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지리학박사학위논문

Spatial Allocation Mechanism of Venture Capital Invested in China

- Role of the Regional Legal System -

중국 투자 벤처자본의 공간배치 메커니즘

- 지역 법제시스템의 역할을 중심으로 -

2017년 2월

서울대학교 대학원

지 리 학 과

김 소 미

Spatial Allocation Mechanism of Venture Capital

Invested in China

- Role of the Regional Legal System -

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이 논문을 지리학 박사학위논문으로 제출함

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Abstract

Spatial Allocation Mechanism of Venture Capital Invested in China

- Role of the Regional Legal System –

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Through the empirical research of venture capital investment in China from 1992 to 2012, this paper examines the mechanism of the regional legal systems' influence on geographical distribution of venture capital and further explores the implications of geography in the capital allocation process.

Four sub-questions and corresponding research issues were deduced from the above main research object and the research was conducted as follows, namely: (1) the study of the characteristics of venture capital spatial allocation patterns, (2) the interpretation of the reason and process of the venture capital spatial allocation phenomenon, (3) the mechanism of the regional legal systems' influence on venture capital spatial allocation, and (4) the implication of geography in the capital allocation process.

Three analysis tools, i.e., the correlation analysis, the qualitative interpretation of legal provisions, and game theory based analysis, were used

to discuss the above questions. The corresponding sub-conclusions can be summarized as follows.

Firstly, there are two features of the geographical patterns of venture capital spatial allocation, i.e., the geographical separation of business operation location vs legally registered addresses, and the capital cycle division being scattered into different locations. The phenomenon where the registration location is separated from the actual place of business operation appears in all stages of venture capital investment cycle, namely, fund raising, establishment, investment, and exit. And within the same investment cycle, these four stages are often allocated in different geographical locations. There are three patterns of the capital allocation. The first pattern is the 'head-tail outside pattern,' which dominated before 2000. In this pattern the fundraising, registration, and exiting locations are all located outside China, while only the investment activity remained within China. The second pattern is the 'mix location pattern,' which means venture capitalist chose to locate the stages in a mixed way according to specific objectives and cases. This pattern appeared most during 2001-2006. The third pattern, which dominated after 2007, is the 'all stage bake in situ pattern' where all stages returned to the registration location inside China.

Second, after confirming that legislation has a strong correlation with the above phenomenon by correlation analysis, the qualitative analysis of the legal provision reveals that extra costs caused by law is the fundamental cause for the above phenomenon. Specifically, there always exists a mismatch between regional economic and legislation signals, thus incurs an extra costs or benefit caused by law. To minimize the extra costs or obtain the extra benefit from the regional legal system, venture capitals take the advantage of the scope feature of law and the divisible feature of capital to split the venture investment cycle into parts and allocate it into different locations.

Third, the mechanism of legal impact on venture capital spatial allocation is virtually a game between the government and enterprises that choose different strategies as regards to law and location to maximize their own profits. The 'hidden costs' caused by the local legal system and the nature of pursuing maximized corporate income is the fundamental principle and trigger of the mechanism.

Fourth, there is a dual role of geography in the process of capital spatial allocation, i.e., the role of 'place' and 'space'.

In the process of legally influenced capital spatial allocation, when enterprise choose to change their legal status to bypass the law, the actual business operation location and the firm's registration location still remain within the region. This is because the extra benefits that it derives from the inherent attributes of the region are greater than the extra costs that are caused by the regional legal systems. The inherent attributes including the informal institutions - history, culture, customs, norms, moral, religious constrains of the region - as well as other attributes that are embedded in the region such as the external economic benefits and social networks are ones that the region may supply to the firm. In this case, the region is an irreplaceable 'place' for the firm.

On the contrary, when 'hidden costs' caused by law exceed the extra benefits provided by the inherent attributes of the region, the firm will separate the registration location from the actual business operation location for the sake of survival and development. The pro forma legal registration address will be placed in an indiscriminate 'space' that is concerned only with the location as a legal factor for the firm. In other words, in this case, the newly chosen location for the detached registration address is merely an indiscriminate legal space for the firm.

In short, the regional legal system affects the capital spatial allocation through a dual mechanism, that is, explicit regulations on economic behaviors and implicit influence on the comprehensive income of the firm. Geography has two implications in this dual mechanism: One, when the impact of the regional legal system on the activity and comprehensive income of the firm is less than the benefits it gains from the regional inheritance attributes, the region is an irreplaceable 'place' for the firm, Otherwise, the corresponding region will merely be an indiscriminate legal 'space'.

Keywords: capital spatial allocation mechanism, venture capital, hidden costs, regional legal system, space and place, game analysis

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Chapter 1 Introduction

1.1 Background and Research Objectives

1.1.1 Research Background

In 1996, the OECD published a report entitled “The Knowledge-based Economy.” Since then, the characteristics of the era, which is represented by the main means of production shifting from “land”, “capital”, and “labor” to “knowledge” as well as the driving force of the economy shifting from “production” to “innovation,” have been clearly defined by the concept of “knowledge-based economy.” The difference between “knowledge-based economy” and “traditional economy” lies in the fact that the main means of production is no longer the scarce resources, which were formerly monopolized by few individuals or groups; on the contrary, “knowledge” which serves as the main means of production in the new era can be produced, copied, disseminated infinitely and can be acquired even after someone has already acquired it. The trend implies that in the knowledge-based economy era, all those who have are willing to learn and have the courage to innovate will have much more opportunity to start their own business, challenge the traditional business giants, and become the new leaders in the world. The rise of the “.com” industry in the early 21st century,

and especially the success of google, apple, and facebook are the best examples of this trend. Inspired by these successful examples while being bolstered by the new trend, more and more venture companies will spring out, and the demand of the venture capitals (VC) , which specialize in fostering venture business will continue growing. In other words, the bursting number of venture companies and venture capitals will be one of the key features of the knowledge-based economy era.

In China, since the reform and opening-up policy launched in 1979, the economy experienced a steady growth, which lasted for more than 30 years. However, since 2011, compared to the rapid growth pace of the previous years, the economic growth rate dropped to below 10% with the fading advantages of demographic dividend and nature resources. Whereas the import and export of high-tech products, as well as the number of new start-ups and small and medium-sized enterprises, have been increasing steadily (Figure 1-1 and figure1-2). This trend clearly shows that the economic transition of China is imperative and it is possible to consider the high-tech industry and venture companies as one of the breakthrough points for transition. The newly proposed 13th five-year national development plan has clearly highlighted this issue while providing five key principles for the transition, namely, innovation, harmony, energy-saving, opening, and communion. Among these principles, “innovation” means the transition from

the secondary element input driving to all-element productivity driving, i.e. paying more attention to emerging high-tech industries. The big trend of the era, the imperative of China's transition, together with the support of government policy, clearly identify the arrival of the booming venture capital industry in China and its continuous existence during the knowledge-based economy era.

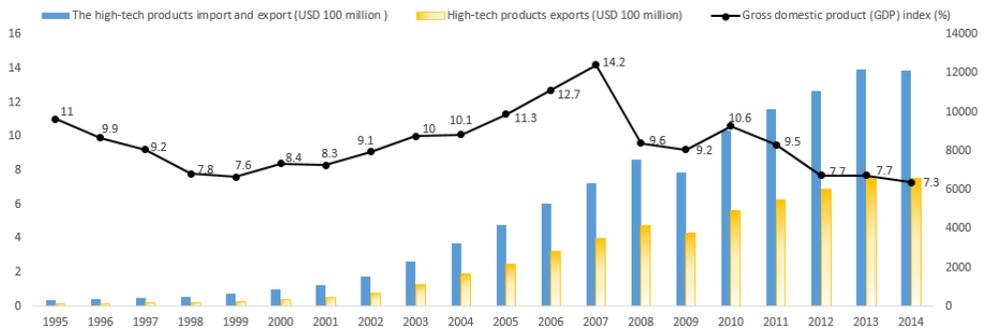


Figure 1-1 Economic Development and High-tech Trade Trend of China

Source of data: Public data of the National Bureau of Statistics

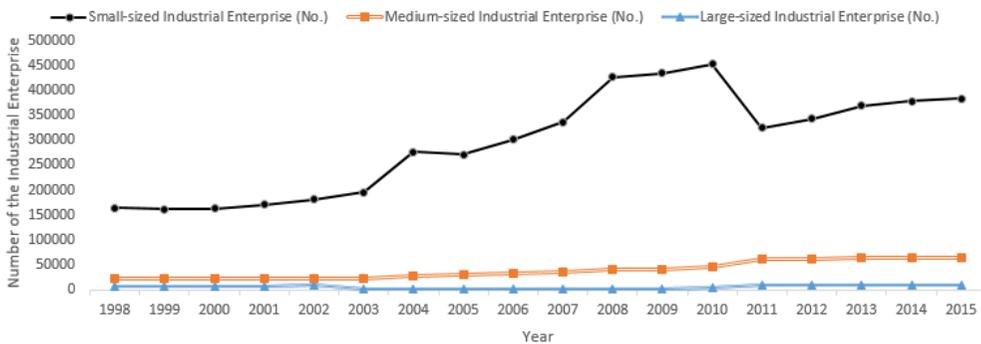


Figure 1-2 The increasing number of small and medium-sized industrial enterprises of China

Source of data: Public data of the National Bureau of Statistics

In fact, China began brewing and promoting the development of venture capital industry since 1984 by introducing series of policy measures¹. These policies facilitated the emergence of some venture capital enterprises²,

¹ For example, in 1984, the Science and Technology for Development Research Center of the State Science and Technology Commission(国家科学技术委员会) (renamed as the Ministry of Science and Technology Department(科技部) after 1998) conducted a “new technological revolution and China’s countermeasures (新的技术革命与我国的对策)” research project, and put forward a proposal of establishing venture investment mechanism to promote its high-tech industry’s development according to the findings. In March 1985, the Central Committee of the Communist Party of China(中共中央,CPC) and the State Council(国务院) published the “Decision on the Reform of Science and Technology System(关于科学技术体制改革的决定)”, and pointed out: “The mechanism of venture investment can be established and supported for high-tech development, which accompanies with rapid changes and high risks”. In September 1986, the National Science and Technology Commission put forward the strategy of developing the Chinese Venture Industry for the first time in the “China Science and Technology Guidelines-White Book of Science and Technology(中国科学技术指南-科学技术白皮书)”.

² For example, in September 1985, the State Science and Technology Commission along with the People’s Bank of China received the formal approval from the State Council to establish China’s first venture capital institution, China High-Tech Venture Investment Company, with the State Science and Technology Commission having 40% of its shares and the Ministry of Finance accounting for 23% of the shares. In June 1989, after receiving approval from the State Council and Ministry of Foreign Trade and Economic Cooperation, the Hong Kong China Merchants Group, the State Science and Technology Commission and the National Defense Commission jointly established the “China KZ High Technology co., Ltd” undertaking the mission to invest in domestic high-tech enterprises. This is one of the

science and technology incubators³, high-tech development zones⁴, as well as national science and technology development programs⁵. However, despite the effort made through these policies, the Chinese venture capital industry did not get on the right track until 2006(Figure 1-3).

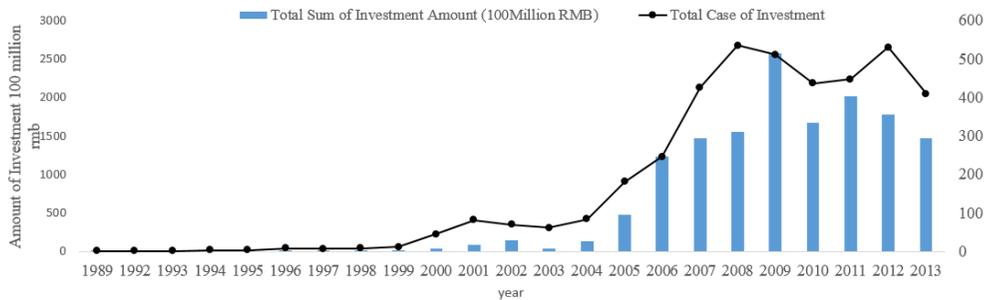


Figure 1-3 China Venture Capital Investment Trend (1989-2013)

Source: pedata.cn

China’s earliest venture capital institutions, and also the first Sino-foreign joint venture venture capital company.

³For example, in June 1987, China's first technology business incubator - Wuhan East Lake High Technology Entrepreneurs Center was established. The incubator was mainly sponsored by the government and aimed to transform scientific achievements into businesses.

⁴In August 1988, China’s first state-level high-tech development zone – “Beijing High Technology Industry Development Experimental Zone” was approved for establishment. Since then, other local governments from all levels of the administrative system began to set up their own high-tech industry development pilot area, and founded the venture capital funds in the experimental zones as well.

⁵For example, in November 1986, the Central Committee of the CPC and State Council formally approved the “High-tech Research and Development Program”. This high-tech research and development program is also referred to as the 863 program.

Note: All foreign currencies have been transformed into Renminbi (abbr. CNY or RMB), the U.S. currency is based on the dollar to RMB exchange rate during the investment year. Other currencies are calculated based on the exchange rate obtained on March 4th, 2016.

The delayed development of China's venture capital industry is due to multiple reasons. Generally, a venture capital company (VC) is an institution established to raise funds from other institutions or individuals to invest in venture companies. After facilitating the growth of venture companies they sell the shares acquired according to their previous investment to realize the yields. Therefore, the factors that affect the development of the venture capital industry can be summarized into three aspects: the abundance of capital, the quantity and quality of investable venture companies, and the existence of exit channels and easiness of exit. And in the case of China, all three aspects have contributed to the delayed development of the local venture capital industry. However, after a more in-depth examination of the matter, we realized that there is a more profound factor behind them, namely, institution. For example, when China suffered the lack of funds during the early reform and opening-up stage of its VC industry in the 80s-90s, the world venture capital industry, especially in Europe and America, was soaring. Tremendous fund pools have been founded not only to focus on the investment of local enterprises but also to actively seek ways to participate in developing countries like China (Landström, 2007; Wright, 2003).

However, the strict restrictions of the Chinese regulations on foreign capitals and the lacking legal entity for foreign venture capitals made it difficult to carry out the related business in China during that time. Later, in the beginning of the 21st century, owing to the positive results from the reform and opening-up policy and China's WTO entry, China accumulated a large amount of capital to support the local venture capital industry (Figure 1-4). Whereas the conservative and lagging institutions of China's financial system, such as the forbiddance of insurance capital, pension funds, and banking capital, as well as a high threshold for individuals to participate in the venture capital industry, made it difficult for the venture capital industry to raise money within China even with the country's capacity. Despite the various reasons for delayed development of China's venture capital industry, the legal system plays an important role for these reasons.

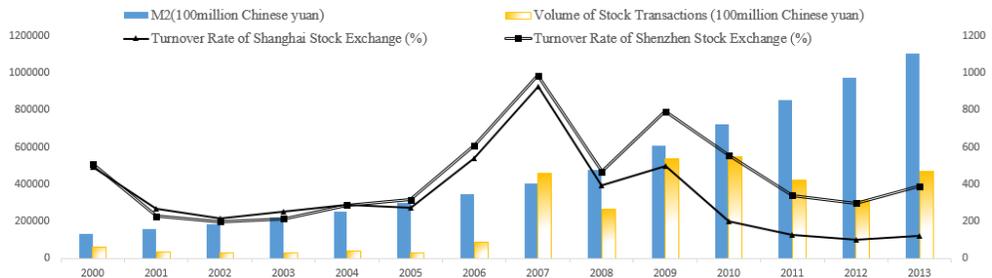


Figure 1 - 4 Accumulated capitals of China and the irrational favor to stock market

Source of data: Public data of the National Bureau of Statistics

Furthermore, since the reform and opening-up, China experienced a long period of “extensive development.” During this period, the main objectives of the state were economic development and social stability. The words of Deng Xiaoping which were “it doesn’t matter if a cat is black or white so long as it catches mice” summarize the characteristics of the Chinese legislation status during that time. In other words, economic development was top priority, while all laws, rules, regulations, and even the inherent concepts and custom could be changed or abandoned according to the needs of economic development. This concept was reflected in the reforming process through many manifestations, such as the adoption of the “dual track system⁶”, which allowed the existence of inequality⁷, as well as

⁶ The “dual track system” is a unique institutional arrangement adopted by China during process of reform and opening-up and it means different standards or rules can be applied to the same kind of matter. Initially it was applied in the pricing system, namely the “dual-track price system”, which allows the existence of different prices of the same products that were produced by the national plan system and firm autonomy production. This dual track system served allowed a smooth transition from the previous planned economy system to the market economy system (further information refer to Wu, 2013; Watson, He Jiacheng, Jiang Yue, Sorghum, & Zhang Shaojie, 1985). Further this dual institutional arrangement was extended to other economic and social fields, including foreign exchange system, household registration system, pension system, land system, labor system, health care system and judicial system etc.

⁷At the 1978 Communist Party of China (CPC) Central Committee Work Conference, Deng Xiaoping announced China’s reform and opening-up policy to the world together with

the existence of a certain degree of irregularities. These trade-offs are the compromises and sacrifices China has made for its economic development after fully demonstrating the situation and weighing the pros and cons of the approach (Wu, 2013). The compromises and sacrifices provided certain spaces for the Chinese economic development, while also bringing many disadvantages, such as the rampant corruption and economic chaos in many fields. Therefore, today one of the major goals in China is to improve the legal system to consolidate economic achievements and promote further economic development by driving China from the “governance of rule of man” to the “governance of rule of law” (Jiang, 1997; Tong, 2015; Wu, 2007; Zhang & Zhang, 2015).

As mentioned above, venture capital backed innovation and entrepreneurship has become one of the main characteristics of the era. Meanwhile, of the improvement of legal systems to regulate and promote economic development also turns out to be a key theme of the era. Many disciplines including economics, business management, law, finance, and geography have provided a large number of excellent studies on the topics. The perspectives of exploring the industrial characteristics, resource endowments, government policies, management systems, financial

the economic policy, which allowed part of the regions, enterprises, as well as workers and peasants to get rich first. (Deng, 1978)

instruments, and geographical features have provided a rich amount of theoretical and empirical evidence to answer the key questions like: What is the basic principles and characteristics of venture capital industry?; how does the venture capital promote innovations and regional economic development?; how foster the venture capital industry; how to successfully operating a venture capital company, etc. However, there still remains some blank areas for further studies such as what is the interaction between the government and venture capitalist in the development process of the venture capital industry; how does the interaction affect the choice of their behavior strategies and own development; how does the interaction and impact reflect on the transition of the regional legal system; what kind of principles and strategies should be adopted by the government in formulating the legal system; how do venture capitalists react to legal systems and what are the countermeasures they adopt; how does the legislation related mutual effect affect the capital allocation across spaces; what is the meaning of location, place, and space in this process; and what role does geography played in the process?

This paper will try to answer the above questions by providing an empirical research on China's venture capital industry. While deepening the understanding of the venture capital industry and regional legislation system, this paper will put forward the policy implications deduced from the study

for both entrepreneurs and governments to further develop the venture capital industry and the regional economy.

1.1.2 Research Objective

To answer the questions above, the research objective of this study has been designed as follows:

Through the empirical research on the Chinese venture capital industry, this paper discusses the mechanism of regional legal systems' influence on the geographical distribution of capital, and further explore the implications of the geography in the capital allocation process.

The research objective will be further divided into four sub-questions. First, in the era of knowledge-based economy as well as the economic globalization megatrend, how does venture capital allocate its capital across spaces? What is the geographical distribution pattern of this allocation? What are the characteristics of this allocation pattern? How does this pattern change across time and space?

Second, what role does the regional legal system play in the process of the geographical distribution of venture capitals across time and space? What is the mechanism behind it?

Third, what role does geography play in the process and mechanism of the regional legal systems' influence on the geographical allocation of venture capitals?

Fourth, can we broaden the scope of existing research methods in the field of economic geography by analyzing the above problems using "Game Theory" in addition to the usual quantitative statistical analysis and qualitative research?

The related theories and prior studies related to the issues mentioned in the above questions will be reviewed and discussed in Chapter 2. Based on this literature research, the analyses framework of the study and detailed study issues will be deduced according to the aforementioned sub-questions of the paper in order to fulfill the ultimate objective of the study.

1.2 Data and Methodology

1.2.1 Data

1. Definition of the Terminology

The empirical studies of the paper were carried out from 1985⁸ to 2012⁹. A venture capital (VC) in this study, according to the regulations of

⁸ The first Chinese venture capital company was established in 1985, but this company was not successful due to multi-institutional reasons and the immature market, and it eventually went bankrupt in 1998. This special case was demonstrated in chapter 5 for game analysis but was not included in the statistical analysis of chapter 4. That is because until 1992 when the International Digital Group (IDG) invested in China there were almost no formal economic activities of venture capital agencies existing in China. Therefore, the starting point for the statistical analysis of the research is 1992.

⁹ From 2012, firstly, there were great changes in the VC-related legal systems leading to a significantly different legal environment after 2012. For example, great changes occurred in the revision of "Securities Investment Funds Law(证券投资法)" (2012), "Companies Act (公司法)" (2014) and other VC registration regulations. Secondly, the major changes in the domestic capital market resulted in great changes in the VC exiting channel after 2012. For example, the irrational fluctuation of stock markets in 2012 led to the suspended publication of IPO in 2012 and 2013, which blocked the channel for IPO-based exit of VC investment in China. At the same time the emergence of the "New OTC Market" in 2013 provided another way for VCs exiting in China. Meanwhile, since 2013, VCs were allowed to be listed in the new OTC market, leading to a different fundraising environment for VCs. Thirdly, a large amount of domestic and foreign capital entered the VC market in China, leading to an explosive growth in the number and capital amount of VC agencies and funds.

"Provisions on the Administration of Foreign-Funded Venture Capital Enterprises"¹⁰, "Interim Measures for the Administration of Venture Capital Enterprises"¹¹, "Securities Investment Fund Law of the People's Republic of China"¹², is defined as a venture investment firm in the form of funds, managed by professional managers to invest in unlisted high-tech companies and provide entrepreneurial management services, in order to obtain capital appreciation incomes. The VC funds include Angel investment in the form of funds, industry funds and private equities investing in unlisted equities. It

Consequently, the performance of VCs in China is totally different after 2013 due to the three reasons above, which are beyond the scope of this paper. Therefore, the ending point of the research is designed to be 2012 and the later period is expected to be carried out as follow-up study.

¹⁰ The name of the provision is “外商投资创业投资企业管理规定” in Chinese. The second release of the Ministry of Foreign Economic Cooperation, Ministry of Science and Technology, State Administration for Industry and Commerce, State Taxation Administration and Administration of Exchange Control, implemented from March 1st, 2003.

¹¹ The name of the interim measure is “创业投资企业管理暂行办法” in Chinese. Passed by the State Council on September 7th, 2005 and published by State Development and Reform Commission Enterprises, Ministry of Science and Technology, Ministry of Finance, the People's Bank of China, State Taxation Administration, State Administration for Industry and commerce, China Banking Regulatory Commission, Administration of Exchange Control, implemented from March 1st, 2006.

¹² The name of the law is “中华人民共和国的证券投资基金法” in Chinese. Passed at the 5th meeting of the Standing Committee of the 10th National People's Congress on October 28th, 2003, revised by the 13th meeting of the Standing Committee of the 11th National People's Congress on December 28th, 2012, and implemented from June 1st, 2013.

excludes the Angel capital in the form of non-fund and individual investment and private equities investing in listed companies.

The legislation of venture capital is the sum of all laws, regulations, sets, rules, and policy documents published and implemented for the venture capital industry. The venture capital legal system is defined as the framework of all the legislative aspects that was implemented for the venture capital industry, including aspects of fundraising, registration, investment, exiting, taxation, supervision, etc.

The main research object of this paper is the spatial allocation of the venture capital. Therefore, the management aspects of VC companies and portfolio companies are not included in the scope of the study. Consequently, this study only involves four stages of the spatial flow of venture capital, i.e. the fund-raising, registration, investment and exiting stages (Figure 1-5). The spatial allocation of fund-raising refers to the geographical location of the source of the capital, i.e. the location of the limited partners (LP). The registration allocation refers to the fund or fund management venture capital company's juridical registration location. The spatial allocation of the investment stage represents the geographical distribution of the VC investment, i.e. the spatial distribution of the funded firms. The spatial allocation of the exiting stage refers to the geographical distribution of

exiting markets when capital is withdrawn and revenue is obtained. This includes the Initial Public Offerings (IPO) place of funded companies, registration place of Mergers and Acquisitions (M&A) companies and Management Buy-Out or Management Buy-In (MBO/MBI) companies.

