is incompatible with the Chinese cultural mindset.

V. RECOMMENDATIONS

The lessons of venture capital development in the United States, Germany, and Japan are clear: a market-oriented corporate governance system is far more able to facilitate the growth of venture capital than a bank-centered one. Further, a country seeking to develop a robust venture capital market must have laws in place to nurture a stock market and ensure a healthy investment environment. China's centralized institutional structure and government-dominated governance system suffer from similar shortcomings as do Germany and Japan. Because the Chinese government is not likely to give up control of the economy altogether in favor of supply and demand created by a free market, the present system is there to stay. Nevertheless, within this framework, China can adopt laws to align itself more with the successful U.S. venture capital model and less with Germany and Japan.

First, in order to encourage formation of venture capital funds, China should legally recognize limited partnerships and develop laws that specify the rights and obligations of the general partners and limited partners. It should also make changes in the tax law to eliminate double taxation and promote investment in limited partnerships. With such incentives, more investors may become interested in venture capital funds, and the industry's dependence on government funding would lessen.

Second, at the point of entry when the venture capital fund makes the initial investment in a portfolio company, China should draft venture capital contracting laws that govern the relationship between venture capitalists and management of portfolio companies. This would include comprehensive regulations regarding board representation, employee compensation, stock options, and restrictive covenants to protect the venture capitalists.

Third, in order to create a means of exit for venture capitalists, China should create a NASDAQ-type stock market and draft securities regulations designed to provide full disclosure.

362. See *id.*

The newly-adopted Securities Law is a step in the right direction but by no means sufficient.³⁶³ More complete accounting rules aimed at migration to international accounting standards would enormously facilitate disclosure of financial information. More importantly, China should abolish the tiered shareholding structure of A, B, H, and N shares, along with the much-maligned quota system for IPOs.

Finally, enforcement of securities laws must be addressed at the highest level of the Chinese government.³⁶⁴ China as a culture has not always enjoyed a tradition of adhering to the rule of law as have the United States, Germany, and Japan.³⁶⁵ As the Chinese proverb goes: “[t]he mountain is high; the Emperor is far away.”³⁶⁶ This saying implies that no matter what the rules are, the Chinese are inclined to do as they please “within their own sphere.”³⁶⁷ Given this cultural mindset, it is imperative that the Chinese government use the full power of its authority to enforce regulations and punish wrongdoers in order to show the public its commitment to the rule of law in the marketplace.

Fundamentally, the growth of a successful venture capital industry in China is possible only if the Chinese government is willing to develop and enforce a set of laws not only uniquely suited to the Chinese society, but also capable of moving the Chinese economy toward integration into the global marketplace. Moreover, as amply demonstrated by the experiences of the United States, Germany, and Japan, venture capital laws do not operate in a vacuum; the success of a venture capital industry depends on a country’s institutional framework.³⁶⁸ China must concurrently develop its financial markets, accounting system, and regulatory scheme, along with the promulgation of venture capital

363. See Zhang, *supra* note 269, at 990.

364. The new Securities Law went to enormous pains to consolidate regulatory power within the CRSC, which should eliminate the regulatory vacuum caused by bureaucratic infighting. See *id.* at 999.

365. KUI HUA WANG, CHINESE COMMERCIAL LAW 37–38 (2000) (commenting that law has no “special sanctity” in contemporary China and is relegated to the status of a “secondary authority”).

366. See CHU, *supra* note 355, at 193. Translated into Chinese, the saying is “*shangao huangdi yuan*” (author’s own translation).

367. *Id.*

368. See Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1606 (2000) (positing that in developing countries, the growth of complex institutions, such as legal, accounting, and securities regulatory systems, is interdependent).

law. As China prepares to join the World Trade Organization,³⁶⁹ these objectives take on new dimensions, with even deeper resonance, because their successful implementation will largely determine whether China is ultimately ready to become an indispensable player in the global economic community.

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369. See *China's Entry to WTO Runs Into Further Delays*, WALL ST. J., Jan. 18, 2001, at A21.

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