The location mentioned above represents the geographical location of the capital across the world. This location will be used to demonstrate the distribution pattern of the venture capital. Whereas, in analyzing the role of the regional legal system, regardless of the actual distance and the administrative relationship, regions applying the same legislations will be seen as a homogeneous area, whereas regions applying different legislations will be deemed as different regions.

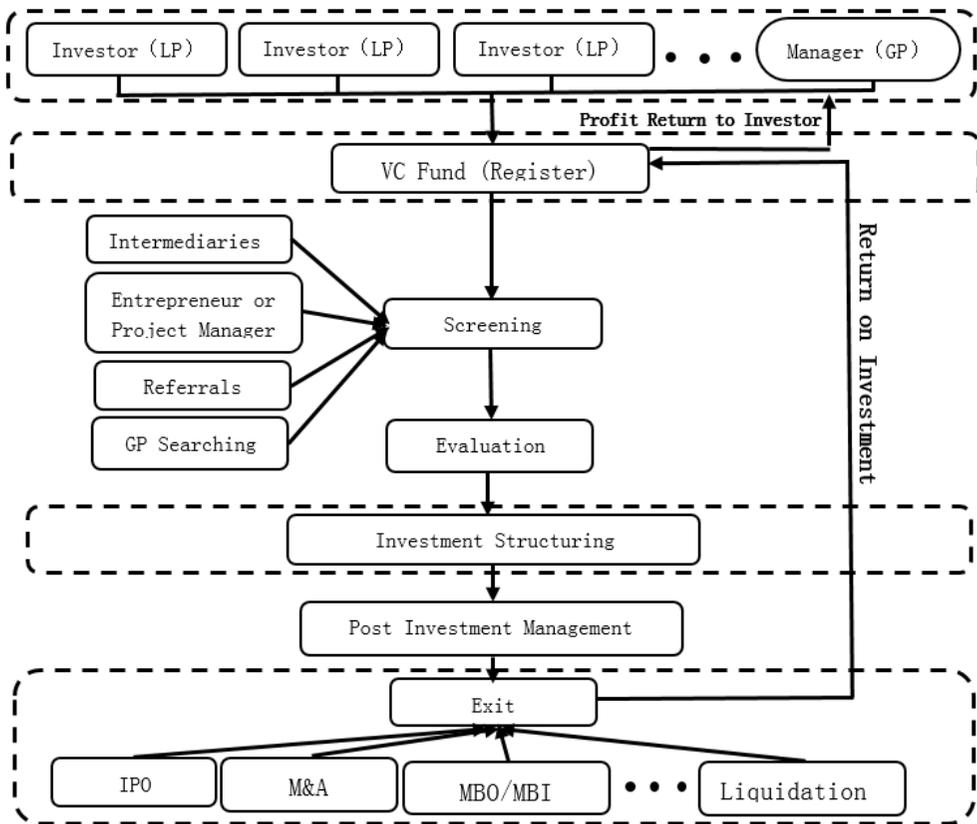


Figure 1 - 5 Flowchart of the venture capital circulation and the research scope of the study

Note: Reorganized based on "China Venture Capital Yearbook 2002"(page 77) and "Venture Capital I"(page 5). The dashed lines represent the stages of the capital flow which demarcated the research scope of the study.

2. Data Collection

The legislations related to the venture capital industry was collected according to the "China Economic code(中华人民共和国经济法典)"¹³,

¹³ Written by Legislative Affairs Office of the State Council, second version of Annotated code, China Legal Publishing House (2014).

"China Financial code(中华人民共和国金融法典)"¹⁴, "China commerce and trade code(中华人民共和国商务贸易法典)"¹⁵, "Code of investment and financing of China(中华人民共和国投融资法典)"¹⁶, "China Company code(中华人民共和国公司法典)"¹⁷, "China securities code(中华人民共和国证券法典)"¹⁸, and "China tax code(中华人民共和国税法典)"¹⁹. Other regulations, sets, rules, policy documents and supplementary information is collected from the Chinese Government website²⁰, Department of Commerce²¹, China Securities Regulatory Commission²², and public media. The collection of the legislations used in the study from 1979 to 2012 are illustrated in Appendix 1.

The data of the venture capital's location is collected from the database of "PEdata.cn"²³. The Chinese venture capital industry, the government²⁴,

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ www.gov.cn.

²¹ <http://www.mofcom.gov.cn/>.

²² <http://www.csrc.gov.cn/pub/newsite/>.

²³ Database of "PEdata.cn", www.pedata.cn, visit time March 15, 2016.

²⁴ For example, the Ministry of Finance of the National Development and Reform Commission(国家发展和改革委员会财政金融司) and the Equity and the Venture Capital Professional Committee of China Investment Association (中国投资协会股权和创业投资专业委员会) jointly edit and release the yearly report of "China Venture Capital Industry Report(中国创业投资行业发展报告)" from 2010.

university & research institutions²⁵, VC service enterprises²⁶, and industry associations²⁷ all have built their own databases and release research reports regularly. However, among all of these, the Zero2IPO Group's Private Equity Database provided the most comprehensive information regarding the time and space span, as well as the contents of the information. While other databases are either too general in that they mainly describe the overall Chinese venture capital industry or bear the limitations of time, space, and capital location information that this study needs. Therefore, this study chooses the pedata.cn database as the data source of the analysis.

The criterion of data selection is based on the exiting case of VC, which means the VC has successfully completed one circulation of the case. Therefore, the panorama of the capital location can be draw out of the cases. The steps and criterion of the data collection are presented as follows. A total of 368 exit cases, up to year 2012, were selected from the "pedata.cn" database. For each exit case, 28 items of information were collected, including information on the exit companies' exit time, name, type, Securities and

²⁵ For example, the Venture Capital Development Research Center of Renmin University of China initiated the "China Venture Capital Yearbook(中国风险投资年鉴)" in 2002. Later, the China Venture Capital Research Institution(中国风险投资研究院) and the Public Policy Research Institution of Hong Kong Polytechnic University jointly took over the work.

²⁶ For example, the Zero2IPO Group (清科集团, <http://www.zero2ipo.com.cn/>).

²⁷ For example, the China association of private equity (中国股权投资基金协会, <http://www.chinacape.org/>); Venture capital association Beijing (北京创业投资协会, <http://www.vcab.org/>); Shanghai venture capital association (上海市创业投资协会, <http://www.shvca.org/vip.asp>); Zhejiang venture capital association(浙江省创业风险投资协会, <http://www.zvca.org.cn/>);

Futures Commission (SFC) industry classification, founding time, registration place, head office in China; information of the exit funds' name, capital amount, registration place, head office in China, founding time and capital type; information of the exit agencies' name, capital type, founding time, head office, profit, return multiples, internal rate of return, cumulative investment amount, time of first investment, exit channel, exit place, capital source, LP registration place, LP type, and LP investment amount. Not all the 368 exit cases have a complete record of the 28 items due to information defects. Meanwhile due to the characteristics of the syndication and staging investment of the venture capital industry, the same exit case may refer to several funds and LPs. Therefore, the four stages of the capital circulation obtains a different number of cases from the selected datasets. The number of the cases corresponding to each stage is shown in Figure 1-6.

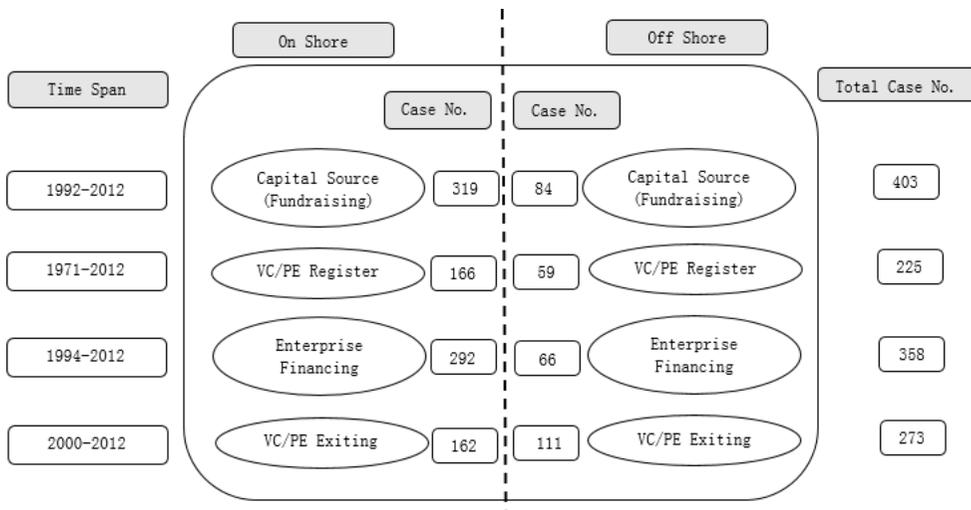


Figure 1 -6 Overview of the venture capital data used in this study

1.2.2 Methodology

In this paper, three analysis methodologies, namely, correlation analysis, qualitative legal clause analysis, and game analysis, are used to study the mechanism and geographical implications of the regional legal systems' impact on capital allocation across space.

First, the correlation between the regional legal systems and the capital allocation are confirmed. There are two reasons for this first step. Firstly, in the era of knowledge-based economy and economic globalization, which is accompanied by the development of information technology and global market integration, there exists some point of view that the flow of capital will no longer be limited by distance and the regional legal system, and will be

free to move according to the market needs(Friedman, 2005; Martin, 1994; O'Brien, 1992). To respond to this view (Agnes, 2000; Engelen, Konings, & Fernandez, 2010; Graham, 1998; Saxenian, 1994; Tripl, Tödting, & Lengauer, 2009; Wainwright, 2013), by comparing the regional legal factor with economic variables, the fact that regional legal system still has a strong correlation with the geographical allocation of the capital will be confirmed. The following analysis and exposition will be further derived under this basic confirm. Secondly, in this correlation analysis, the regional legal systems will be quantified into regional legal index. It is hoped that this attempt will provide another practical basis for future analysis of regional legal systems. The method of quantifying the regional legal system into a legal index will be described in Chapter 4 and the Appendix 2 in detail.

After confirming the correlation between the spatial allocation of the capital and the regional legal system, a qualitative analysis of interpreting the legal clauses will be chosen, instead of the quantitative causation analysis, to give a more detailed analysis of the impact of legislation on capital allocation. The relevant individual laws, regulations, clauses, and terms will be fully examined to find out the hidden influence on the venture capital allocation across space. These influences will be further confirmed and visualized in maps per the empirical dataset collected from the Chinese venture capital industry.

Finally, the mechanism of the legal impact on capital spatial allocation will be deduced according to the game analysis between regional government and venture capital relevant agencies. In the analysis, the government strategies and enterprise strategies will be examined respectively and the implications of geography in the strategic decision making process will be deduced accordingly. To deepen the understanding of the analysis, practical case studies will be provided to accompany the analysis above.

1.3 Framework of the Dissertation

In chapter 2, the theoretical basis of this study will be built by reviewing the related prior literature. The research of these literature in this paper will be divided into two parts. In the first part, capital allocation studies will be first sorted out and discussed from the enterprise management and regional government control views, respectively. Through a thorough understanding of both party's position, the foundation and basic principle of the game between enterprise and government will be elaborated. Later, the second part of the literature study will specifically explore the existing literature about the legal system's impact on the venture capital industry. At the end of the chapter, the research framework and three main research issues will be deduced from these studies.

In the first part of chapter 3, the emergence and development of VC industry will be introduced from a global perspective. The legal environment of venture capital in each country will also be illustrated in this part. In this setting, the second part of chapter 3 will further elaborate the legal environment and the non-legal environment for the Chinese VC's development. It will also demonstrate the actual growth process of China's venture capital industry.

The main task of the fourth chapter is to analyze the correlation between the legal system and the capital allocation of venture capitals. It will also find out the reason and principle about legislative effects on the spatial allocation

of capital. To achieve this goal, chapter 4 examine the relationship between legal and capital spatial allocation through the following three aspects. First, a correlation analysis among capital spatial allocation and legal/non-legal environment will be conducted to confirm the first research issue of the study. Second, the specific legal provisions of venture capital related legislation will be examined closely. Detailed interpretation and in-depth study of the specific impact on capital spatial allocation will be provided to supplement the result of the correlation analysis conducted priorly. On the other hand, this detailed interpretation will also pave the way for the following analysis of the reason and principle for capital spatial allocation affected by law. At the end of the fourth chapter, the causation and principle of capital spatial allocation affected by law will be derived according to the prior information and analysis provided in chapter 3 and chapter 4.

The first part of chapter 5 will combine the causation and principle derived from chapter 4 to further derive the underlying mechanism of the phenomenon. In the later part of the chapter, by building a game model and analyzing the game process, a specific content about the mechanism and process of the influence will be clearly elaborated. Thus, the answer to the third research question in this study will be derived.

Finally, chapter 6, which summarizes the results and implications of the study, limitations and further study fields, will also be provided for both researchers inside and outside the field of economic geography.

The framework of this paper is as follows.

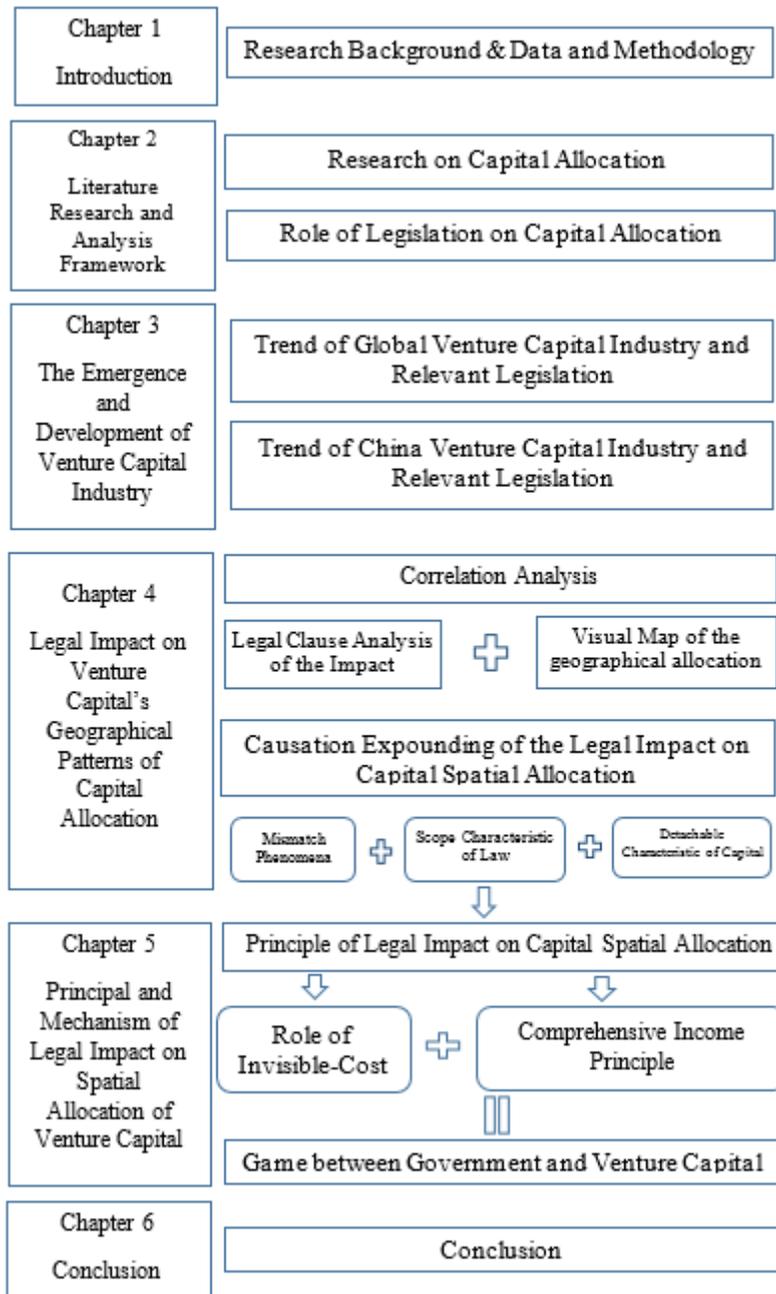


Figure 1 -7 Flow chart of the dissertation

Chapter 2 Literature Review

2.1 Researches on Spatial Allocation of Capital

2.1.1 Enterprise management on Capital Allocation

Enterprises are the most important unit element⁵⁵ in current economic activities. Although they are of various sizes⁵⁶ and possess different types of ownerships⁵⁷, they all share a common principal that is their economic activities. They commonly organize resources, carry out production and interoperate with the outside world to meet people's needs. In other words, an enterprise first detects or creates people's needs, and then meets these needs while gaining profit by the process of organizing all kinds of resources, including human resources, materials, financial resources ect., and producing goods. In other words, an enterprise itself is a system that organizes and allocates certain resources.

The resources of an enterprise can be divided into the resources presented in financial statements and those that are not presented in financial statements. Resources outside the financial statements can be summarized into

⁵⁵ However, it is not the only relevant unit element. For example, there are many other forms of economic activity units, such as freelancers, temporary workshop, short-term project-focused cooperative groups, rural cooperatives, industry associations and so on in China.

⁵⁶ The size ranges from small-scale enterprises that only have few employees, to large-scale cross-sector enterprise groups, and cross-border multinational companies.

⁵⁷ For example, there are private enterprises, partnerships, companies, state-owned enterprises, as well as China's unique collective enterprises for the classification of ownership.

three aspects following the ancient Chinese philosophy of “Time(天时)”, “Location(地利)”, and “Relation(人和)”⁵⁸. “Time” represents the macroeconomic environment (including economic system, policy environment, legal situation, etc.), market situation (including supply and demand conditions, market size and growth spaces, etc.), technical environment (including technology maturity, stage of technology cycle, etc.), industry environment (including industry structure, rival firms’ condition, upstream and downstream firms’ condition, etc.), and the enterprise’s own development stages. “Location” represents products’ market location, activity location, and resource location. “Relation” represents the networks between the enterprise and related government organizations, non-government organizations, rival firms, upstream and downstream enterprises, institutions, and personnel links inside and outside the enterprise boundary.

Resource allocation is a hot issue in many disciplines, besides the fields of economics and business management, a lot of researches and achievement have emerged in the field of geography such as corporate geography, institutional economic geography, legal geography and so on. Among this Kim (Kim, 2012) provided a comprehensive and detailed review of FDI theories. Specifically, in the field of economic geography, there has been a great deal of research on the above-mentioned contents. For example, in the

⁵⁸ From “Sun Bin’s Art of War”. (《孙臏兵法·月战》“天时、地利、人和，三者不得，虽胜有殃”。)

17th century, before economic geography was settled as a discipline, the predecessor of economic geography was named “business geography”. By describing the distribution of natural resources around the world, explored by navigations, “Time” and “Location” were first explored. Later, the agricultural location theory proposed by German economist von Thünen (von Thünen & Hall, 1966), the industry location theory proposed by Webber in 1909, and the central-place theory proposed by Kristaller in 1933, all take a market and production angle to explore the location strategy principles, which can also be sorted as the “time” and “location” aspects. Marshall(1890)’s external economies provided another theoretical foundation for further exploring the industry location. During the 1950s and 1960s, behavioral science rose as another branch of studying economic activities. Influenced by this wave, economic geography also began to explore the role of human behavior in location determinations. However, until the end of the 20th century, studies on the role of human behaviors in location determinations were only restricted to individual decision-making levels. After 2000, with the emergence of relational turn(Bathelt & Glückler, 2003; Boggs & Rantisi, 2003; Ettlinger, 2001; Murphy, 2003) and cultural turn(Barnes, 2001) in economic geography studies, theories and concepts such as industrial clusters, regional innovation systems, learning regions, which emphasize the connections among economic individuals in the region have appeared with a large number of case studies.

These studies, either from a “time” and “location” aspect or from a “relation” aspect, all have contributed to the understanding of economic behaviors in space, and also provided useful principles for local governments to develop their economies. However, there are three issues overlooked by these studies.

First, none of the above studies have taken a corporate financial statement point of view to approach the issues. However, the fundamental purpose of the enterprise is profit creation. And keeping a healthy financial balance sheet is extremely important for its survival and development. Therefore all economic activities are fundamentally revolve around the principle of maintaining the balance of payments and creating surplus values. However, so far, in economic geography, there hardly exists any analysis that examines the business behaviors from the enterprise financial statement perspective. Second, no distinction between the on-balance sheet resources and off-balance sheet resources have been made to examine the capital allocation strategies. Third, the location selection and resource allocation (or re-combination) are not analyzed from the standpoint of enterprises’ comprehensive income.

There are many definitions of capital. In a broad sense, capital consists of any resources that can enhance a person’s economic power. Classical and neoclassical economics regard capital as one of the factors of production. Specifically, it can be classified into numerous types such as material capital, intellectual capital, human capital, financial capital, social capital, tangible

capital, intangible capital, etc. From the enterprise perspective, all the capital can be classified into capital inside and outside the enterprise. The interaction between the internal capital and external capital determines the location strategies of the firm.

Early studies like the representative theories of agricultural location(von Thünen, 1930) and industry location (Weber & Friedrich, 1962) have demonstrated that the external capital's influence on economic locations. While Alfred Marshall have taken another point of view to explain the influence of the intangible onsite capital on economic locations(Marshall, 1927). This intangible capital, also known as externality and agglomerative economies effect, inspired numerous following studies to provide more detailed and comprehensive theories and concepts. Some of the studies are the industrial districts and clusters concepts (Brusco, 1990; Markusen & Park, 1993; S. Park, 2001; Pinch, Henry, Jenkins, & Tallman, 2003), the national and regional innovation systems theory(Braczyk, Cooke, & Heidenreich, 1998; Lundvall, 2010), the learning region concept(Florida, 1995; Hassink, 2001), the tacit knowledge concept(Leonard & Sensiper, 1998; Nonaka & Takeuchi, 1995; Reber, 1989), the social network theory and the structural embeddedness theory used in geographical studies(Koo & Park, 2012; S. O. Park, 2000; S. O. Park & Nahm, 1998; Simsek, Lubatkin, & Floyd, 2003), etc. and they further explore the specific geographical characteristics that are related to economic locations. All these theories and concepts have demonstrated how external resources, which are embedded in specific

locations influence the location selection of economic activities. It is the regional specific characteristics that cause spatial heterogeneity even though we are in the midst of the globalization megatrend and the era of knowledge-based economy. That is to say, with the embedded factors above, geography is not merely an indiscriminate space, but an irreplaceable place for economic activity (Agnew, 2011; Carter & Donald, 1993; Healey, 2004; Tuan, 1977).

On the other hand, the studies of foreign direct investment(FDI) continuously provide excellent theoretical and practical achievement of capital spacial alloction from the enterprise management perspective. The early monopolistic advantage theory(Hymer, 1960), the oligopolistic reaction theory(Knickerbocker, 1973), the internalization theory(Buckley & Casson, 1976), the product cycle theory(Vernon, 1966), the eclectic theory (Dunning, 1980), the new imperialism theory(Harvey, 2003), and the dependency theory(Hays, 1964) all have analyzed and explained the reasons and mechanism of capital spatial allocation from the aspects of production, market, product, competitor, external economic environment and policy environment. All these factors are of great significance to the enterprises' choice of . This is because the different factors between firms will directly induce the difference in sales performance, i.e. the financial health and further development of the firm. In other words, the most fundamental reason for enterprises allocating their resources is to approach the factors that are beneficial to the comprehensive income of the enterprises is. Whereas, so far, few studies have

combined the above factors to further explore the implications from the perspective of firms' comprehensive income.

2.1.2 Regional Governance on Capital Allocation

“Location” is an option for enterprises in most cases of economic activities. On the contrary, location is an indiscerptible foundation for the local government, while it is an option for economic activities and agencies. The ultimate goal of the regional government is to achieve the regional economic prosperity and social stability. The local government therefore needs to choose the right way to organize its resources in promoting regional economic development and competitiveness. The national competitiveness theory proposed by Porter(Porter, 1990; White, 1991), the national/regional innovation system and cluster theories, and the global pipeline concept(Bathelt, Malmberg, & Maskell, 2004) have all provided a deep insight into the role of governance on regional development either from the intra-regional aspect or inter-regional aspect.

Most of the studies have taken the approach of examining the interactions of economic agencies such as government, enterprise, university, institutions, etc. while all activities should be founded on certain types of economic institution, which is the most basic resource allocation mechanism. So far, although both types have many variations there are two systems of economic resource allocation, namely, planned economic system and market

economic system. After World War II, when the world's political pattern of the socialist camp and the capitalist camp were formed, the planned economic system was adopted by socialist countries following the Soviet model of Soviet Union, while the market economic system was adopted by capitalist countries. However, socialism is not equal to planned economy. Furthermore, the use of the administrative plan system to govern the national economy originated from Stalin at the end of the 1920s to the early 1930s to cope with a severe domestic and international situation(Stalin, 1962; Wu, 2013). Although Marx emphasized the social relations of production in his work, *Capital*(Marx & Engels, 1976), he did not explicitly put the problem of resource allocation as an intermediate link with the productive forces and production relations, not to mention the relations of the planned economy with the socialism(Wu, 2013).

Despite this, after World War II, Eastern Europe and Asia as well as other socialist countries followed the example of the Soviet Union by choosing the planned economic system as the main way of resource allocation. After decades of practice, the drawbacks of planned economy emerged and these countries began to seek ways to reform their economy and transform the economy system.

China also underwent nearly 30 years of turbulence with a planned economic system and later sought ways for reformation. In the beginning of the reformation, an intense, long-term debate arose around the issues of the compatibility of market economy and socialism as well as the direction

China's reformation was heading. After fully investigating and discussing the key issues of the socialist⁵⁹ nature, the conception of planned economy⁶⁰, and the principle of the market economy(Wu, 2013), China finally established the policy of "The nation governs the market, And the market guides the enterprise(国家调节市场, 市场引导企业)"(China, 1987). Since then, China continuously strengthened and enlarged its reformation by making enhancements from the pricing system, enterprise reformation, public finance, tax system, to the financial system. At present, the Chinese economy is a 'socialist market economy' with the state-owned sector acting as the main body of the economy while multi-ownership private sectors exist. In this economic system, the government's functions are gradually shifting from planning and governing everything to a market economy with a smaller government that provides a favorable policy environment to secure the nation's development.

On the other hand, the evolution of the market economy from the past to present have always been accompanied with government involvement(Hicks, 1969). A completely free market economy has never existed since anarchy can only lead to the chaos and paralysis of the society and economy. This has been repeatedly confirmed by the world's economic history and the recent

⁵⁹ The essence of socialism is about emancipating productive forces, promoting productive efficiency and realizing common prosperity. Both the planned and market economy are the means of resource allocation, rather than being the equivalent of socialism or capitalism(Wu, 2013).

⁶⁰ It originated from the use of Stalin from the 1920s to the 1930s in response to the severe Soviet Union severe domestic and international situation at the time(Stalin, 1962; Wu, 2013).

economic crisis. 'Market failure' requires the function of government. The various forms of private companies' nationalization and the government bailout of capitalist countries during the economic crisis also demonstrated the indispensable role of the government's administration.

It can be seen that whether it be socialism or capitalism, the resource allocation mechanism has taken a convergence approach, that is, the combination of the government administration and market regulation. There are two basic conditions for the market to operate properly, i.e. the protection of property rights and the guarantee of contract performance. This requires trust and self-discipline among market participants. Although similar constraints can be provided through interpersonal-ties, culture, moral restraint, and spontaneous business unions, the continuously growing social division of labor and complex market economy make it difficult to maintain the conditions that market economy needs merely through the informal forms mentioned above. Therefore, a strong common rights authority that can provide the above-mentioned protection for market operation is needed. Legislation provided by the government as a public necessity solidify the consensus market rules and fix it in the form of law, as well as equip it with the enforcement agencies and supervisory authorities. In short, the market needs a legal system to ensure its effective operation. On the other hand, the administrative directive, i.e. the planned economy also requires the solidification of the law to prevent bureaucratization. In other words,

regardless of market economy or planned economy, the rule of law is the ultimate practical tool for resource allocation.

Governments may use the legislative tool to make the following allocation of regional resources. First, governments can form the structure of the regional industry through intentioned legislation. That means allow favorable laws and policies to induce and promote promising industries while setting barriers to restrict or prohibit the development of certain industries within the region. Inter-industry resource allocation can be achieved through this methis. Second, legislative tool can be used to select the participating economic agencies in achieving resource allocation between individuals. Third, legislation can be leveraged to balance the disequilibrium between regions to achieve resource allocation between regions. All three aspects are related to the spatial distribution of capital. Whereas, in this allocation process, enterprise entities and economic activities are the options the local government can select, and the local legislation provided by the government will determine the entrance and survival of economic activities.

2.2 Role of Legislation on Spatial Allocation of Venture Capital

2.2.1 Location strategies of The Venture Capital Industry

Location study is one of the most important research fields in economic geography. The most basic motivation and principle for enterprises' location selection is approaching the most favorable factors that may significantly reduce cost and increase the firm's revenue. Since each industry has different characteristics, the factors that each enterprise needs to approach are different. Consequently, location selection strategies may differ greatly depending on the characteristics of each industry. Based on the previous studies of location theories, the influencing factors can be categorized into three categories, namely, factor of production (Fearon, 2002; S. O. Park, 1993; von Thünen, 1930), market factor (RICHARDS, 1962), and information factor (Koo & Park, 2012; S. O. Park, 2000, 2006, 2009; S. O. Park, Alvstam, & Schamp, 2005; S. O. Park & Choi, 2005; S. O. Park & Koo, 2010; S. O. Park & Markusen, 1995; S. O. Park & Nahm, 1998).

From the means of production perspective, the main means of VC's production are capital, human resource, and financing enterprises. A region's capital stock, banking policies, as well as other financial factors all have significant impact on the acquisition of capital for venture capital companies (Bygrave & Shulman, 1988; Bygrave & Timmons, 1992; Wright, 2003). Meanwhile, the fund manager of the venture capital, i.e. the general

partner(GP)'s reputation in the venture capital industry also greatly affects the venture capital's fundraising activities (Cumming, 2012; Florida & Smith, 1993; Fried & Hisrich, 1994; Hellmann, 2000). That is because raising money for the VC fund requires the GP to have extensive and successful interpersonal relationships as well as outstanding performance records(P. A. Gompers & Lerner, 2004; Landström, 2007; Wright, 2003). Moreover, for a successful investment with a higher return on investment, GPs are required to possess extremely high professional knowledge, skills and practice experiences on both project selection and post investment management stage. Therefore, human resource, i.e. the GP is another important factor that affects the development of the VC industry. In addition, the stock and quality of the potential investable financing enterprise is also an important factor for the VC industry's development (Murray, 1995; Roure, Keeley, & Van der Heyden, 1990). However, the highly mobile characteristics of capital and labor enables VCs to move freely between regions under the condition that no legal barriers exist⁶¹. Therefore, the motivation of approaching the production raw materials is not the most important factor in a VC's location selection. In the same way, although the capital market plays an important role in the VC industry's development (Bartzokas, Mani, & NetLibrary, 2004; Black & Gilson, 1998; Bygrave & Timmons, 1992; Cumming, Fleming, & Schwienbacher, 2006;

⁶¹ The actual operation of VC does not require a lot of land, production equipment and labors. The core production activities of VC is collecting and processing the investment related information. Its investment team member usually ranging from several people up to twenty or thirty. Therefore, theoretically, with the absence of legal friction capital can flow into any regions and industry field freely with relatively low cost. And any place can be the office of the investment team.

Murray, 1995; Roure et al., 1990), it is not the decisive factor for a VC's location selection. Rather, it is the information acquisition factor that determines a VC's location.

In Silicon Valley, there is a well-known 20-minute theorem, that is, a venture company should be located within 20 minutes' drive from the VC to receive their investment. This is because during project screening as well as the processing of due diligence, contract establishment, post-investment management and exiting, frequent information feedbacks are necessary to minimize uncertainty and secure the success of the investment (Batty, 2006; Fritsch & Schilder, 2012; AnnaLee Saxenian & Sabel, 2008). For this reason, VC and start-ups tends to be located near each other. That also means that, although venture capital firms can raise money from anywhere, they may have strong geographical limitations on their investment locations (Harrison & Mason, 2000). But in reality, there are a considerable number of long-distance investments, which mean that the VC can be located far away from their portfolio companies. The characteristic of the VCs' syndication investment provides a reasonable explanation for this phenomenon. The fact that is there usually more than one VC that jointly invests in one project, and among all the investors, at least one VC is located near the financing company, and these nearby VCs usually lead the joint investment project. (Lerner, 1994; Sorenson & Stuart, 2001). This phenomenon and location strategy also obey the principle that VCs tend to locate themselves nearby the information sources (Harrison & Mason, 2000).

These studies provide valuable evidence for explaining the regional concentration phenomenon of VC investment behavior. However, the following three issues have not been fully considered.

2.2.2 Games between Governments and Enterprises

Game theory is commonly used as an analysis tool for studying situations where there are conflicts of interest. For geography, within the same geographic space, there exists numerous types of interest groups that may have different understandings and requirements. These differences induce the conflicts of interest related to the usage of space between them. Therefore, by using the analysis tool of game theory, different behavior strategies related to different spatial understandings and requirements can be well interpreted, and thus the mechanism as well as implications of interaction between human activity and geography can be further explored.

The contemporary game theory is a branch of the applied mathematics or operations research. It is defined as a model to analyze the decision-making activities of interdependent individuals under certain circumstances. The focus of the analysis is on the prediction and optimization of individual behavior strategies. The game theory was established as a formal discipline in 1928 when Von Neumann demonstrated the principles of the theory by using mathematic methodologies (Neumann, 1928). In fact, the ideology of game theory was formed as early as in the ancient times. The ancient Chinese works

on the art of war and chess game strategies can be seen as the prototype of the game theory. However, all these works and thinking only stay in the logical description level and did not develop it into a formal theory. In 1944, in the book 'Theory of Games and Economic Behavior', Von Neumann and Morgenstern extended the two-person game to a n-person game (Von Neumann & Morgenstern, 1944) that further solidified the systematical structure of the game theory and also allowed it to be applied in the economic field. Since then, innumerable studies emerged (Harsanyi, 2013; J. Nash, 1951; J. F. Nash, 1950; Selten, 1960, 2013) to either further develop the theory or to apply it into other disciplines such as international relations, political science, military science, computer science, psychology, marketing, finance, welfare, biology, etc.

Game theory is a tool for modeling complex realities rather than being a single theory. Describing the reality by building appropriate models, the analysis of the game provides approaches to obtain in-depth insight of the result. Therefore, according to the different situations game analysis applied to, various models may be built in different disciplines and studies. Based on the criteria such as number of players, type of information, length of the game, etc., models can be sorted into different categories such as two-person game, three-person game, n-person game, zero-sum game, non-zero sum game, symmetric information game, asymmetric information game, dynamic game, static game, mixed strategy game, continuous strategy game, cooperative game, non-cooperative game, complete information game, incomplete

information game, limited game, infinite game, and so on. Each of the model applied in a specific situation may deduce a unique theory. Therefore, game theory does not use the same method to analyze all things. Rather, it provides the idea to establish a reasonable model for the real world. However, the use of this methodology is not common in the field of geography.

When reprinting their 1944 edition of the book, Von Neumann and Morgenstern attempted to apply game theory in the study of location (Von Neumann & Morgenstern, 2007). Meanwhile, some pioneering works from the economic geography discipline also began to seek ways to use game theory in exploring the location strategies of enterprises (Savage, 1954; WALD, 1950; Webber, 1972). These studies proved to be useful attempts in studying the uncertainties faced by firms when making location related decisions. However, the role of regional legal systems on the locational selection process was not discussed in these studies. With the emergence of the 'cultural turn' in the discipline of economic geography (Barnes, 2001; Barnett, 1998) in the late 20th century, studies on the interaction of regional institutions and economic agencies began to emerge, and the descriptions of the location selection process and economic activity distribution demonstrated a way similar to the game theory. However, none of these studies formally used game theory as its analytical framework. Even among the studies of the venture capital industry, only few works using game theory as the analysis tool (Cable & Shane, 1997) can be found.

As mentioned in previously, the government and enterprise have different goals and positions when it comes to resource allocation. Consequently, the implications and usage of location may differ greatly depending on their different interpretations and requirements. These differences induce conflict and may hinder cooperation between them. Therefore, building a proper game model to describe the conflicting situation, to analyze enterprise strategies for location selection and government's legislative strategy will further enhance the understanding about the mechanism of legal impact on capital spatial allocation.

2.2.3 Analyses Framework

The first issue of the study is to examine the characteristics of the venture capital spatial allocation patterns. These geographical patterns will be illustrated and examined by using visualized maps of the related database. After that, before analyzing the effect of legal impact on spatial allocation of the venture capital industry capital, the correlation between spatial disposition of capital and non-legal environment and legal environment will be analyzed. The objective of this analysis is to confirm whether the legal system still has a significant impact on the spatial disposition of capital under the current environment of economic globalization and high capital mobility. The analysis will also provide a tentative attempt to index the regional legal system of the venture capital industry. Therefore, the correlation analysis will

only serve as a verifier while the reasons for the correlation will be examined by the analysis of legal provisions. After exploring the reason for the correlation between the legal system and capital spatial allocation, an in-depth discussion about the characteristics of legislation and capital will be processed. Based on this discussion, the motive and feasibility of the influence of legal impact on spatial allocation of capital will be extracted. The combination of the motivation and feasibility of the implementation will further deduce the rule and principle that legally affects the spatial disposition of capital and this refers to the second research issue of the paper. Based on these results, the mechanism behind the legal impact on capital spatial disposition, which refers to the 3rd issue of the paper, will be discussed by using the tool of game analysis. In the end, the 4th issue of the paper, which is the geographical implications of the process, will be further deduced.

The detailed analysis framework of the paper is as follows.

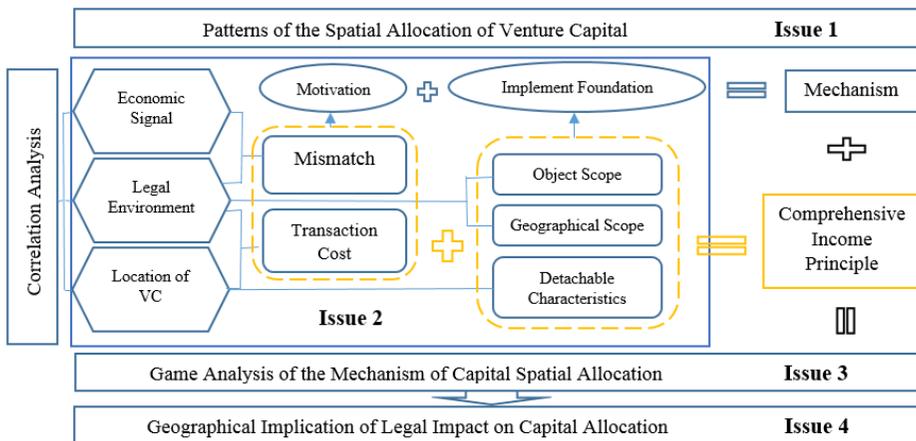


Figure 2-1 Analysis framework of the paper

Chapter 3 The Emergence and Development of The Venture Capital Industry

3.1 The Development of Global Venture Capital Industries and Legal Systems

3.1.1 The Development of Global Venture Capital Industries

Small and medium companies, especially at their early stage, always suffer from financing difficulties due to lack of collateral assets, poor expectations of short-term earnings, and uncertain prospects. The venture investment, defined as the economic activity to provide loans and supports for these companies, can trace its origin back to the Hammurabi era (Lutz, 1932) of Babylon in the 18th Century BC (P. A. Gompers & Lerner, 2004). The modern venture capital industry began to take shape in the United States at the end of the 1800s. It is generally accepted that, after the Second World War, the establishment of American Research and Development Corporation (ARDC) in 1946 is the beginning of modern venture capital industries. However, due to the unsuccessful operation of ARDC, there are almost no similar companies that was founded between 1946 and 1958.

Meanwhile, the disarray in the U.S. financial and securities industries due to the disorderly operation in stock markets during the 1920s and 1930s moved the Securities and Exchange Commission (SEC) increase the threshold of financing of companies in capital markets. This in turn made it difficult for

small and medium companies to receive financial support from the capital market (Seligman 1982). To encourage the growth of small and medium companies while solving their financing problems, the U.S. Congress passed the “Small Business Investment Act” in 1958. This Act facilitates the establishment of venture investment agencies to invest in small companies. Besides the official government support through direct participation in the venture industry, the successful listing of the Digital Equipment Corporation (DEC) (invested by ARDC in 1957) in 1968 also shed positive light that further inspired the development of venture capital industries from then on.

After its initiation in the U.S., venture capital began to spread throughout the world quickly. In Japan, following the 1958 Act in the U.S., the local government proposed the “Small Business Investment Act in Japan” in the 1963. Three small and medium venture investment enterprise incubations were established in Tokyo, Osaka, and Nagoya, respectively. This marks the beginning of venture capital industries in Japan. On the other hand, Germany started its venture capital industry from 1965, however, there were only more than 60 active venture investment funds until 1995, due to its typical conservative financial system led by banks. The first venture investment company in Taiwan was established in 1976 and the official development of venture industries began in the 1980s. For UK, the beginning of VC industries was represented by the establishment of Charterhouse Industrial Development in 1934, Industrial and Commercial Financial Corporation (ICFC) and 3i in 1945. However, the development of VC was in a state of stagnation due to

continued high interest rate policies and lack of OTC during that time. It was not until 1979 that the “Medium Term Financial Strategy” was published for the development of private enterprises, and thus the UK’s VC industry development officially began. Meanwhile, the venture capital industries in Israel and China began to rise in the 1980s and 1985 respectively. However, the development in these two countries was very slow due to excessive economic intervention and strict financial control by the national government. In summary, despite the fluctuation and adjustment of industry cycles in these countries, the venture capital industries developed steadily and gradually after its emergence and soon became a vigorous economic activity worldwide.

According to the OECD census and the European Venture Capital Association Yearbook, the U.S. is the most developed country for venture capital in terms of absolute fundraising capital volume. In 1999 alone, the total venture capital volume in the United States was 2.29 times the total private equity capital volume in Europe (Feng, Tan, Feng, & Guo, 2010). However, when it comes to the venture capital share in GDP, the United Kingdom holds the highest percentage in the world (Figure 3-1). Compared to other countries, China lags far behind during the period ‘1995 to 1999.’ Nevertheless from 2000 onwards, especially after 2006, the Chinese venture capital industry ushered in an era of rapid development (Figure 3-3 and 3-4).

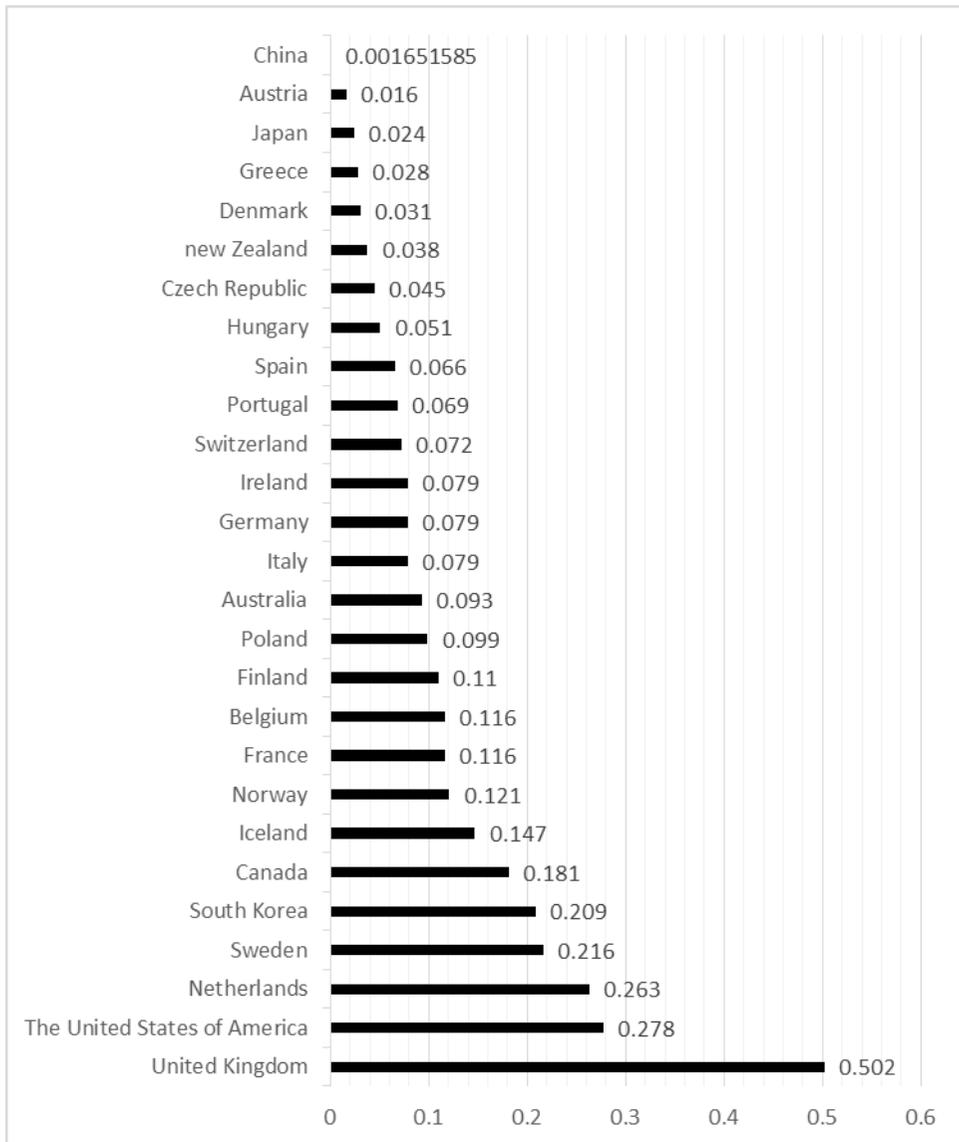


Figure 3-1 The average venture capital share in GDP by country (1995-1999)

Data Source: reorganized from Feng et al. (2000) by adding Chinese venture capital index. The Chinese GDP data was collected from the China National Bureau of Statistics and the venture capital fundraising data was collected from “pedata.cn”.

3.1.2 The Development of Legal Systems for Global Venture Capital

Industries

There is no clear and agreed academic definition of legal systems related to venture capital industries. In this study, all the legislations that are related to venture capital industries have been collected and sorted into six categories, which are fundraising pertinent legislation, registration pertinent legislation, investment pertinent legislation, existing pertinent legislation, taxation pertinent legislation, and supervision pertinent legislation. This paper refers to these six fields of VC related legislation combined together as the venture capital legal system (Figure 3-2).

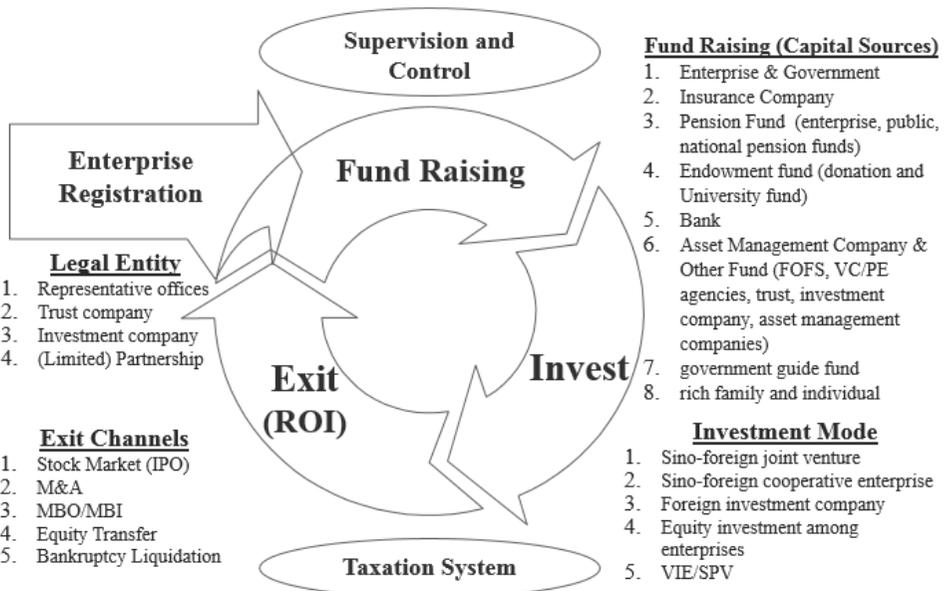


Figure 3-2 Legal System of Venture Capital Industry

There are several reasons for this sorting and definition. First, despite the fact that the venture capital industry's characteristics, volume and the relevant legal system in each country differ greatly due to the different economic environment, financing systems, regional commercial culture and industrial development history, the venture capital cycle have the common process of fundraising, registration, investment and exiting. Furthermore, all VCs have to obey the taxation policy and are placed under the supervision of the local government. Therefore, by sorting the regulations according to the abovementioned six aspects, a comprehensive panorama of the venture capital industry's legal environment may be well represented. Secondly, regulations for each of the above aspects are not isolated from each other but have strong interdependent relationship with each other. For example, one regulation may refer to several aspects of the venture capital's activities and a single activity by the VC may also have to obey several regulations from various legal fields. These VC related regulations have a complex connection with each other, and even a single missing regulation will affect the whole performance of the industry. That is why, we should consider the venture capital related legislation as a system rather than a mere collective document of related subjects⁶⁹.

Currently, there are two forms of legislations for venture capital. The first form is the non-special legislation of venture capital industry that

⁶⁹ It should be noted that the above definition of the VC legal system is not a complete legal system. The management related regulations are excluded from the system because the paper focuses on studying the location strategies of the VC.

dissolves the regulations into other related fields such as ‘securities laws,’ ‘Law on Promoting Small and Medium Enterprises,’ etc. Countries following this legislation include the U.S., UK, Germany, Canada, Israel and Japan. More specifically, for countries with continental law systems, the VC regulations are specified as chapters in the same securities or fund code. For example, the U.S. passed the “Investment Company Act (1940)” and the “Small Business Investment Act (1958)” to regulate VC establishment. The capital sources (i.e. fundraising) were regulated by modifying the “Prudent man”⁷⁰ clause in the Employment Retirement Income Security Act (ERISA) in 1974⁷¹ and 1977, and other tax revenue and securities laws. Nevertheless, the exit of VC was influenced and regulated by Article 4(2) and regulations on capital markets in the “Securities Act” (1933) published by the SEC, and adjustment of capital gains tax and investment tax in the “Internal Revenue Code⁷²” (1978) and “Economic Recovery Tax Act”⁷³ (1981). In UK, in addition to self-regulation, the VC industry is supervised by the Financial Services Agency(FSA)’s “Financial Services Act” (1986),” “Financial Services and Markets Act (2000),” and “Investment Act” (2001).

⁷⁰ The US Labor Department relaxed certain parts of the ERISA restrictions under the “prudent man rule” thus allowing corporate pension funds to invest in private equity. This resulted in a major source of capital available to invest in venture capitals and other private equities.

⁷¹ Corporate person funds were prohibited from holding certain risky investments including many investments in private companies.

⁷² Reduced the capital gains tax rate from 49% to 28%.

⁷³ Lowering of the top capital gains tax rate from 28% to 20% made high risk investments even more attractive.

As one of the countries practicing a continental law system, Germany specified detailed regulations for the establishment, operation, and information disclosure of hedge fund in Chapter 4 of the “Investment Law”. The regulations in this chapter applies to other regulations in the Law. Meanwhile, for the PE fund, the rules on organization mode, behavior, and investment range, product mode (except the raising and issuing system) were not overly strict. On the contrary, great freedom was specified for the organization, behavior and information disclosure of PE funds, compared to public funds (Zhang 2009). Most Japanese VCs are contractual funds, supervised by the “Securities Investment & Trust Law”, “Investment Trust and Corporation Law” (revised on December 1st 1998), “Provisions on the definition of the second article of Securities Exchange Act” and Securities Investment and Trust Association.

On the contrary, despite the lagging development of China’s venture capital industries, the government sought to regulate VC activities through legislation since the beginning of its development. This forms the second form of the VC industry legislation, i.e. the ‘special legislation on venture capital’. The typical legislation is the ‘Interim Measures for the Administration of Venture Capital Enterprises (创业投资企业管理暂行办法)’ that was jointly issued by the State Development and Reform Commission, the Ministry of Science and Technology, the Ministry of Finance, the Ministry of Commerce, the People's Bank of China, the State Administration of Taxation, the State Administration for Industry and Commerce, the China Banking Regulatory

Commission, China Securities Regulatory Commission and the State Administration of Foreign Exchange in 2005. However, this specific legislation does not fully cover all areas of the VC industry. Instead, it is closely linked with other laws and regulations, which constitute the legal system of Chinese venture capital industry when combined together. The development of VC industries and relevant legal systems in China will be further introduced in the following sections.

3.2 The Development of Venture Capital Industries and Legal Systems in China

3.2.1 Non-legal Environment for Development of Venture Capital in China

There are many influencing factors for the development of the venture capital industry. Some factors are volume of regional capital, number of small and medium companies in the region, number of entrepreneurs, number of regional patent holdings, level of risk-free interest rate, activity level of regional capital market, capital gains tax rates, and so on. Theoretically, sufficient volume of regional capital means that there is sufficient capital available for the VC industry, which is in turn beneficial for the regional development of the VC industry. A large number of small and medium companies as well as entrepreneurs imply a high demand for VC financing. A large amount of patent holdings means that many venture companies can transform the patent into products, and consequently more start-ups will emerge and more venture capital investment will be necessary. Therefore all of these factors does have a positive effect on the development of the VC industry.

Figure 1-1, 1-2, 1-4, 3-3, and 3-4 have represented good signals for venture capital development from the aspects of high growth GDP rate, vibrant high-tech economic activities, continuously increasing small and medium-sized enterprises, abundant capital stock (M2), high volume of stock

transaction and turnover rate, as well as the enlarged volume of high-tech companies and pattern stocks. All these signals can be interpreted as favorable conditions for the venture capital industry's development such as sufficient capital source, potential demand of VC financing, active capital market for VC to exit. Thanks to this favorable environment, the venture capital industry did develop steadily during this period in China (Figure 1-3, 3-5).

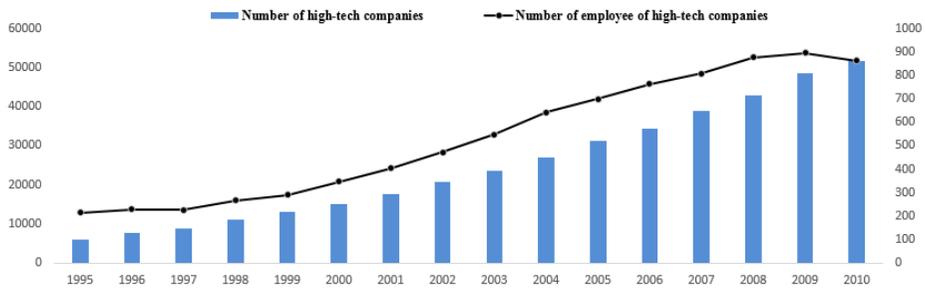


Figure 3-3 Number of High-tech companies and Employees in China (1995-2010)

Source: China National Bureau of Statistics

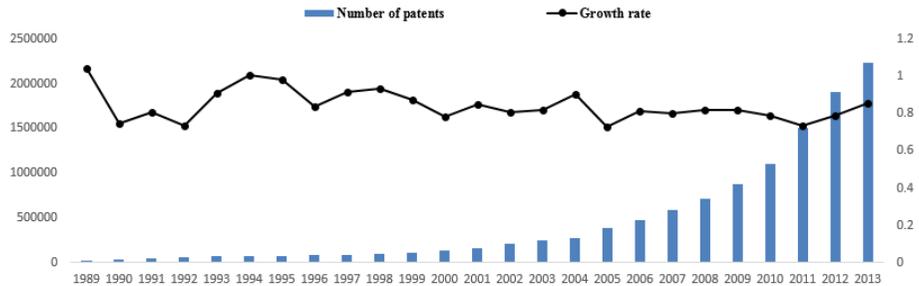


Figure 3-4 Patent Stock and Growth rate in China from 1989 to 2013

Source: China National Bureau of Statistics

However, despite the steady growth of venture capital investment in China, there are three issues that need close consideration. Firstly, when examining the matter from a venture capital firm registration perspective, it was clear that the development of the venture capital industry is not in the same pace as the economic growth. As shown in figure 3-5, the development of the venture capital industry is lagging far more behind the economic development. The reason for this phenomenon was because the venture capital investment in China does not necessarily register in China. Long-distance investment, which fall out of the government’s statistical census partly contributed the phenomenon. In other words, some venture capitals firm’s location was dualized into locations of registration and actual operation.

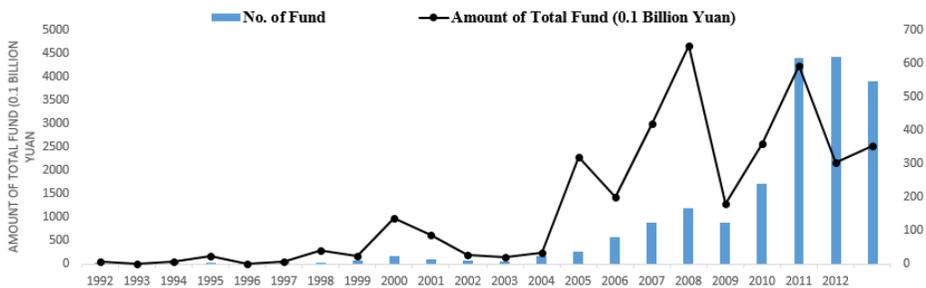


Figure 3-5 Chinese Venture Capital Fundraising Trend (1992-2013)

Source: Data is from Investment field, Investment trend, “pedata.cn”

Note: 1. The data from 1992 were collected

2. The data of angle fund, VC, PE were collected

3. The data for the period of 1992-2005 come from the Investment field and Investment trend while the data from “pedata.cn” is used for after 2006.

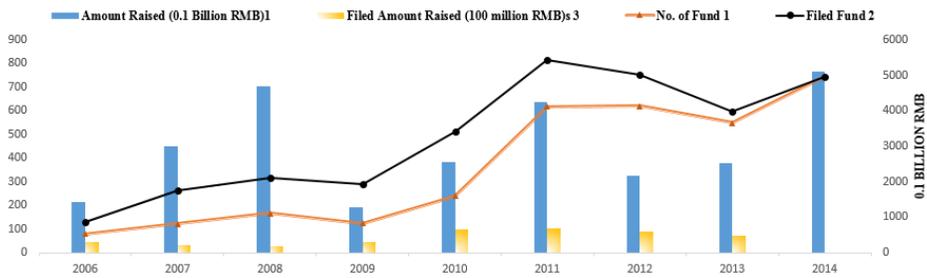


Figure 3-6 Filed and Unfiled Fund of China's Venture Fundraising Trend (2006-2013)

Source: Filed fund data were collected from '2014 Report on Development of Venture Capital Industries in China', while total fund data constituted based on data collected from pedaily.cn and investide.cn.

Second, huge gaps exist between each database that were collected by different institutions. According to the "2014 Report on Development of Venture Capital Industries in China" that was provided by the Financial Department of National Development and Reform Commission Equity and Venture Capital Specialized Committee of China Investment Association, there are a total of 1225 venture investment companies from 2006 to 2013. This is far different from the data that were collected from China Venture Capital Yearbook(中国风险投资年鉴), pedaily.cn(投资界), investide.cn (投资潮), and pedata.cn(私募通). This is because some collected the data based on the investment case's criterion, while others collected the data based on the exit case criterion or fund registration criterion. This reveals another phenomenon that is venture capitalists detach the venture investment cycle into pieces and allocate them into different places. Venture capitalists may raise funds in one place, while investing the money at a another place, and may exit from a third place to receive the investment returns.

Third, further examination of the data based on the currency type criterion revealed different trends of RMB fund and foreign currency fund. For example, the amount of venture capital funds invested in China was dominated by foreign currency funds before 2008. However, after 2008, the amount of RMB funds exceeded foreign funds and became the dominant investors in China's venture capital industry. On the other hand, the amount of foreign currency funds was higher than RMB funds before 2009, but the situation was reversed in 2009 and RMB became the main currency of venture capital fund in China from 2012. Theoretically, good external economic environment is beneficial for both the domestic and foreign venture capital's development. However, in the same environmental context, i.e. the steady development trend of the venture capital industry, the domestic and foreign capital display different development trends. This demonstrates that there exists significant capital allocation between onshore and offshore investments according to some specific factors that appeared in each period.

The reason for the above phenomena will be further examined and explained after a detailed examination of the transition of China's venture capital legal system and its relationship with the industry's development.

3.2.2 Legal Environment for the development of VC in China

According to the definition demonstrated in section 3.1.2, China's venture capital legal system can be illustrated as table 3-1. The system can be

divided in to six parts in total and each part covers certain activities of the venture capital industry.

Table 3-1 China Venture Capital Legal System

VC Field	Related Legislation Field	
Tax	Sales tax	Capital gains tax
	Corporation tax	Tax preferences
	Income tax	Tax subsidy
Fundraising	Guidance fund	Social security fund
	Trust	Securities company
	Enterprise	University endowment
	Bank	FOFs
	Insurance	Sovereign wealth fund
Establishment	Agency	Corporate juridical person
	Branch office	Partnership
Investment	Sino-foreign	VIE/SPV
	Equity investment	
Exit	IPO-mainboard	IPO-local equity trading center (OTC)
	IPO-SME board	M&A
	IPO-GEM board	MBI/MBO
Supervision	People's Bank of China	National Development and Reform Commission
	Department of Commerce	Ministry of Science and Technology
	Ministry of Finance	State administration of taxation
	Securities regulatory commission	State administration of industry and commerce
	Bank regulatory commission	State administration of foreign exchange
	Insurance regulatory commission	State-owned assets supervision and administration commission
	Ministry of Foreign Economic and Trade	China securities investment fund industry association

This legal system experienced a long term of transition from its advent to what it is today. Generally, three stages, namely the legislative blank stage (-2000), partial legislative stage (2001-2006) and positive legislation stage (2007-2012) can be recognized. The regulations involved in each stage are listed in Appendix 1. Before moving to the examination of the legal impact on capital spatial allocation, a general review of the transition process of China's venture capital legal system will be first demonstrated in this section.

(1) Period of legislative blank stage (1979-2000)

Since the reform and opening-up in 1979, China's development focus has shifted from class struggle to economic development. However, in the early stage of reform and opening-up, China's overall economic development direction was not that clear. Issues about whether market economy can be applied in a socialist country still face many controversies. China's economic situation at that time, quoting Deng Xiaoping's words, was 'wade across the stream by feeling the way'. Consequently, the entire legal system was also extremely simple and the legislation was also 'wade across the stream by feeling the way.' During this period, it was almost impossible to put forward the legislation on venture capital. Therefore, the legal system of venture capital was almost nonexistent during this period. When venture capital began participating in China's economic development, only several partially related laws and regulations were available for them to rely on. For example, when

foreign venture capitals registered or invested in China, only the law of foreign-funded enterprises, law of Sino-foreign cooperation joint ventures, and law of Sino-foreign joint venture were available for them to apply. On the other hand, for domestic venture capitals, only company law was available for them to rely on for carrying out legal economic activities while protecting their rights during that time. This legislative blank, on one hand, increased the cost of enterprises' economic activities, while on the other hand, provided certain growth space and possibilities for enterprises to find their own way in surviving the harsh environment.

(2) Period of partial legislative stage (2001-2006)

In September 2001, the introduction of the 'Interim Provisions on the Establishment of Venture Investment Companies with Foreign Investment' announced the formal formation of China's venture capital legal system. In addition, with the help of Deng Xiaoping's speech in 1992, the direction of China's economic policy, which stated that China will continue on its journey to reform and opening-up, has been further clarified and stabilized. Along with the certitude of the economic policy's direction, legislation activities that were relevant to the situation began to emerge and developed vigorously. This situation combined with the initiation of China's financial system reform, which launched in 1995, facilitated the advent of a range of financial and securities regulations such as the trust law, securities law etc. Meanwhile,

other relevant laws, like the company law, was also revised several times during this period. All of the above have contributed to the enrichment of the content and framework building of China's venture capital legal system. Thus, this period formed the initial prototype of China's venture capital legal system, which centered on the 'Interim Provisions on the Establishment of Venture Investment Companies with Foreign Investment,' as well as some other regulations that were related to the venture activity.

However, it was almost impossible for venture capitals to exit from the China's domestic capital market due to its backward financial system and capital market as well as the side effects that were caused by the revitalizing of non-performing assets belonging to large state-owned enterprises in China. Therefore, venture capitalists had to use the 'flexible' approach to find overseas exit channels. In this regard, the government as well as the entrepreneurs was aware of the trick. However, in order to promote the industry's development and overall economic growth by seeking use of the overseas capital, the government chose to turn a blind eye to this. Therefore, during this period, using the red-chip model to achieve the overseas listing was very popular among venture capital investment in China. This phenomenon, as a matter of fact, is one of the manifestations that was caused by the imperfect legal system at that time.

(3) Period of positive legislation stage (2007-2012)

During this period, the legislation on venture capital industry was continuously enriched and perfected, and the entire legal system framework was completed. The specification of the legislative contents not only cover the capitals that come from both inside and outside of China, but also cover almost all aspects that are relevant to venture capital agencies and activities. This legal framework together with the government's objective to encourage venture capital performance in China, provided them with a full road map for activity in China, a protection guarantee of their business rights, and a well-designed fetter while doing business. A typical example is the introduction of the 'Notice on improving foreign capital merging and management of exchange (also known as No. 11 document)' in 2005. According to this provision, the red-chip approach was actually no longer available for firms to achieve overseas listing. This meant that the government officially announced the ending of its 'turning a blind eye' attitude and showed that they will clearly encourage the on-shore development of its venture capital industry. More detailed information of the red-chip structure and its relationship with the venture capital spatial allocation will be further discussed in the next chapter.

Chapter 4 Legal Impact on VC's Geographical Patterns of Capital Allocation

4.1 Correlation Analysis of VC Capital Allocation and Legal System

Due to the separable characteristic of capital and the fact that legislation is an important factor that affects the location choice of venture capital as discussed in chapter 2, the investment cycle of venture capital can be divided into several parts and located in different places for the sake of gaining advantages or avoiding disadvantages caused by certain regulations. Later, in chapter 3, the observation of China's venture capital industry shows that venture capitalists actually implemented this in practice. To further explain the geographical patterns of this capital spatial allocation, the above situation is illustrated into the following abstract diagram (Figure 4-1).

In this diagram, the middle ovals represent the four stages of the venture capital investment cycle, namely, fundraising, fund registration, investment, and exiting. They are correlated but independent of each other, which means each of them can be located within China or overseas. Different location means different regulations being applied. The domestic registered capital (on-shore) should comply to the regulations represented by the left squares in the diagram, while the overseas registered capital (off shore) should comply to regulations in the right squares. Each part of the capital cycle may be related

to several laws and regulations and the sum of these regulations eventually forms the venture capital legal system. The differences in regulations between regions is expected to affect the capital spatial allocation, and the changes in these regulations is assumed to transform the capital spatial allocation patterns.

To confirm these assumptions, the actual spatial allocation patterns of the venture capital investment in China will first be illustrated. Then, after confirming the correlation of the legal system with the above patterns, more detailed legal provision analysis will be conducted to further explore the related causes and principles.

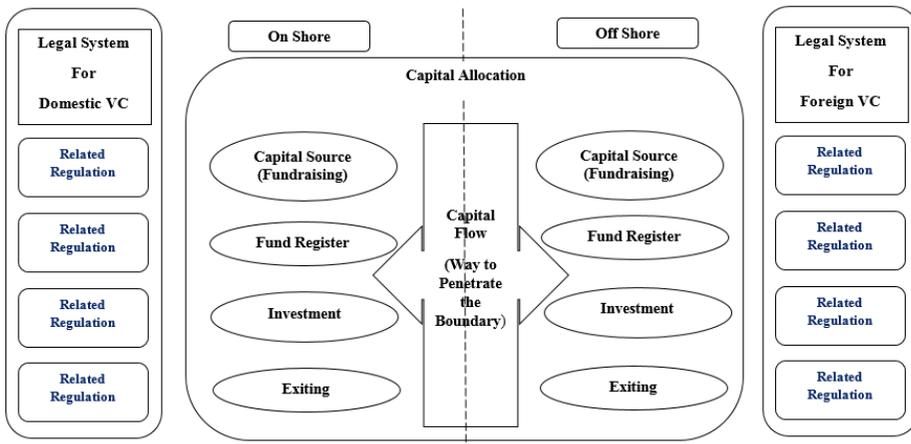


Figure 4-1 Abstract diagram of the description of legal system and capital spatial allocation

4.1.1 Transition of the Geographical Patterns of the Venture Capital

Investment in China

Based on the database collected from pedata.cn, three capital spatial allocation patterns can be detected from 1992 to 2012.

The first pattern is the “head-tail outside pattern”. In this pattern, the location of the fundraising, registration, and exiting are all located outside of China, while only investment activities are located within China. This pattern was especially dominant before 2000.

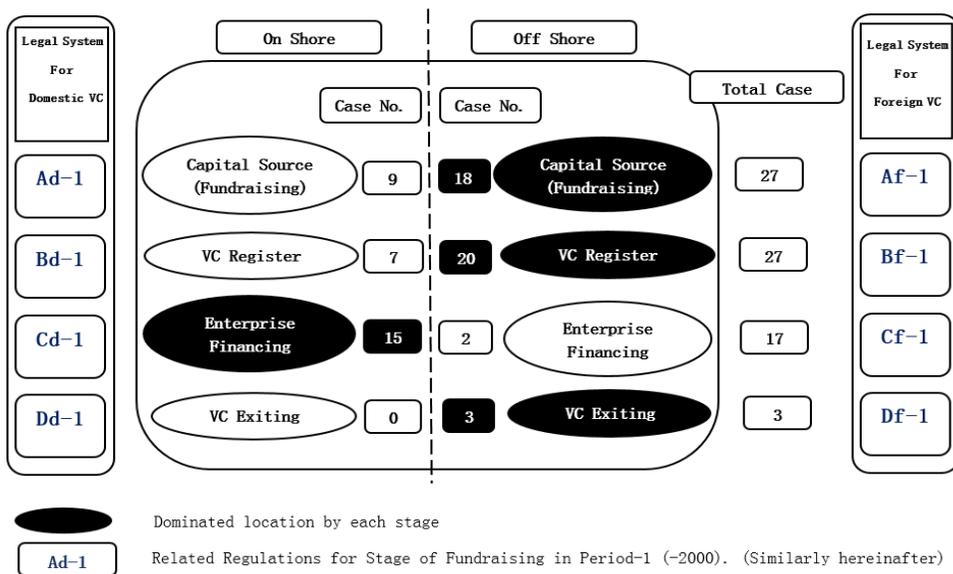


Figure 4-2 Head-Tail Pattern of Venture Capital Allocation (Pattern 1)

The second pattern is the ‘mix location pattern’. In this pattern, the individual stages of the venture cycle were placed into different locations according to the specific economic and legislative situations as well as the specific needs of the investment cases. This pattern appears most between

2001 and 2006 when China's venture capital legal system was initially founded although it was yet to be complemented.

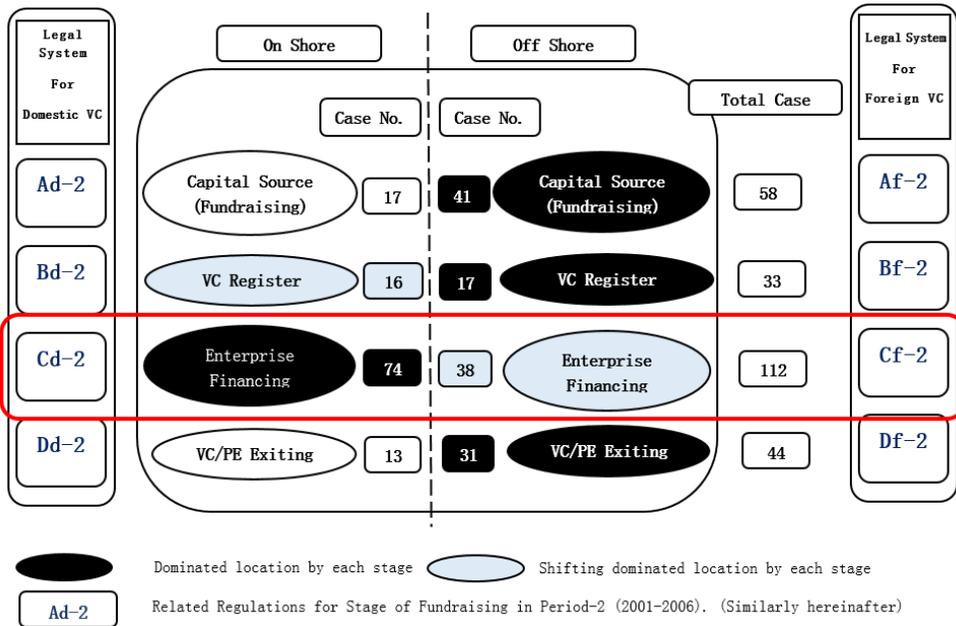


Figure 4-3 Mix Location Pattern of Venture Capital Allocation (Pattern 2)

The third pattern of the venture capital spatial allocation invested in China is the 'all-stage back in situ pattern'. In this pattern, all the four stages of venture cycle are all located within China, which means the capital source, fund registration, investment, and exiting activities are all conducted within the boundaries of China. This pattern dominated from 2007 to 2012 when the Chinese government introduced intensive regulations to encourage the

domestic venture capital industry's development while blocking the way for overseas circuitous listings.

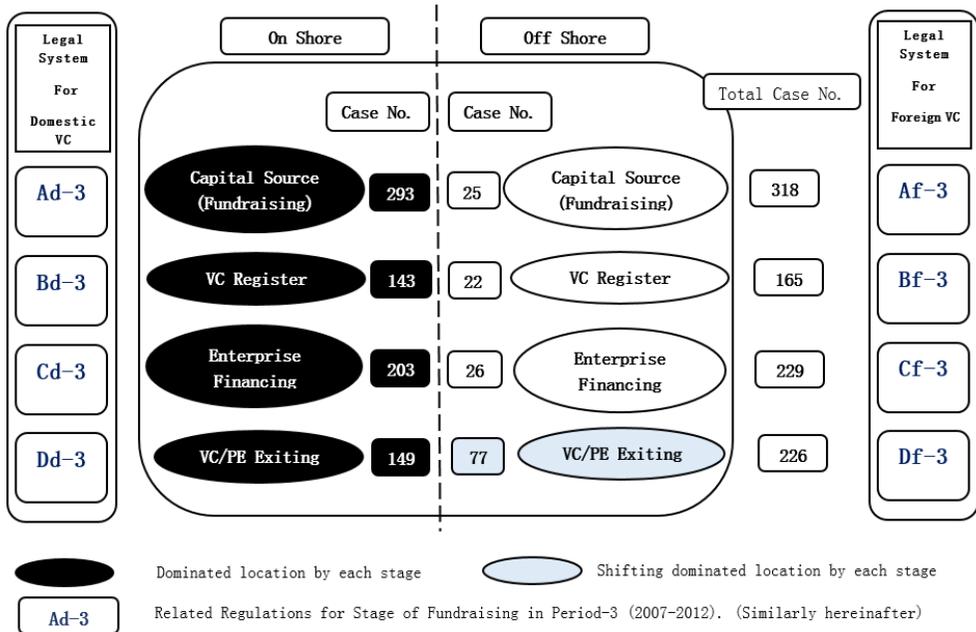


Figure 4-4 All-Stage Back in Situ Pattern (Pattern 3)

4.1.2 Correlation between Legal Systems and Geographical Patterns of Venture Capital Allocation

Before discussing the causes and mechanisms of the legal impact on venture capital spatial allocation, whether a correlation between the two parties exists will be first examined in this section through the correlation analysis approach.

Three sets of variables are selected to examine the correlation between the legal system and spatial allocation of venture capital. The first set of variables is the locational variables for the four stages of the venture capital cycle. These variables represent the geographical patterns of the venture capital industry and it consists of 8 variables, namely, Y-Ad, Y-Af, Y-Bd, Y-Bf, Y-Cd, Y-Cf, Y-Dd, Y-Df, and they represent the capital source from China, capital source from outside of China, fund registered in China, fund registered outside of China, portfolio company registered in China, portfolio company outside of China, exiting within China, and exiting outside of China (Table 4-1).

Table 4-1 Locational Variables of Correlation Analysis

Variable Code	Implication of the Variable	Variable Code	Implication of the Variable
Y-Ad	Capital from China	Y-Af	Capital from overseas
Y-Bd	Fund registered in China	Y-Bf	Fund registered overseas
Y-Cd	Funded companies registered in China	Y-Cf	Funded companies registered overseas
Y-Dd	Exit in Chinese capital markets	Y-Df	Exit in overseas capital markets

The second set of variables are legislation variables. To carry out the correlation analysis with the other two variable sets, this paper classifies the legislation environment into eight categories, in consistency with the locational variables illustrated above. These legislation variables are Ad, Af, Bd, Bf, Cd, Cf, Dd, Df, and each of them represent the legal environment for

domestic fundraising, overseas fundraising, domestic fund registration, foreign fund registration, domestic investment, foreign investment, domestic exiting, and overseas exiting respectively (Table 4-2). By scrutinizing each of the provisions that are related to the corresponding venture activities, the legal environment was scored according to a quantization processing. This indexation approach is based on the pioneer works of Berkowitz et al. (2003) and Abiad et al. (2008). The legislation documents required for the indexation are listed in Appendix 1, and the methodology and process of the coding is described in Appendix 2.

Table 4-2 Legislation Variables of Correlation Analysis

Variable Code	Implication of the Variable	Variable Code	Implication of the Variable
Ad	Regulations on domestic fundraising	Af	Regulations on overseas fundraising
Bd	Regulations on domestic fund	Bf	Regulations on overseas fund
Cd	Regulations on domestic funded companies	Cf	Regulations on overseas funded companies
Dd	Regulations on domestic exit	Df	Regulations on overseas exit

Overseas financing and investment are excluded from the correlation analysis because they are not within the scope of the Chinese legal system. It should be noted that among the variables, the activities that related to Af and Bf are beyond the supervision scope of the Chinese legal system. Therefore, these two variables are excluded from the analysis set.

The third set of variables are non-legal environment variables. As discussed in chapter 2, the economic environment, regional capital stock, high-tech enterprise, high-tech labors, and patent stock all have a significant impact on the venture capital industry's development. Therefore, the five variables below are selected to form the non-legal environment variable set as the comparison variables (Table 4-3).

Table 4-3 Non-Legal Environment Variables of Correlation Analysis

Variable Code	Implication of the Variable
X1=GDP=XEG	GDP
X2=M2=XEM2	Broad measures of money supply (M2)
X3=High-tech Enterprise No.=XEE	Number of high-tech companies
X4=HR No.=XEH	Number of employee of high-tech companies
X5=Patent Stock=XEP	Number of patents

The results of the correlation analysis conducted by SPSS are presented as follows.

Table 4-4 Correlation between Non-legal Environment and Venture Capital Geographical Allocation

		X1	X2	X3	X4	X5
Y-Ad	Pearson Correlation	.935**	.937**	.684**	.801**	.936**
	Significance Probability (Both Sides)	.000	.000	.003	.000	.000
	N	21	21	16	16	21
Y-Af	Pearson Correlation	.131	.109	.377	.312	.031
	Significance Probability (Both Sides)	.570	.638	.150	.239	.893
	N	21	21	16	16	21
Y-Bd	Pearson Correlation	.948**	.953**	.722**	.836**	.951**
	Significance Probability (Both Sides)	.000	.000	.002	.000	.000
	N	21	21	16	16	21
Y-Bf	Pearson Correlation	.313	.292	.316	.247	.283
	Significance Probability (Both Sides)	.167	.198	.233	.356	.213
	N	21	21	16	16	21
Y-Cd	Pearson Correlation	.650**	.612**	.882**	.905**	.512*
	Significance Probability (Both Sides)	.001	.003	.000	.000	.018

	N	21	21	16	16	21
Y-Cf	Pearson Correlation	.334	.311	.693**	.576*	.215
	Significance Probability (Both Sides)	.139	.170	.003	.019	.349
	N	21	21	16	16	21
Y-Dd	Pearson Correlation	.879**	.894**	.631**	.755**	.895**
	Significance Probability (Both Sides)	.000	.000	.009	.001	.000
	N	21	21	16	16	21
Y-Df	Pearson Correlation	.654**	.648**	.801**	.846**	.549**
	Significance Probability (Both Sides)	.001	.001	.000	.000	.010
	N	21	21	16	16	21

****.** Significant at 1 percent level. (Both Sides).
*****. Significant at 5 percent level. (Both Sides).

**Table 4-5 Correlation between Legal Environment and Venture Capital
Geographical Allocation**

		X1-Ad	X1-Bd	X1-Cd	X1-Cf	X1-Dd	X1-Df
Y-Ad	Pearson Correlation	.936**	.801**	.637**	.595**	.843**	.593**
	Significance Probability (Both Sides)	.000	.000	.002	.004	.000	.005
	N	21	21	21	21	21	21
Y-Af	Pearson Correlation	.080	.257	.410	.509*	.264	.441*
	Significance Probability (Both Sides)	.729	.261	.065	.018	.248	.046
	N	21	21	21	21	21	21
Y-Bd	Pearson Correlation	.949**	.826**	.665**	.613**	.858**	.612**
	Significance Probability (Both Sides)	.000	.000	.001	.003	.000	.003
	N	21	21	21	21	21	21
Y-Bf	Pearson Correlation	.248	.319	.329	.384	.280	.273
	Significance Probability (Both Sides)	.278	.158	.146	.085	.220	.231
	N	21	21	21	21	21	21
Y-Cd	Pearson Correlation	.761**	.839**	.754**	.745**	.770**	.732**
	Significance Probability (Both Sides)	.000	.000	.000	.000	.000	.000
	N	21	21	21	21	21	21
Y-Cf	Pearson Correlation	.311	.490*	.594**	.712**	.464*	.684**
	Significance Probability (Both Sides)	.170	.024	.005	.000	.034	.001
	N	21	21	21	21	21	21
Y-Dd	Pearson Correlation	.828**	.702**	.566**	.545*	.775**	.554**
	Significance Probability (Both Sides)	.000	.000	.007	.011	.000	.009
	N	21	21	21	21	21	21
Y-Df	Pearson Correlation	.692**	.711**	.641**	.706**	.766**	.707**
	Significance Probability (Both Sides)	.001	.000	.002	.000	.000	.000
	N	21	21	21	21	21	21

****.** Significant at 1 percent level. (Both Sides).
*****. Significant at 5 percent level. (Both Sides).

The results show that both the legislation and economic variables have close relationships with the capital spatial allocation of the venture capital industry. After this confirmation, the causal relationship between the legislation and the capital spatial allocation as well as the principles and mechanisms behind the causation will be further explored in the following section through a detailed interpretation of the legal provisions and game analysis.

4.2 Legal Impact on Geographical Allocation of VC Capital

Basically, the operation process of the venture capital is as follows. Venture capitalist, i.e. fund managers initiate a proposal for raising money from investors to establish a fund with certain preferences on risk appetite, industry field, technology type, investment region and period. After the establishment of the fund, the money raised will be invested in well selected potential companies. By providing a series of additional services, venture capitalists facilitate the development of portfolio companies. When the portfolio company grows to a certain extent, or are subject to certain requirements of the venture fund contract, venture capitalists will choose a proper time to sell the shares they acquired in early investment stage to the capital market in order to gain investment capitals as well as an extra return on the investment.

The above operation process involves a number of activities. Each of the activity is protected and subject to a number of relevant laws and regulations. The protection and limitations may in turn affect the location strategies of the activities, and the transition of location strategies may occur following the changes in corresponding regulations. In this section, the above aspects will be examined in the order of fundraising, registration, investment and exit, respectively. In each part of the discussion, legislations that are related to the

corresponding activities will be listed in a chronological order along with detailed interpretations that are obtained from a close study of the specific law provisions. The result of the legal interpretations will be further compared with the empirical data collected from pedata.cn. And a visual map will also be provided to facilitate the intuitive understanding of the discussion above.

4.2.1 Legal Impact on Fundraising Stage

A venture capital fund initiated from a proposal of the fund initiators, which include the contents of the investment area, industry field, technology type, risk appetite, time span, and strategies, etc. Along with the proposal scheme, investment invitations will be sent to the potential investors privately either through the fund initiator's personal network or directly to the target investors. After signing up the 'Term Sheet' and establishing the general assemblies of initiators and investment partners, the fund operating process now turn into the fund registration stage.

In most cases, fund initiators act as fund managers, i.e. the general partner (GP), while the investment invitees are limited partners (LP) in the venture fund. According to the 'Provisions Concerning the Administration of Foreign-funded Business-starting Investment Enterprises' (2003)⁷⁴, the GP is

⁷⁴ Chapter II Article 7 (6): An indispensable investor of a non-legal-person enterprise shall subscribe to and actually pay no less than 1% of the subscribed contributions and the

responsible for 1% of the total amount of the fund and LP for the remaining 99%. Therefore, the capital source of the fund that this study is focusing on will mainly refer to the geographical locations of LPs. In reference to international practice, there are roughly about 9 channels for venture capital funds to raise money. They are company and government, insurance companies, pension⁷⁵, donation funds⁷⁶, banks, asset management companies, hybrid funds⁷⁷, government guided funds, rich families and individual⁷⁸, etc.⁷⁹

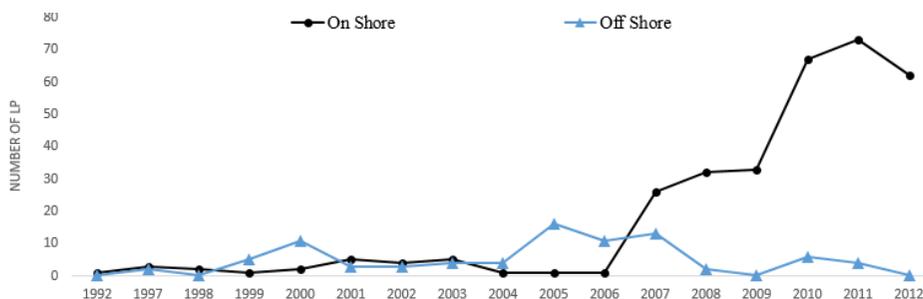


Figure 4-5 Venture Capital Source Location – Limited Partner Registered Location

actual total contributions respectively, and it shall bear joint liabilities for the debts of this enterprise.

⁷⁵ Including enterprise fund, national pension fund, public pension fund, etc.

⁷⁶ Including general donation fund and university fund.

⁷⁷ Including fund of funds (FOFS), venture capital agencies, trust companies, investment companies, asset management companies, etc.

⁷⁸ This data is beyond the scope of this study due to the lacking information of individual investors.

⁷⁹ Including listing enterprises, real estate development and management enterprises, etc.

Data collected from ‘pedata.cn’ shows that most of the capital source that constitute the early venture capital funds invested in China came from overseas, while domestic capital source dominated the industry in the later period (Figure 4-5).

From the LP type point of view, the domestic capital source channels are extremely limited to the point that almost all the early domestic capitals came from enterprises, governments and relevant industries. Meanwhile, no other types of capitals can be detected have participated in the venture capital industry (Table 4-6). It was not until 2007 that the LP type extended to other capital source channels such as insurance companies, pension fund, endowment fund, banks, asset management company and other funds, etc. On the contrary, the LP type that comes from outside of China is relatively diversified compared to China’s domestic LPs (Table 4-7).

Table 4-6 On Shore Limited Partner Type

Source	1	2	3	4	5	6	7	8	Total
1992	1	-	-	-	-	-	-	-	1
1997	2	-	-	-	-	1	-	-	3
1998	-	-	-	-	1	1	-	-	2
1999	1	-	-	-	-	-	-	-	1
2000	1	-	-	-	-	1	-	-	2
2001	2	-	-	-	-	3	-	-	5
2002	2	-	-	-	-	1	1	-	4
2003	2	-	-	-	-	3	-	-	5
2004	-	-	-	-	-	-	1	-	1
2005	-	-	-	-	-	-	-	1	1

2006	1	-	-	-	-	-	-	-	1
2007	9	-	-	-	-	14	-	3	26
2008	16	-	-	-	1	10	4	1	32
2009	10	-	1	1	-	15	3	3	33
2010	26	-	1	1	-	31	5	3	67
2011	23	2	1	1	-	33	6	7	73
2012	21	-	-	-	-	30	7	4	62
Total	117	2	3	3	2	143	27	22	319

Note: Source 1-8 represents Enterprise & Government, Insurance Company, Pension Fund, Endowment Fund, Bank, Asset Management Company & Other Funds, Government Guide Fund, and Others respectively.

Table 4-7 Off Shore Limited Partner Type

Source	1	2	3	4	5	6	7	8	Total
1997	-	-	1	1	-	-	-	-	2
1999	1	-	2	-	-	2	-	-	5
2000	7	1	-	-	-	-	1	2	11
2001	1	-	-	-	-	1	-	1	3
2002	1	-	1	-	-	1	-	-	3
2003	1	-	-	-	-	3	-	-	4
2004	1	-	1	2	-	-	-	-	4
2005	1	-	1	5	-	5	-	4	16
2006	1	-	1	2	1	6	-	-	11
2007	2	-	3	3	-	3	-	2	13
2008	-	-	-	-	-	1	-	1	2
2010	-	-	2	-	1	3	-	-	6
2011	1	-	-	-	-	1	1	1	4
Total	17	1	12	13	2	26	2	11	84

Note: Source 1-8 represents Enterprise & Government, Insurance Company, Pension Fund, Endowment Fund, Bank, Asset Management Company & Other Fund, Government Guide Fund, and Others respectively.

Here, special attention should be paid to the LP data of China's on-shore pension fund, donation fund and insurance companies. Because from 1992 to 2008, no LP came from these investors although they actually do not lack in investable funds (Figure 4-6, 4-7, 4-8).

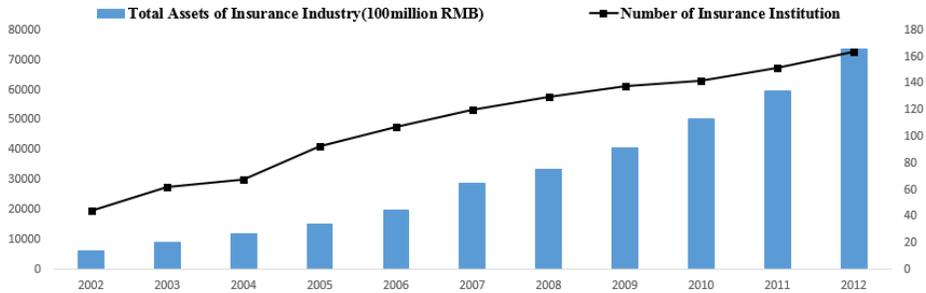


Figure 4-6 China's Insurance Industry Capital Stock

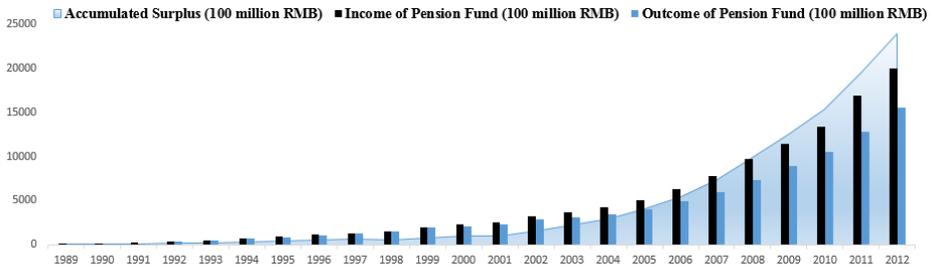


Figure 4-7 Trend of China's Pension Fund

The reason for these mismatches can be found when matter are considered from a legal perspective.

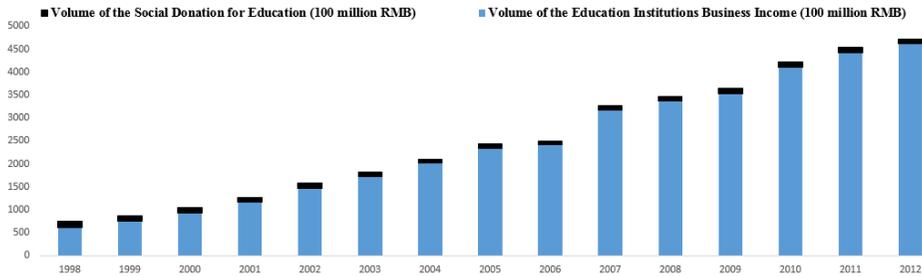


Figure 4-8 China’s Education Endowment Fund

Source: National Bureau of Statistics of the People’s Republic of China

Until 2000, there existed virtually no legal basis for venture capital fundraising in China. Although since 1985, the Chinese government began to release a series of policy documents, like ‘Decisions on The Reform of Science and Technology Institution (1985),’ ‘Science and Technology Guide-White Paper on Science and Technology (1986),’ ‘High Technology Research and Development Program (1986),’ ‘863 Plan (1986),’ ‘Torch Plan (1988),’ etc., to support the development of the venture capital industry. However, in practice, there was no relevant supporting legislation to facilitate the implementation of the idea that the government released in the documents, not to mention the legal provisions to guide and protect the related activities. During this period, only one ordinance, namely the ‘Interim Regulations on Beijing New Technology Industry Development Experimental Zone⁸⁰,’ explicitly mentioned the venture capital industry in its provision of Article 9 that states. ‘Sino-foreign joint venture type venture capital companies are allowed to be established in the experimental zone.’ Similar to the policy

⁸⁰ Promulgated by the State Council of China in 1988.

documents that was issued by the government, this ordinance did not contain any other details that were related to the establishment and operation of venture capital companies. Therefore, although this interim regulation for the first time included the venture capital industry into formal laws and regulations, it still failed to provide practical guidance and protection for China's venture capital industry development. Consequently, during this period, despite the good economic and political signals which showed a vast potential for venture capital to develop in China, the lacking support of relevant regulations made it almost impossible to be realized.

However, as the old saying goes, 'where there is a will there is a way,' despite the lack of a sound legal environment during this period, the attractiveness of profits impelled capitalists to seek all possible ways to break through the barriers and participate in the economic activities. At this point, venture capitalists chose a way to raise money outside of China and then invest into China's portfolio companies in the form of foreign direct investment (FDI). By transforming their legal status from venture capitalists to foreign direct investors, the drawbacks of the non-existent legislative support for venture capital when carrying out legitimate investment activities was avoided.

On the other hand, China was at the early and transitional stage of reform and opening up during that time. Local governments were eager to revitalize state-owned assets, encourage technology innovation and develop regional

economy by supporting high-tech industries. In addition, there were no regulatory barriers for the government to be involved in the fundraising of venture capital industries. Therefore, the government investors became the main source of domestic fundraising. On the other hand, the 12th article of "Company Law" (1993) regulated that the accumulated investment capital of companies investing in other limited liability companies and corporation limited (except for investment and share holding companies approved by State Council) should not exceed 50% of the firm's total net asset. The emergence of this provision enabled domestic companies to become the main source of domestic LP.

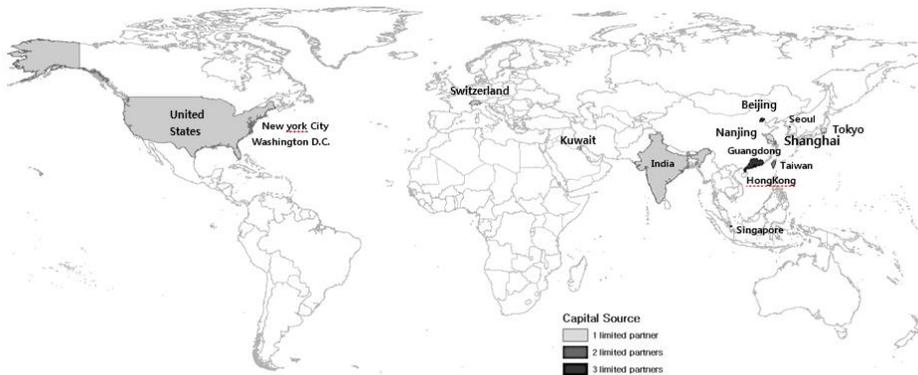


Figure 4-9 Capital Source Location (before 2000)

Therefore, the capital source of venture capital investment in China were either located outside China or within the economic reform pioneer regions like Beijing and ShenZhen (Figure 4-9).

Since 2001, special legislations on venture capital started to be published. These include the ‘Interim Provisions on the Establishment of Venture Investment Companies with Foreign investment (2001),’ ‘Provisions on the administration of Venture Investment Companies with Foreign investment (2003),’ ‘Interim measures for the administration of venture investment companies (2005),’ and ‘Trust Law (2001),’ etc. However, there was no specification on the fundraising sources in these regulations and there were no obvious changes in regulations related to other capital sources. Therefore, overseas capital was still the main source of venture capital (Figure 4-10).



Figure 4-10 Capital Source Location (2001-2006)

In September 2007, the ‘Reply to the pilot project of direct investment of CITIC Securities Company Limited and CICC Limited’ was published by

CSRC. Financing management agencies such as securities companies started to enter venture investment fields. From April 2008, pension funds approved by the State Council were allowed to invest in industrial funds and market-based equity investment funds once approved by the National Development and Reform Commission. On April 30th 2009, the ‘Guide on The Pilot Direct Investment of Securities Companies’ was published by CSRC. It was regulated that the pilot direct investment of securities companies should be approved by CSRC, which issued an agreement document, and the direct investment should be in the form of subsidiary company establishment. The qualification and investment processes were also regulated. Although it faced several tough situations, the pilot institution, initiating the equity investment of securities companies, has continued to date. On September 5th 2010, the “Interim measures for the equity investment of insurance funds” was published by the China Insurance Regulatory Commission. Since then, insurance companies started to invest in venture capital funds. In addition, the “Suggestions on encouraging and guiding the healthy development of private investment” and “New 36 articles” were published by the State Council in 2010. It started to give up monopoly and allowed private capital’s investment in equity funds to participate in the construction and financing industries. The bank capital, restricted by the “Commercial Bank Law (2003)⁸¹,” was not allowed to be involved in venture investment until 2012. There are no

⁸¹ According to the 43th article of "Commercial Bank Law," commercial banks should not conduct trust investment and securities business in China and should not invest in non-self-use estate or non-banking financial agencies and companies.

regulatory barriers for the sole policy bank⁸² approved by the Ministry of Finance to invest in venture capital industry. On the contrary, overseas fundraising was completely not restricted by Chinese regulations and had a variety of capital sources. Therefore, the geographical allocation of LP during this period was formed as shown in figure 4-11 and 4-12, and the inconsistency between the volume of regional capital and venture capital source can be explained from the regulatory interpretation presented above.

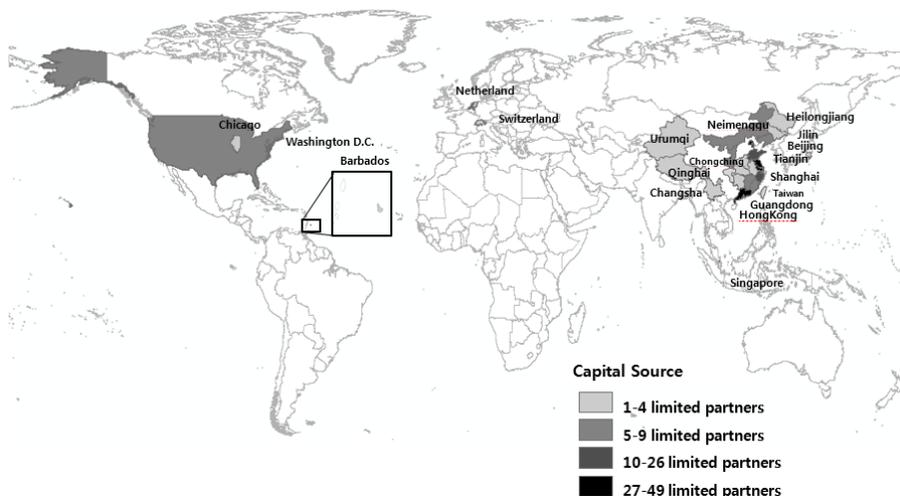


Figure 4-11 Capital Source Location (2007-2012)

⁸² There are three policy banks in China: Export-Import Bank of China, China Development Bank, Agriculture Development Bank of China. There are no legal barriers for policy banks to make equity investment if approved by the Ministry of Finance. Two of the three banks have participated in PE investment with the Ministry of Finance's approval, e.g. the investment of China Development Bank on Zhongrui Fund, China ASEAN Cooperation Fund, Bohai Industrial Investment Fund.

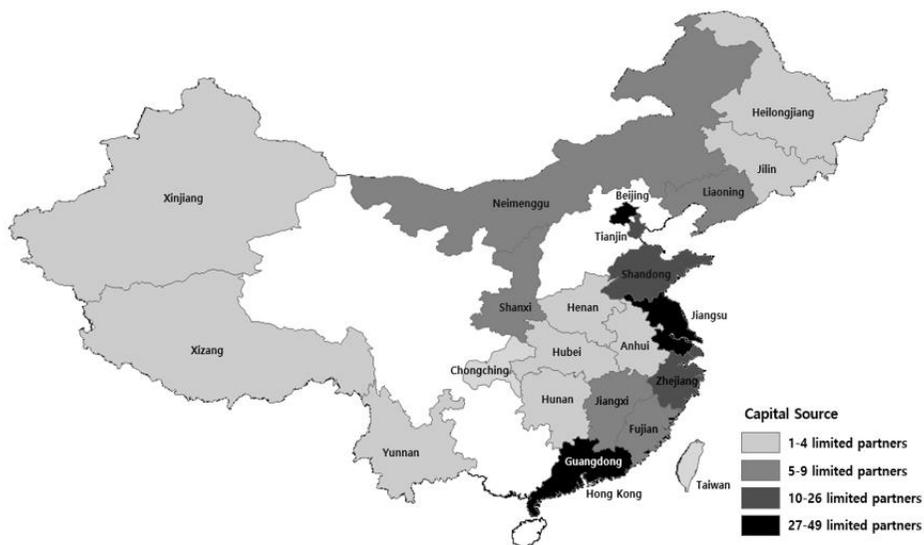


Figure 4-12 Domestic Capital Source Location of China (2007-2012)

4.2.2 Legal Impact on Registration Stage

The raised fund will be managed by a venture capital management company or be registered as an independent legal entity to carry out the venture investment activities. Generally, venture capital funds may take the form of contract, trust, investment companies and limited partnership. There are many uncertainties in the contract form, which is not widely used. Whereas, trust and investment company are more common than the contract form and should apply to the “Company Law”. However, there are some disadvantages for this second form, that is, this form of fund has to bear the burden of a double taxation regulation while putting up with the slow investment decision-making process due to its rigid organization structure. The limited partnership is not a legal person in law, therefore no corporate

income tax needs to be paid. The partners only need to pay their own personal income tax, which enables them to avoid the burden of double taxation. Meanwhile, it is theoretically and practically proven that this partnership form has a positive effect on the venture capital's performance due to its flexible decision-making structure and effective incentive mechanism. Therefore, partnership is the most popular form of venture capital fund form.

In the development process of the Chinese venture capital legal system, except for the 'Company Law' (1993, 1999), there were almost no regulations related to fund registration before 2000. Whereas, the 12th article in this law regulated that the accumulated investment of the company should not exceed 50% of its registered capital. This regulation created a large amount of idle funds for venture capital fund registration as the cooperate company. In other words, if venture funds registered as a cooperate company, at least 50% of the fund could not be used to invest in portfolio companies. This limitation, without doubt, increased the capital cost of the fund and lowered the efficiency of the investment activities. On the other hand, despite the fact that foreign capital was allowed to participate in China's venture market in the form of Sino-foreign joint venture, the lack of venture capital relevant legislation reduced the capital efficiency while increasing the cost of capital operation. That is because the Sino-foreign capital company had to carry out non-venture capital businesses along with the investment activities according to the relevant foreign direct investment laws.

In 1997, the ‘Partnership Law’ was introduced in China, however, it did not mention ‘limited partnership’ in its provisions. Although this ‘partnership law’ enabled venture funds to register as a partnership firm, which helped them to avoid the disadvantages of double taxation, the incentive mechanism that was induced through the arrangement of differentiating the rights and responsibilities between limited partners and general partners will not function properly without a clear legal definition. As a result, the limited partnership was virtually unavailable in China during this time. Consequently, venture capital funds during this period either registered outside of China or was simply managed by existing venture capital management companies offshore. In addition, there was another option for them. That is, cooperating with the Chinese government, establishing a government-private cooperation company to avoid the limitations of the law while seeking more comprehensive investment opportunities and protection from it. In other words, the legal environment during this period led to venture capital funds seeking to register overseas or cooperate with the local government, while both options were virtually bypass ways for venture capitals to participate in Chinese venture market. Figure 4-8 illustrates the location pattern of the fund management companies, which correspond with the situation of non-register fund. While figure 4-9 illustrates the location pattern of the registered fund, which is made up of almost only government-private cooperation venture companies.

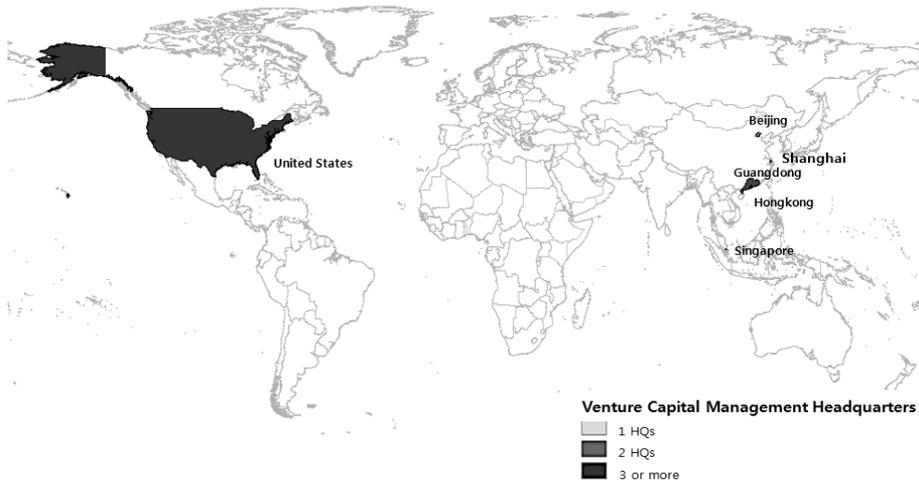


Figure 4-13 Fund Management Headquarters' Location (before 2000)

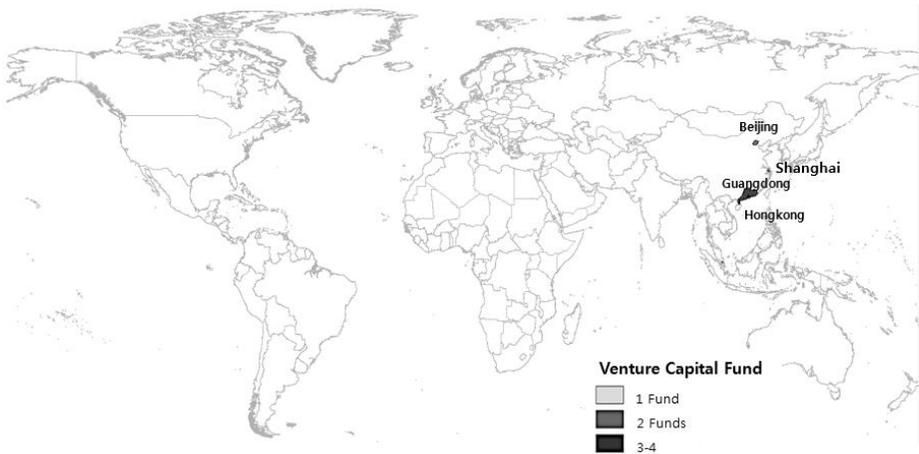


Figure 4-14 Fund registration Location (before 2000)

Since 2001, special legislations on venture capital was gradually introduced. For example, the introduction of the “Interim measures for the

establishment of venture investment companies with foreign investment (2001),” “Provisions on the administration of venture investment companies with foreign investment (2003),” “Interim measures for the administration of venture investment companies (2005)” enable venture funds to register in the form of Limited Company in China. Meanwhile, the revised ‘Company Law’ released in 2005 eliminated the previous 12th article, which limited the accumulated investment amount of the company under the 50% line of its registered capital, further relieved the burden of limited company form funds which in turn attracted more funds to be registered in the form of companies. However, the problem of double taxation and inefficient investment decision-making system remained unsolved. Therefore, although some of the fund registrations returned to China, overseas registration was still more attractive than domestic registration. Figure 4-10 shows the fund management companies’ location pattern while figure 4-11 shows the registered fund location during the period, 2001 to 2006.

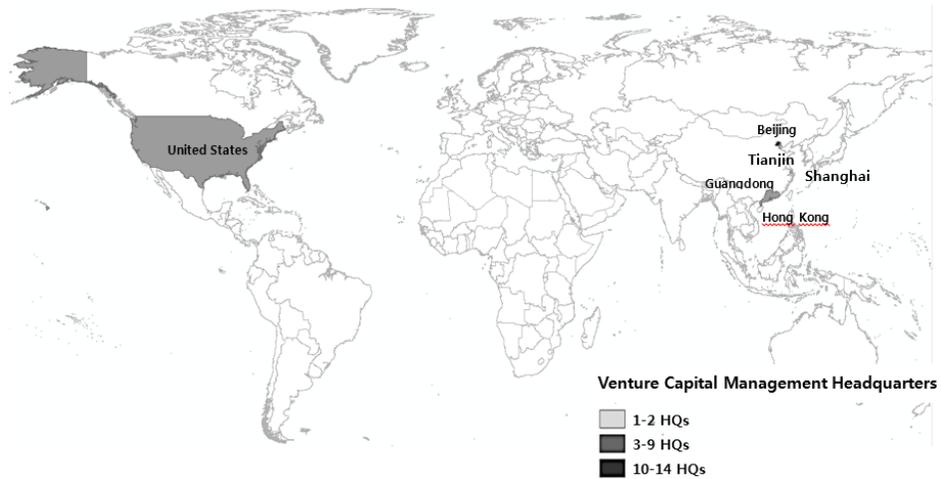


Figure 4-15 Fund Management Headquarters Location (2001-2006)

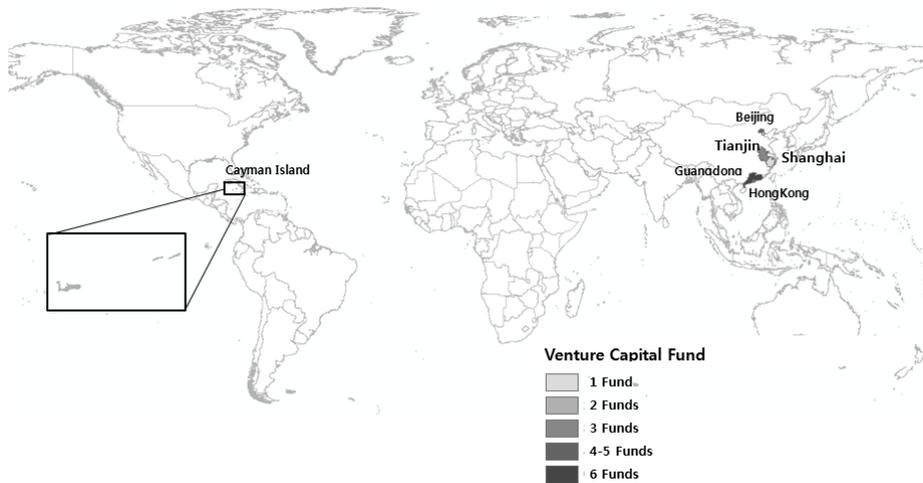


Figure 4-16 Fund registration Location (2001-2006)

Thus, the geographical pattern of fund registration and its transition - overseas registration dominated in the early stage, partial registration returned to China in the middle, and domestic registration became the trend from 2007

(Figure 4-11) - is hard to be explain with economic factors but can be clearly understood through the legal interpretations illustrated above.

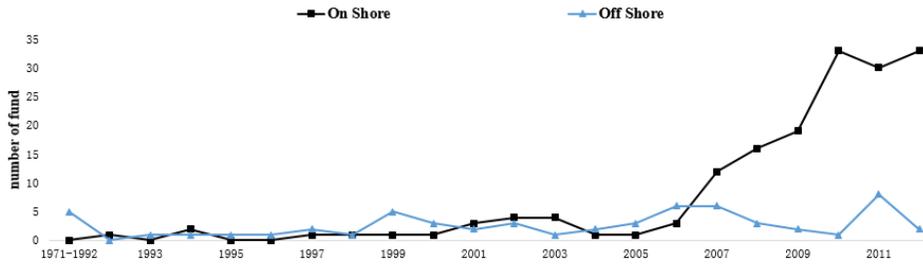


Figure 4-17 Trend of Venture Capital Fund Registration Location

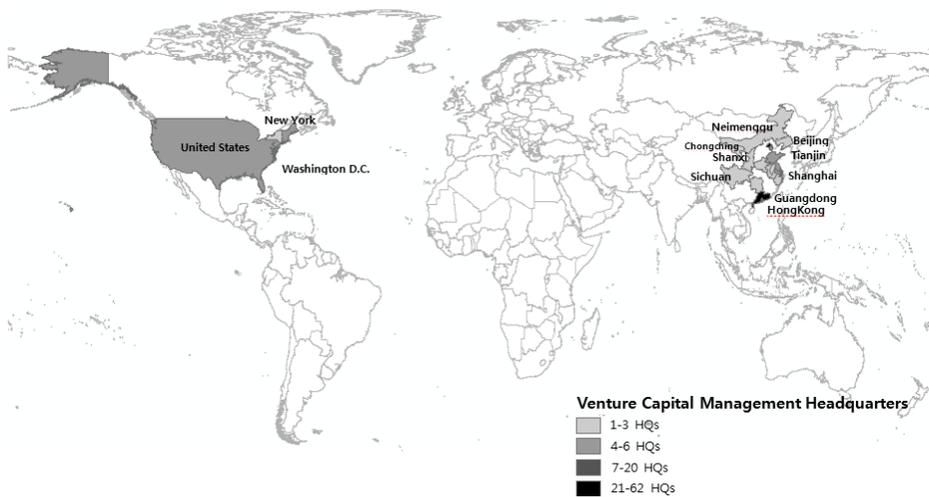


Figure 4-18 Fund Management Headquarters Location (2007-2012)

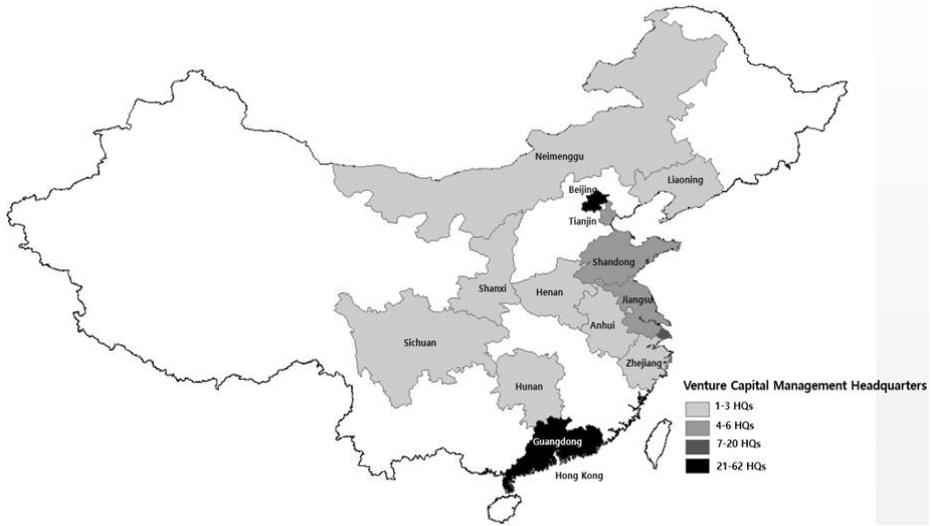


Figure 4-19 Fund Management Headquarters Location within China (2007-2012)

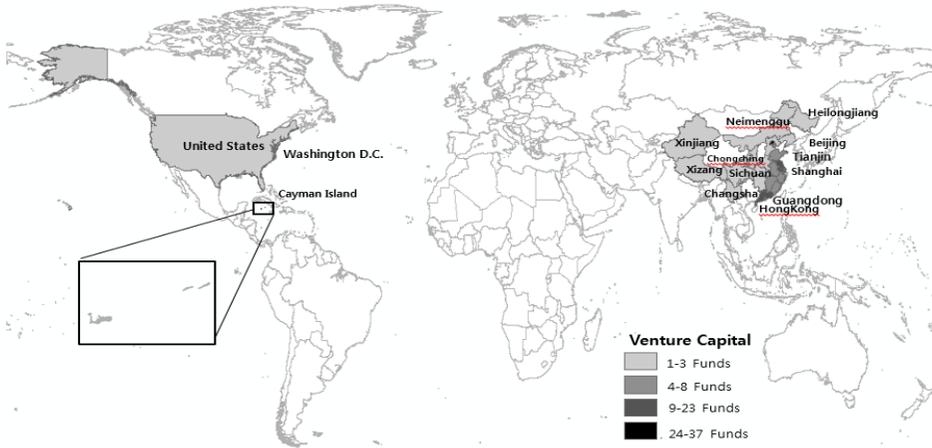


Figure 4-20 Fund registration location (2007-2012)

to everyone. Domestic capital and foreign capital are subject to different constraints and have different opportunities to access investment targets.

For example, foreign venture capitals need to consider the foreign exchange control, the directory of industry guidance, as well as legal and regulatory restrictions. Therefore, the investment pattern and transaction structure of foreign venture capitals are determined by the above factors while, domestic venture capitals do not need to consider these issues. In addition, the investment stage is closely linked with other venture capital aspects such as business entities, fundraising, exit, supervision, taxation and so on. All these aspects may have a certain effect on the venture capital's ability to capture investment opportunities. The investment strategy will also in turn affect other parts of venture capital activities as well as their ultimate, comprehensive income.

While foreign capital in China may enjoy some preferential policies and priorities to participate in a certain area, a number of industry fields are still unavailable for access. That is, certain restrictions on foreign capital in China makes it impossible for them to invest in a huge number of industry fields. In other words, the source of the raised capital will affect the scope of the venture capital's investable area as well as the possibility to access certain opportunities. For example, after China's reform and opening-up, China encouraged foreign companies to invest in China. However, most of the investment areas encouraged were in fields where advanced science and

technology as well as production equipment were needed, not to mention areas favorable to China's exporting enterprises.

The examination and approval of the investment had to be approved by "China's state council department that in charge of foreign economic relations and trade" or "the agencies authorized by the state council⁸³." Judging from the literal statement, China encouraged foreign capital to invest in China, but Article VI of the examination and approval system in 'Law of the People's Republic of China on Foreign - funded Enterprises' made the implementation of the law embrace a large space for interpretation, which could eventually bring huge uncertainties to foreign investors. In 1995, China promulgated the Interim Provisions on the Direction of Foreign Investment (1998), which for the first time specifically formulated the Catalog of Industries for Foreign Investment Guidance. Since then, China's investment policy toward foreign investors shifted from full encouragement to partial regulation. Despite the shift from encouragement to regulation, the clear classification of the investment industry field made the actual implementation of the law much more transparent, and to some extent, narrowed down the interpretation of the law and lowered the related uncertainties. The "Catalog of Foreign Investment Industries" explicitly classifies foreign investment projects into four categories: encouraged, permitted, restricted and prohibited. Among them, the most favorable investment areas like the ICT industry always maintains a high

⁸³ <Law of the People's Republic of China on Foreign - funded Enterprises> (1986), provision 6.

barrier for foreign capital entry, while some industries either prohibit foreign capital participation or limit their shareholding ratio in certain investments. These provisions, combined with China's immature market environment in its venture capital industry, resulted in only 8% of the funds established investing in the technology industry during this period, while 65% of the funds were invested in the expanded reproduction of existing firms or the emergence of non-technological innovations such as coal and real estate (China, 2003). Later, the guide catalog underwent many revisions, such as in 1995, 1997, 2002, 2004, 2007 and 2012. However, foreign investment in China still has more barriers and obstacles than the domestic capital when considering the available investment fields. On the contrary, domestic capital do not need to consider the issue of market entry barriers.

To solve this problem, the venture capital has two ways to obtain the investment opportunity. The first way is through a multiple structuring of the firm to convert the legal status of the foreign capital into a domestic one, so as to avoid the "foreign investment industry directory" limitations. For example, foreign investors first set up "foreign-funded" enterprises in China, and then use the "foreign-funded" enterprises as contributors to re-register a domestic enterprise in China, thereby turning the foreign capital into domestic capital. However, this "first-time" foreign-funded enterprise cannot adopt the foreign-invested enterprise type as its legal status, which means it cannot have the investment function. That is because, according to "the law of foreign-

invested venture capital enterprise" and other special laws, the nature of the financing enterprises receiving investment from an investment-oriented foreign investment company will remain in its foreign status by law, despite the foreign capital's local registration(DOCVIT, 2011). This issue also involves the subject of corporate qualifications and taxation (to be described in detail later). Another solution is to transfer the registration location of the financing enterprise to overseas, so that the status of the financing enterprise changes into a foreign enterprise. The reason for changing the registration location is to convert the investment into a foreign capital investing in foreign company case, which fall out of China's legal supervision, so as to avoid the investment market restrictions in China. This is why there is a significant proportion of overseas investment in the venture capital's portfolio that were mainly active in China before 2005. In other words, the rule of law affects the choice of the investee's registration location.



Figure 4-22 Investment location – portfolio firms' registration location (before 2000)

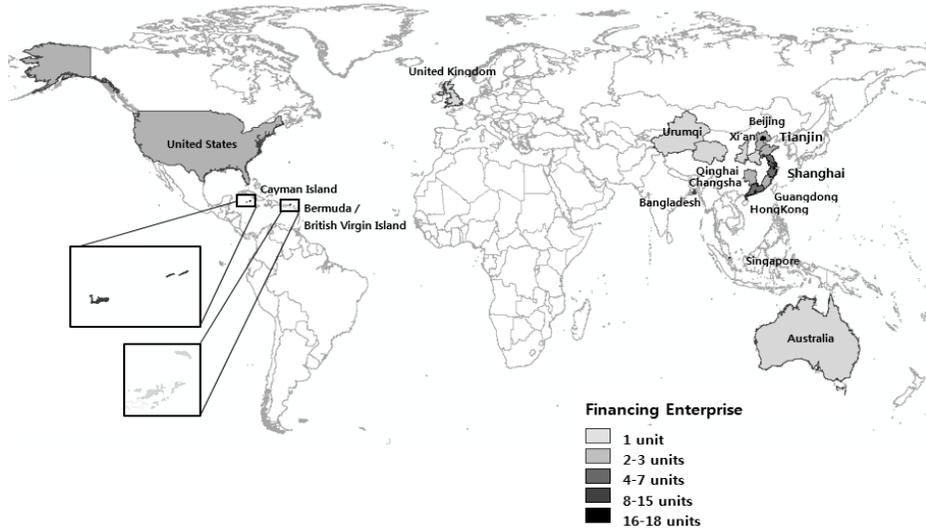


Figure 4-23 Investment Location - portfolio firms' registration location (2001-2006)

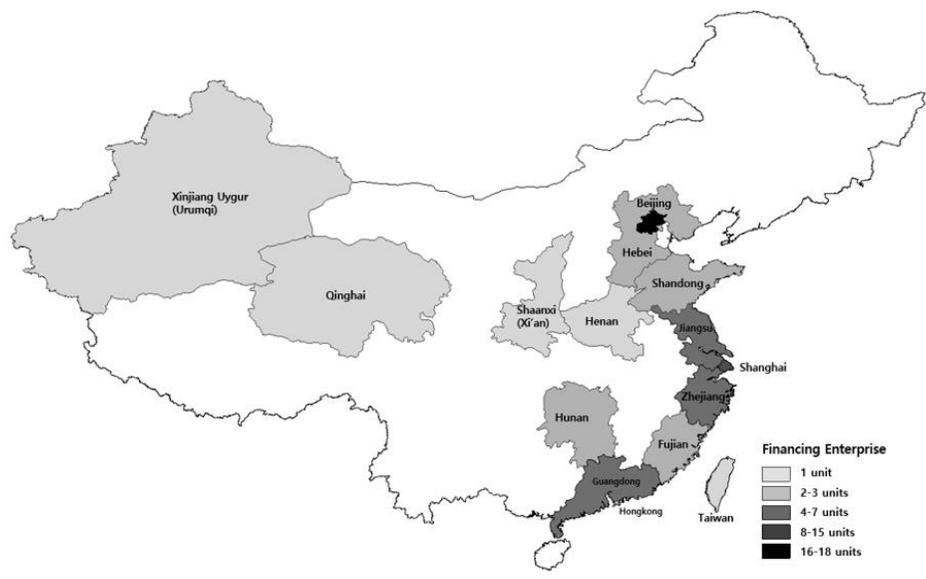


Figure 4-24 Investment Location within China (2001-2006)

The VC registered in China can invest domestically or overseas. The former can invest in domestic companies by means of investment companies or by investing in funded companies in the form of equity investment. The domestic investment is affected by the “Company Law” and other relevant investment regulations.

A foreign investment of domestically registered VCs can be achieved by directly investing in foreign companies or through round-trip investments via SPV and VIE. The latter is not the foreign investment of domestic capital in a strict sense, but a special foreign fundraising and investment method to offset regulations or pursue foreign listing.

The overseas registered VC funds can invest in domestic or foreign companies. The form of Sino-foreign enterprises applies for domestic investment, which is affected by regulations on foreign investment. The foreign investment is beyond the supervision of Chinese regulations. In practice, to offset the restraint of regulations in China over the VC activities, VCs can always transform and divide its registration and organization, and later reassemble to skillfully offset regulations.

The object of this study is VCs operating in China, i.e. VCs investing in domestic companies. As shown in Figure 4-19, not all VC invested companies are registered in China. Especially before 2005, foreign registered VC companies occupy a certain proportion. The data shows that the funded

companies registered overseas are companies managed by Chinese with economic activities, business and headquarters in China.

From 2006, funded companies registered in China increased while funded companies registered overseas decreased.

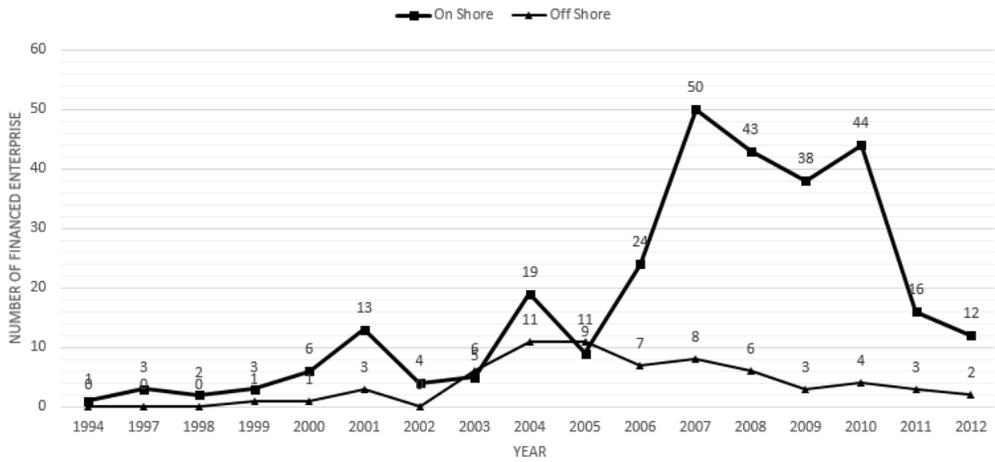


Figure 4-25 Trend of the Investment Activity's Spatial Allocation

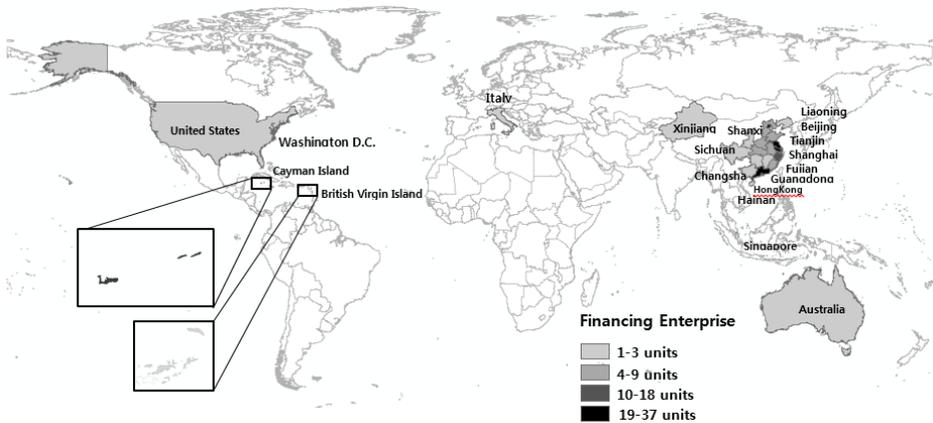


Figure 4-26 Investment Location - portfolio firms' registration location (2007-2012)

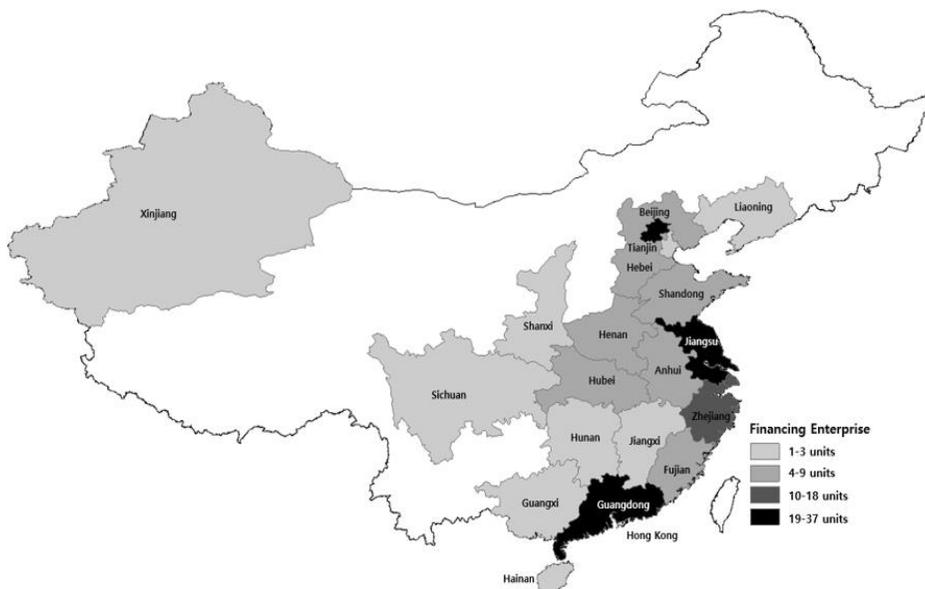


Figure 4 - 27 Investment Location within China (2007-2012)

4.2.4 Legal Impact on Exiting Stage

The theory and practice show that IPO has the highest investment revenue among the five exit methods of VC/PE. Therefore, the IPO exit is the first choice in practice. Securities markets have been created in China from 1990. There was only the main board at its early stage, which was mainly to encourage state-owned capital. This led to a high listing threshold and it was impossible for venture enterprises to exit the market. There were few IPO exit cases until 2003. The equity transfer between fund capitalists and funded companies seemed to be the only exit method.

In 2004, the small and medium boards (SMB) were established. Multi-level capital markets started in China. Despite the fact that the listing threshold was greatly reduced compared to the main board, the SMB was not attractive to VC/PE due to its small volume, long preparation time for listing and control of capital. On April 1st 2003, the China Securities Regulatory Commission announced to remove the institution of “Agreement Document.” This led to a shorter overseas listing time and reduced listing process, cost and time. After the removal of barriers, the overseas investment experienced a rapid increase. In addition, the VC/PE investment could be done by overseas listing and red chip listing.

The “Measures for the foreign investment in domestic companies (2006)” specified that the investment of companies with special purposes must be approved by Ministry of Commerce, Securities Regulatory Commission, by the submission of relevant documents. This regulation proposed detailed requirements for overseas listing and fundraising. The additional administrative approval brought barriers for the overseas exit of VC/PE. As a result, there is no successful example of entering overseas capital markets through the red chip model. The establishment of venture boards in 2009 reduced the threshold, increased the volume of capital market and revenue, and extended the exit channels. It became more and more difficult for overseas listing. From 2009, thus the overseas exits decreased while domestic exits greatly increased.

Therefore, the reason why the exit link is mainly in the form of overseas exit at its early stage and domestic exit in the later stage can be explained from the legal perspective.

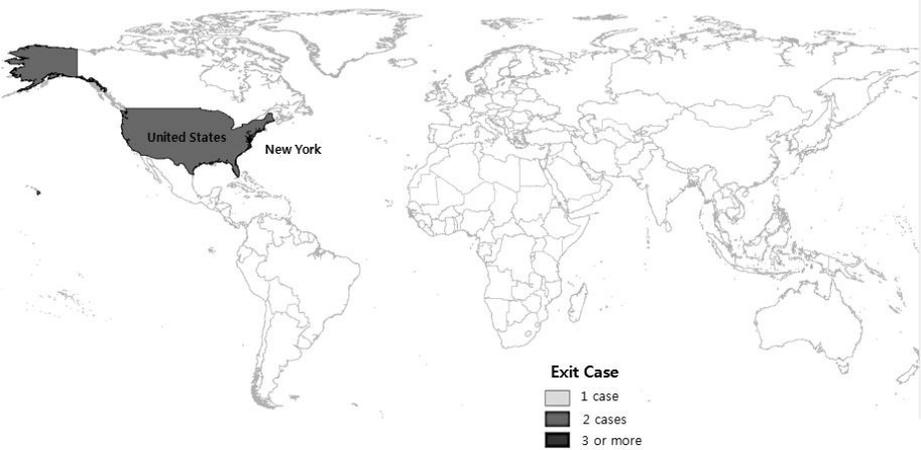


Figure 4 – 28 Exit Location (before 2000)

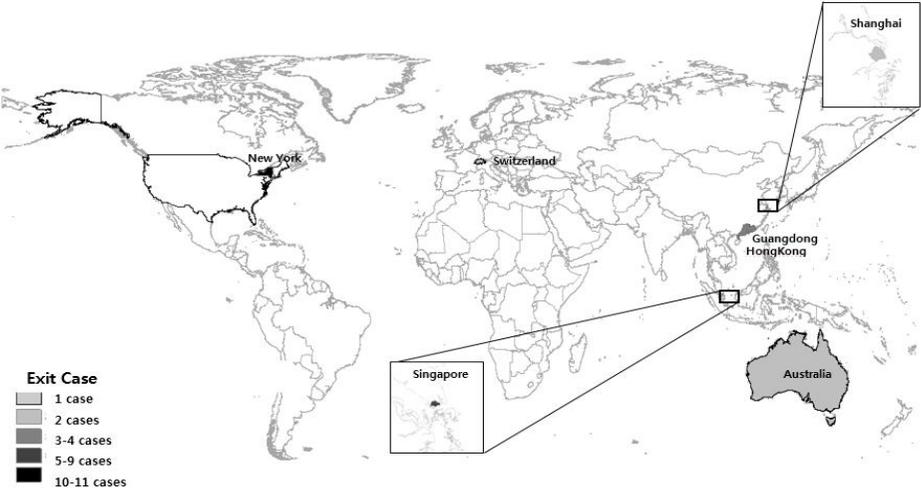


Figure 4 – 29 Exit Location (2001-2006)

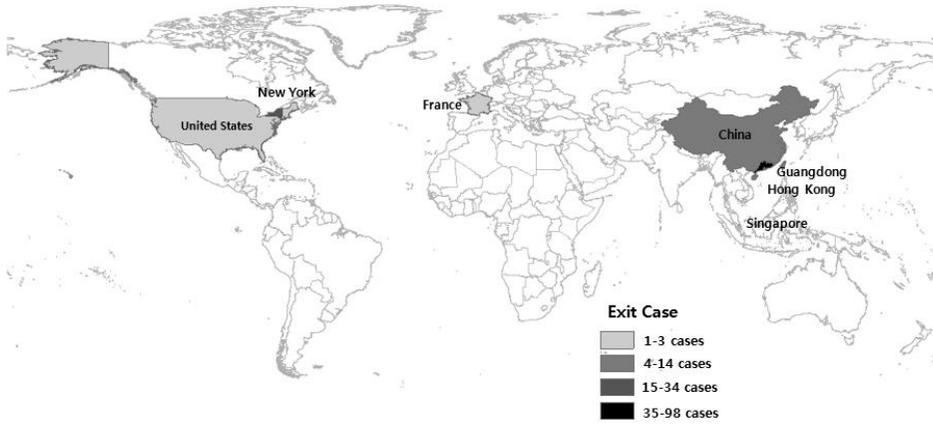


Figure 4 – 30 Exit Location (2007-2012)

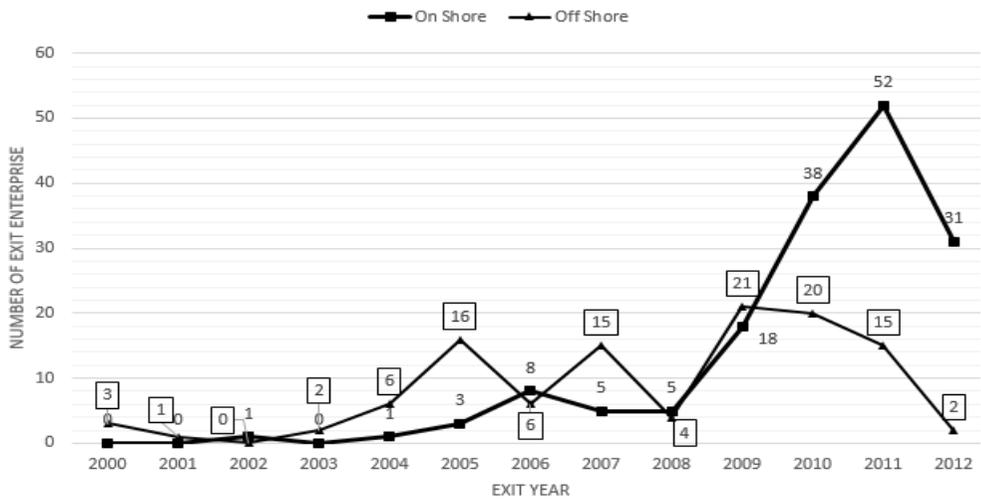


Figure 4-31 Trend of Exit location

Table 4-8 Exit Channel and Location

Exit Year	Exit On Shore					Exit Off Shore					Grand Total
	IPO	MBO/MBI	M&A	Equity Transfer	Total	IPO	MBO/MBI	M&A	Equity transfer	Total	
2000						3				3	3
2001						1				1	1
2002		1			1						1
2003						2				2	2
2004		1			1	6				6	7
2005	1		2		3	16				16	19
2006	3		5		8	5		1		6	14
2007	2		2	1	5	14		1		15	20
2008	2		2	1	5	3		1		4	9
2009	9		6	3	18	15	1	2	3	21	39
2010	34		4		38	18	1	1		20	58
2011	44	2	4	2	52	14	1			15	67
2012	23	2	6		31	2				2	33
Grand Total	118	6	31	7	162	99	3	6	3	111	273

4.3 Analysis of causes of legal impact on capital spatial allocation

4.3.1 Role of the mismatch between economic environment and legal environment

The results from Section 4.1 show the inconsistency between the regional economic signals and VC/PE economic activities. This indicates that there are other factors affecting the VC/PE in addition to the economic environment. From the relationship between regulations and spatial allocation of VC/PE and analysis in Section 4.2, it is observed that the effect of regulations comes from the inconsistency between regulations and regional economic environment and variation of regulations in space.

In practice, the regional economic signals and legal environments are inconsistent. The regional regulations always exceed or lag behind the regional economic signals. When the local government guides the development direction of the regional economy, the regulations always exceed the economic signals. On the other hand, when good economic signals which are not supported by relevant regulations, the regional regulations will lag behind the regional economic signals. In this case, the economic entities will indirectly participate in the VC/PE. The government will start the legislation when the regional economy develops and has great influence on the region. This indicates that regardless of the regional economy's performance,

regulations will act as a “filter” to attract or control the economic activities that affect the spatial allocation of capital.

There are three implications of the legal system for the enterprises. First, the legal system serves as a protection and guarantee for their economic activities and properties. Second, the legal system can be an obstacle for enterprises to access certain areas or opportunities to gain profits. Third, it also can be an implicit cost or income for enterprises. While legislation is the most effective tool (if not the only tool) for governments to regulate and stimulate local economic development, there exist a unity of opposites between the two parties. When the legal system serves as an obstacle, the opposites exist between the two parties. From an economic development aspect, the profits enterprises gain bring to the region an increase in taxation, employment, products and services, as well as the improvement of local living standards, and these make the two parties have a united interest. However, in reality, the interests of the two parties do not always match with each other. When the legal system hinders enterprises to take advantage of gaining profit, new methods to circumvent the rules will be created. Spatial allocation of capitals is one of the outcomes that arose from this mismatch.

In the case of China’s venture capital industry development, the phenomena of spatial allocation caused by legal systems are particularly clear and typical. That’s because, first of all, China established its nation under the socialist ideology after the Second World War and followed the Soviet

Union's economic system of central planning the economy during its first 30 years after the new state was founded. However, after a series of turmoil and fumble, the drawbacks of the planning economy system was widely realized and the nation began to reform itself while opening up toward the outside world and gradually moved towards the market economy system. During this process, the Chinese legal system experienced the transformation from the central administrative order system to the gradually improved legal system, which serves as a supportive system that keeps the market system functioning well. This process well represents the route of the legal system's transition and the corresponding spatial allocation patterns of capital affected by this transition. On the other hand, following by the reform and opening up policy, China's economic development created numerous opportunities for enterprises both inside and outside China. However, in most cases, the lagging legal environment often hindered economic actors to take advantage of the opportunities. This mismatch of economic opportunity and legal system endowed the enterprises an incentive to find new methods in circumventing the regulations while taking hold of the economic advantages. Using the scope characteristic of legislation and the dividable characteristic of capital circulation, spatial allocation of capital served as one of the legal circumvention methods. Along with the improvement of China's legal environment, the strategies and patterns of capital allocation also changed in the geographical space. Therefore, the process of China's venture capital

industry development also gives a good example to examine the spatial capital allocation caused by the changes of the legal system.

In addition, the inherent characteristics of legislation and capital also encouraged the spatial allocation of capital.

4.3.2 Role of the category characteristics of legislation and the detachable characteristics of capital

The basic characteristics of the legal system is its categorical feature. The first chapter of any regulation will clearly specify the spatial coverage and subject coverage. Different regulations apply to different regions. In the same region, different legal subject identities apply to different detailed regulations. As mentioned above, when the regional economic signals are inconsistent with the legal environment, the subjects of economic activities will change its allocation or legal entity identity to utilize or offset relevant regulations. This is the process of spatial allocation of capital according to regulations.

It is noted that regulations have a dual effect on the spatial allocation of capital, i.e. superficial or virtual. The former means that the subjects of economic activities utilize or offset regulations by changing the registration location. The latter represents the effect of regulations on the actual operation of the subjects' economic activities. The effect of regulations on the registration location of VC/PE capital is different from those applied to actual

operation. When the non-legal environment has sufficient attractive benefits for VC/PE but the legal system is imperfect, the VC/PE can resort to other methods such as leveraging overseas registration to participate in domestic economic activities, rather than choosing domestic registration or establishing branch offices. On the other hand, this is unnecessary in regions where regulations have sufficient attraction points for VC/PE such as positive registration form, tax, and fundraising. The VC/PE may register in this region and obtain beneficial policy support or subsidies, and invest in other regions to seek higher profit. In most cases, if the development of VC/PE in China is judged by whether it established agencies in China, the development of VC/PE will be inconsistent due to the preferences and demands of the economic environment. From a different perspective, that is, whether or not VC/PE participates in the development of VC/PE industries in China, it is clear that many VC/PE participated in indirect ways.

On the other hand, the high mobility and separable property of VC currency funds are one of the main reasons for the effect of regulations on the spatial allocation of capital. The regulations have different effects on different stages of the venture capital cycle. Different geographical allocations are selected for different links of investment cycle to pursue maximum revenue (Figure 4- 32).

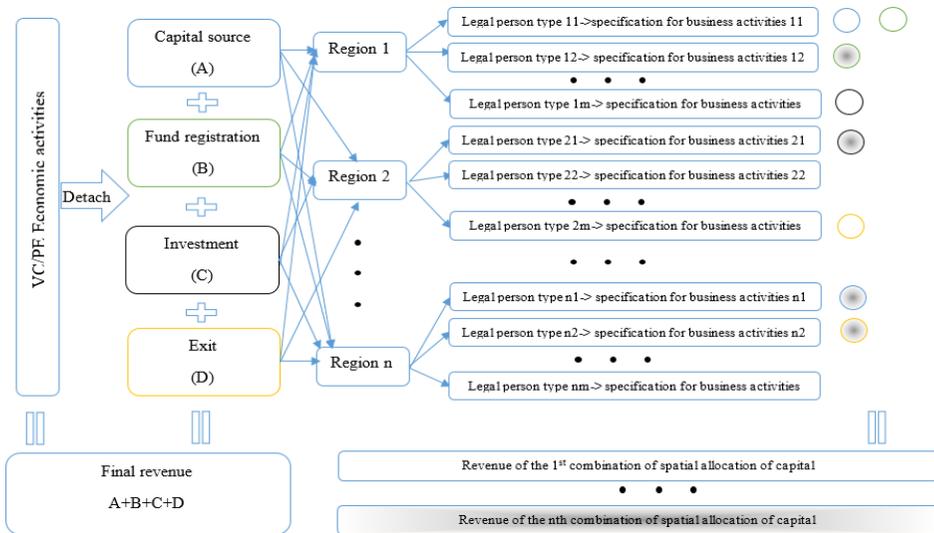


Figure 4-32 Diagram of capital spatial allocation realized by splitting the business process

However, it is worth noting that although the detachable characteristic of capital enables venture capitalist to split the entire investment cycle into several parts and allocate them in different locations, these parts are still closely correlated and inter-dependent with each other, and will work together to influence the comprehensive income of the firm. For example, the capital source and selection of the registration location depend on not only the relevant legal environment but the following links of VC investment cycles. Funds with domestic fundraising and domestic registration are considered as domestic enterprises. Its investment range is larger than that of overseas-registered foreign capital. For the exit link, the overseas exit of overseas

registered funds can partly offset domestic regulations and the revenue gained through this process is more efficient and higher.

If domestically raised money is used to register a fund abroad, the registration has to follow the foreign investment laws in China and relevant regulations in the region of registration. The problem lies in that the investment by overseas registered funds in China is considered as foreign capital (although the capital source is from China), which must comply with the “Foreign Investment Guidance Catalogue” and is available only for limited investment fields. The advantage is that it is convenient to exit from foreign capital markets without the interference and control from China.

The overseas registered funds with foreign capital are completely free from the Chinese legal systems. Their VC-related economic activities in China can be carried out by entrusting domestic management companies in the form of Trust, establishing branch offices in China, or entities in China. These three methods allow equal participation in the VC investment in China.

4.4 Summary

Regional legal systems does have a significant impact on the venture capital's spatial allocation strategy and geographical patterns. This impact is achieved mainly through the role of "entrance barriers" and "hidden costs" imposed by law. More specifically, nowadays, with the advance of technological development and global integration, and all kinds of conditions including the advanced international clearing system realized by computer systems and international networks, the increasingly integrated global market, highly protected assets, and the gradually unifying financial standards, allows that same capital to flow freely between places. However, the existence of heterogeneous legal elements, such as differentiations of legal family, legislative intent, law enforcement efforts, and detailed terms and clauses, which are embedded in each region, results in enterprises performing differently in each region according to the obstacles and costs they have to overcome and pay.

The role of "obstacles" is mainly reflected in access barriers. In the venture capital industry, there are direct entrance barriers and indirect entrance barriers regulated by law. The direct entrance barriers can be divided into two groups, economic agent regulations and economic activity regulations. Can the domestic capital or foreign capital participate in the local economy? Should it be a legal entity or non-legal entity? Can foreign

enterprises invest in as many fields as domestic counterparts do? Is there any different treatment or privilege that exists between different economic agents? Does every economic agent have the same opportunity to exit in domestic and foreign capital market? Do the examination and verification imposed on different economic agents follow the same principles? All the differences that arise in these questions create different access barriers for capitals to participate in local economies while impelling enterprises to find ways to allocate their capitals in different locations to avoid the high barriers and take advantage of the low barriers. In the case of China's venture capital industry, the access barriers imposed by the Chinese legal system changes through its development process. The entrance barrier for economic agents was first opened to foreign capital and legal entities. After several years of development, however, this barrier was lowered for domestic capitals and non-legal entities. The examination and approval system for venture capital agents also transformed itself from a strict examination and approval system to a modified registration system. It is such transformation of the legal environment that gave rise to the different patterns of spatial capital allocation conducted by venture capitalists to circumvent the barriers caused by these regulations.

The role of "implicit costs" caused by the legal system is mainly reflected in the extra charges besides the production and operating costs and may vary significantly according to the different choices of the law applied. In

this study, during the earlier stage of China's venture capital industry development, different tax rates were imposed on domestic capital and foreign capital. Likewise, the final tax amount differed greatly depending on the legal form the venture capital chose. Specifically, if a venture capital chose its organization form to be that of a legal entity, it has to bear the double taxation regulation, which means it has to pay both the corporate income tax and the personal income tax as a shareholder of the fund itself. However, if the venture capital chooses to operate as a non-legal entity like the limited partnership form, it will only have to pay for the personal income tax as a shareholder of the fund. Obviously, capital prefers lower tax rates and will locate itself in places where lower taxation regulations are endowed. Besides taxation, regulations refer to the examination and approval system, supervision system and exit channels like the M&A market and stock market, and may also bring about a significant amount of extra costs. These costs can take the form of expenses for the documents and claims local regulation requires, the time consumed to receive certain approval, as well as the opportunity cost that occurs with the aforementioned time consumption and expenses. These "implicit costs" caused by regional legal systems vary from place to place and change during times. Therefore, it is not surprising for a venture capitalist to allocate their capital in different locations to lower these extra costs.

To summarize, other than the economic factors offered by a region, the existence of “access barriers” and “implicit costs” that arises by law also makes the local legal system function as a critical principle affecting the spatial allocation of capital.

At this point, it has been proved that the legal impact on the spatial distribution of capital is significant, and its effect is mainly derived from the scope features of the legal system and the detachable features of capital. Then, is there a rule to follow when legislation put their impacts a capital’s spatial disposition? What is the principle and mechanism behind this influence? In the next chapter, a game theory model will be provided to find out the principles and mechanism behind this phenomenon.

Chapter 5 Game Analysis of Legal Impact on Venture Capital Spatial Allocation

5.1 Modeling of the Game

5.1.1 Background Statement

Since its reform and opening-up, China has become an attractive place for the venture capital industry. However, the immature legislative environment made it difficult for venture capitals to participate in the Chinese economy. This compelled them to seek alternative ways to overcome the obstacles caused by the law. Through circumventing regulations, VCs could operate venture capital activities in China and gained their profit, but the circumvention had certain corresponding costs as well. Venture capitals compared the benefits of participating in the regional venture capital industry to the costs of circumvention to determine whether or not they should participate in it and further examined ways to circumvent the law. The VCs' ultimate goal was and is to maximize the returns on investment.

On the other hand, the Chinese government had the intention to promote its economy by fostering the venture capital industry. However, during the earlier period, due to a lack of understanding about the venture capital industry and the lack of sound legal environment in China, the relevant

legislation on the venture capital industry was not in its place. As a result, the Chinese government took the direct involvement strategy by establishing government owned VCs while tacitly acquiescing the circumventing behaviors developed by the private sector. Later, following the venture capital industry's development and the improvement of China's legal environment, China's understanding of the venture capital industry gradually increased and relevant regulations to encourage or regulate the development of China's venture capital industry was introduced. The laws and regulations enacted by the government will affect the development of enterprises, which in turn determines the development of the local economy, in other words, the payoffs of the government.

Within the same region, the government can choose a variety of strategies to carry out legislations. Different legislative strategies will lead to different regional economic development results, i.e. the government payoffs. On the other hand, enterprises can also choose a variety of strategies to deal with government regulations. Different coping strategies will also bring different business benefits, i.e. the enterprise payoffs. Thus, it can be said that there is a game between the enterprises and the government surrounding the strategy of choosing how to deal with the law.

Law and regulations are open to the public while the legislative process is extremely complex and always needs a long time to be firmly established⁸⁴. The location selection process in the firm also has to go through a time-consuming process⁸⁵ and these actions are always under the supervision of the government. That means, both the enterprises and government may have sufficient time to obtain their counterparts' information when building their own strategies. Therefore, the information on both sides in the game can be regarded as complete information. As for the payoffs of the game, although corporate tax will become the government's revenue, taxation is only one part of the payoffs for both sides in the game. The firm's ultimate goal is not to minimize the tax but to maximize the return on their investment. Tax is only one of the variables, which affects the amount of the return. On the other hand, besides the the government's direct revenue gained from corporate taxation,

⁸⁴ In China, the process of legislation needs to go through the proposal of relevant industry practitioners or experts and scholars to discuss the relevant issues. And then, the results of the discussion will be proposed to national leaders or the relevant departments' authorities. Later, the relevant departments will organize several rounds of discussions and seek opinions from all other relevant parties. The result of the discussion will be submitted to the top decision-making leadership level. The leadership team will develop relevant resolutions based on the results and publish the resolutions in a formal meeting or through official platforms, such as government documents, newspaper, government websites, and other official media. Thereafter, the local authorities and relevant department will enact their own local law and department regulations according to the central government's resolution. The legislation process will repeat the central government's legislation process demonstrated above. The relevant implementation rules will be enacted based on relevant central or local laws while regulation and procedures will be the as same as the above.

⁸⁵ Includes the process of market investigation, internal discussion, shareholder decision-making and manager's execution, etc.

there are greater level of payoffs for it. That is, the regional economic development promoted by the industry, either through direct or indirect effects, is the the governm'nt's major payoffs. That is to say, the enterprises' loss in the game does not exactly equal the government's income, therefore, the game between them is a non-zero-sum game. It is common for enterprises to lobby to the government for favorable policies, while the government also regulates enterprises to gain the incentive of of local economic development. Therefore, the existence of negotiation between the two parties turns the game into a cooperative game. In summary, this is a 'non-zero-sum cooperative game with complete information.'

5.1.2 Components of the Legal vs Capital Game

Essential elements of a game include players, actions, information, strategies, payoffs, outcome, and equilibria. The combination of players, actions, and results forms the rule of the game (Rasmusen & Blackwell, 1994). A player of a game represents an individual or a group that makes decisions. The goal of each player is to maximize their utility by choosing the most appropriate actions (Rasmusen & Blackwell, 1994). In this study's game model, two players were designed to represent the legislation enactment group (G) and the legislation application group (VC). The legislation enactment group (G) includes government legislatures and all other relevant government departments, institutions and agencies. The legal application group (VC)

includes venture capital enterprises, financing enterprises, intermediary agencies, like legal firms, accounting firms, securities companies and all other agencies that may affect the venture capital's capital allocation decision.

Player's action represents the choice that the player can make in the game. In this game, the legislation enactment group (G)'s action set (A_G) includes 'do not provide law', 'enact incentive law', and 'enact restriction law'.

$$A_G = \left\{ \begin{array}{ll} \text{Action}_G 1 & \text{Do not provide law} \\ \text{Action}_G 2 & \text{Enact incentive law} \\ \text{Action}_G 3 & \text{Enact restriction law} \end{array} \right\}$$

The legislation application group (VC)'s action set (A_{vc}) includes 'strict compliance with the law', and 'circumvention of the law'.

$$A_{vc} = \left\{ \begin{array}{ll} \text{Action}_{vc} 1 & \text{Strict compliance with the law} \\ \text{Action}_{vc} 2 & \text{Circumvention of the law} \end{array} \right\}$$

According to the law's scope characteristic, there are two ways to realize the circumvention, namely, changing the legal status within the same region

and switching the registration location to other regions. Therefore, the legislation application group (VC)'s action set (A^{vc}) can be detailed as 'strict compliance with the law', 'circumvention of the law by changing legal status within the same region', 'switching the registration location to other regions'.

$$A^{vc} = \left\{ \begin{array}{ll} \text{Action}^{vc} 1 & \text{Strict compliance with the law} \\ \text{Action}^{vc} 2 & \text{Circumvent the law by changing legal status} \\ \text{Action}^{vc} 3 & \text{Circumvent the law by changing location} \end{array} \right\}$$

Both players will continue to adjust their actions according to the information they obtain from their counterpart to maintain an equilibrium under the current status, i.e. the economic signal. The information of the game includes economic signal and regional legal environment signal.

Payoffs of the game refer to the utility of the players after they have chosen their game strategies. That is, the utility is actually a function of the strategy chosen by the player and its counterpart. In this game, the utility of the legislation enactment group (π_G) equals the sum of the tax revenue (t) the government obtains from the VC industry and the direct and indirect effect (b) the regional economic development obtains from the VC industry minus the

cost the government paid to promote the VC industry's development (ic), or/and minus the cost of the government caused by regulating the industry.

$$\pi_G = t + b - ic - sc$$

On the other hand, the utility of VC (π_{VC}) is equal to the sum of the return on investment (r) and the benefit obtained from circumventing the law (cb), minus tax (t), fixed cost (fc), and the circumvention cost caused by law (cc)⁸⁶.

$$\pi_{VC} = r + cb - t - fc - cc$$

According to the scope characteristic of the law, the circumvention cost can be further split into two types of cost, namely, costs resulting from the conversion of legal identity (stc) and costs resulting from altering the registered location of the enterprise (slc). Correspondingly, the benefits of the circumvention can be further split into income generated through conversion

⁸⁶ For example, if the local legal environment does not support the development of the industry although enterprises strictly comply with the law, extra costs will incur for the firm to overcome the legislative obstacles. If enterprises attempt to circumvent the law, then actions of reconstructing the firm's structure will be necessary. Either by establishing new subsidiaries or holding companies in different places will cause certain corresponding expenses. It will also require the help of lawyers, accountants and other relevant agencies, which may also charge certain fees to the firm.

of corporate legal identity (stb) and benefits generated from changing the company's registered location (slb).

$$\pi_{VC} = r + stb + slb - t - fc - stc - slc$$

5.1.3 Description of the Legal vs Capital Game

There are three ways to describe a game, namely, the description in words, the description by normal form, and the description by game tree. The above game model can be summarized as follows (Table 5-2).

Table 5-1 Game Model for Spatial Allocation of Venture Capital

<p>Players</p> <p>Player 1 (G) : The legislation enacting group;</p> <p>Player 2 (VC): The legislation application group</p>
<p>Information</p> <p>Economic signals, legislation signals</p>
<p>Initial State</p> <p>Good economic signals but no legislation signals</p>

Actions

$A_G =$	{	Action _G 1	Do not provide law	}
		Action _G 2	Enact incentive law	
		Action _G 3	Enact restriction law	

$A'_{vc} =$	{	Action' vc 1	Strict compliance with the law	}
		Action' vc 2	Circumvent the law by changing legal status	
		Action' vc 3	Circumvent the law by changing location	

Payoffs

$$\pi_G = t + b - ic - sc$$

$$\pi_{vc} = r + stb + slb - t - fc - stc - slc$$

Note: r: Venture capital's return on investment from its investment portfolio

cc: Circumvention costs

sc: Surveillance costs

ic: Incentive costs

b: Local benefit from venture capital industry, such as contributions to local economic development, increase in local high-tech enterprises, increase of local employment rate, etc.

t: Tax

The normal forms of the game are illustrated in tables 5-2, 5-3 and 5-4. Table 5-2 demonstrates the situation where firms choose between complying with the law and circumventing the law based on their counterpart's strategies. Table 5-3 further divides the strategy of circumvention into two sub-strategies, namely 'circumvent the law by changing legal statuses' and 'circumvent the law by changing locations.' Here, since the tax an enterprise pays (t) equals to the government's tax revenue and the fixed operating fee (fc) has a uniform industry standard, the parameter of t and fc can be seen as constants. Therefore, table 5-3 can be reduced to table 5-4 after eliminating the constants.

Table 5-2 The Normal Form of Venture Capital Spatial Allocation Game: General Parameters-1

		Venture Capital's strategy		
		Nonparticipation	Strictly abide by the law	Circumvent the law
Government Strategy	Payoffs: (G, VC)			
	Acquiescence	0,0	0,0	b, r-cc
	Stimulation	0,0	b+t-ic, r-(t-ic)	b+t-ic, r-cc-(t-ic)
Control	0,0	b+t, r-t-sc	b, r-t	
		Parameters of Venture Capital's Utility (π_{VC})	Parameters of Government's Utility (π_G)	
		r: Return on investment fc: Fixed charges according to the industry-level standards t: Tax cc: Circumvention costs	t: Tax b: Benefit of the regional economy that is gained through the spill-over effect achieved by venture capital economic activities, including the development of venture capital related industries, increased regional employment rate, growth of regional capital income, etc. (only applicable when the venture capital company does not change its registration location) ic: Incentive cost sc: Surveillance cost	

Table 5-3 The Normal Form of Venture Capital Spatial Allocation Game: General Parameters-2

Payoffs: (G, VC)		Venture Capital's strategy		
		Place Concept		Space Concept
		Strictly abide by the law	Circumvent the law by changing legal status	Circumvent the law by changing locations
Government Strategy	Acquiescence	0,0	$(t+b')$, $(r-fc-t-stc+stb)$	b'' , $(r-fc-slc+slb)$
	Stimulation	$(t+b-ic)$, $(r-fc-t+ic)$	$(t+b'-ic)$, $(r-fc-t-stc+stb+ic)$	b'' , $(r-fc-slc+slb)$
	Control	$(t+b-sc)$, $(r-fc-t)$	$(t+b'-sc)$, $(r-fc-t-stc+stb)$	$b''-sc$, $(r-fc-slc+slb)$
		Parameters of Venture Capital's Utility (π_{VC})		Parameters of Government's Utility (π_G)
		r: Return on investment fc: Fixed charges according to industry-level standards t: Tax stc: Status transition cost stb: Status transition benefit slc: Cost caused by changing firm structure or registration location slb: Benefit achieved by changing firm structure or registration location		t: Tax b: benefit of the regional economy that is gained through the spill-over effect achieved by venture capital economic activities, including the development of venture capital related industries, increased regional employment rate, growth of the regional capital income, etc. (only applicable when the venture capital company does not change its registration location) b': Has the same implication while applicable to the situation where the venture capital company changes its legal status b'': Has the same implication while applicable to the situation where the venture capital company changes its registration location $(b > b' > b'')$ ic: Incentive cost sc: Surveillance cost

Table 5-4 The Normal Form of Venture Capital Spatial Allocation Game: General Parameters – Simplified

Payoffs: (G, VC)		Venture Capital's strategy		
		Place Concept		Space Concept
		Strictly abide by the law	Circumvent the law by changing legal status	Circumvent the law by changing locations
Government Strategy	Acquiescence	0,0	b' , (stb -stc)	b'' , (slb -slc)
	Stimulation	(b-ic), ic	(b' -ic), (stb+ic-stc)	b'' , (slb -slc)
	Control	(b-sc), 0	(b' -sc), (stb-stc)	b'' -sc, (slb -slc)
		Parameters of Venture Capital's Utility (π_{VC})	Parameters of Government's Utility (π_G)	
		stc: Status transition cost stb: Status transition benefit slc: Cost caused by changing firm structure or registration location slb: Benefit achieved by changing firm structure or registration location	b: benefit of the regional economy that is gained through the spill-over effect achieved by venture capital economic activities, including the development of venture capital related industries, increased regional employment rate, growth of the regional capital income, etc. (only applicable when the venture capital company does not change its registration location) b': Has the same implication while applicable to the situation where the venture capital company changes its legal status b'': Has the same implication while applicable to the situation where the venture capital company changes its registration location ic: Incentive cost sc: Surveillance cost	

5.2 Game Analysis and Interpretations

5.2.1 Analysis Results

From the above model, we can see that in the game between the legislative group and the law-application group, taxation is not the key factor influencing the choice of strategy. For the legislation enactment group (G), the benefits of the regional economy development caused by the VC industry activity (b) and incentive cost (ic) as well as regulatory costs (sc) are the key factors that really influence the strategy choice of the government. When legislation conflicts with the enterprise's utility, firms will choose to circumvent regulation rather than strictly abide by the law and will not participate in the relevant economic activity (Table 5-3). If the company chooses to circumvent the law by changing its legal identity, some sort of resource wasting and extra cost will incur as a consequence and this may hinder the industry's development and will in turn slow down the regional economy's development. For example, as demonstrated in chapter 4, before China enacted the 'partnership law', VCs could only register as a legal form of 'company'. However, according to China's 'company law' before 2004, the investment that a company made could not exceed 50% of its net asset and this inevitably caused the waste of half its capital. This legislation obstacle not only hinders the VC industry's development but also results in many Chinese start-ups failing to receive sufficient support from VCs and

eventually affect the development of the whole regional economy. Therefore, although VCs change their legal status to circumvent regulations, the main body of the firm still remains in the region, resulting in the benefit of the legislator (b') being less than the benefit it can generate from the situation in which enterprises strictly comply with the law (b). Likewise, when VCs choose to alter their registration location, the local government will lose partial tax revenue in addition to the loss of b' . That means the benefit of the local government under the condition of VC altering their registration location (b'') is smaller than b' , i.e. $b'' < b'$.

In other words, in the game between the legislation enactment group and the legislation application group, it is the benefit that the local economy generates from the direct and indirect effects caused by the regulated industry, rather than the taxation, that determines the government's strategy. This benefit may be maximized when enterprises strictly comply with the law (b), and will be less when VCs choose to change their legal status to circumvent the law (b'), and the benefit of the G will be at its minimum when VCs choose to alter their registration location. Therefore, the optimum strategy for the government is to maintain the VC's real business as well as their registration location within the region. However, enterprises have their own calculations and will choose different strategies to cope with the actions legislation enactment group makes.

For businesses, profit comes first. They will always find a way to gain more profit and the greater the profit the greater motivation for them to innovate to gain it. The rule of law has two meanings for them. First and foremost, is the obstacles to their activity, and secondly, the tools available to help them gain more profit. For most businesses, with attractive profit in front they will not be bothered to learn more about the law if the law does not constitute a significant threshold or barrier for their entry or even prohibit them to access business opportunities. Meanwhile, if the law hinders them to access business opportunities and gain profit, they will make every endeavor to overcome the obstacle or circumvent regulations. That is partly because entrepreneurs are characterized by an adventurous and innovative spirit. The spirit of adventure in front of the rule of law is "daring to act first," i.e. they will do whatever they want regardless the existence of any rule. They will bend over backwards to first gain profit, and then think about other things, like consequences, reason, or even legitimacy. This is why almost all (Chinese) companies need to go through the process of reorganizing and sorting out illegal elements or paying fines with the help of lawyers and accountants before they go public. Therefore, calculating the legal impact on their final profit is one of the major concerns of enterprises when they face legislation. Meanwhile, by utilizing and circumventing regulations enterprises maximize their final profit. This is the primary motivation and reason for them to allocate the capital across region.

Table 5-3 shows that, according to the government's choice of strategy, enterprises will determine their way to participate in the regional economy, i.e. either strictly abide by the law or circumvent the law. However, bypassing the law is not the only reason or even the radical reason for firms to allocate their capital across spaces. That is because, according to the law's scope characteristic, firms can circumvent the law by changing their legal status in the region as well. In this situation, the real business location and the registration location both remains within the region. While changing the firm's legal status may cause certain extra costs (stc) along with the benefit it may gain from the change (stb). If a firm chooses to circumvent the law by altering their registration location, then the actual place of business and location of legal registration will be detached with the corresponding benefit (slb) and the costs (slc) accompanied by it.

Under the same condition, i.e. the same government strategy, enterprises will calculate the total benefit and loss according to the amount of the stb, stc, slb, slc caused by the law, as well the incentive benefit (ic) and the cost (sc) that may result from the law, and then decide which strategy they may leverage to maximize the result. It is the pursuing of profit maximization that truly affects the capital spatial allocation while circumvention of the law is just one of the method to realize this goal.

In addition, due to the detachable characteristic of business activities and monetary capital, companies can split its whole body into different parts to

make further use of such characteristic. If enterprises allocate the detached part into different locations to better avoid the disadvantages of local legislation, the total return on investment may increase as a whole. For example, in this article, venture capitals in China detach the capital circulation process into 4 stages (Figure 4-32). By allocating these 4 stages to different locations, venture capital funds have successfully avoided the obstacles caused by China's legal system and realized the development of the Chinese venture capital industry. And this is the reason why the aforementioned 3 patterns of venture capital industry appeared in China.

Here, one thing that should be noted is a cooperative game. Both players can influence its counterparts while adjusting their own strategies either by collecting sufficient information they need or negotiating with the counterpart. During this process, several dynamic equilibriums may appear according to the actual amount of real world parameters. In the next section, 3 analogs and 5 cases according to the government strategies will be illustrated to further explain the analysis results obtained in this section.

5.2.2 Interpretation by Case Study⁸⁷

Analog One: Legislative group choose acquiescence strategy

Although China introduced the policy for venture capital industry development since 1984, there was no actual incentive benefit (ic) a venture capital can gain during that period, while the lack of relevant legislation stopped VCs from legally participating in China's venture capital industry. Therefore, during this period, the government strategy equaled the 'acquiescence' strategy in the game. At this point, if enterprises strictly complied with the law, then no VC would have been able to participate in China's economic development, and both player's payoffs in the game will be 0. Under these circumstances, circumvention of the law was necessary to carry out the venture capital activity. Three types of circumventions have been tried out to avoid obstacles. The first type is the 'direct government intervention strategy' and a typical example of this is the case of "China New Technology Venture Investment Company".

Case 1: Direct government intervention case

⁸⁷ The data of the cases collected from the companies' prospectuses, "private.cn" databases, as well as other publicly available data.

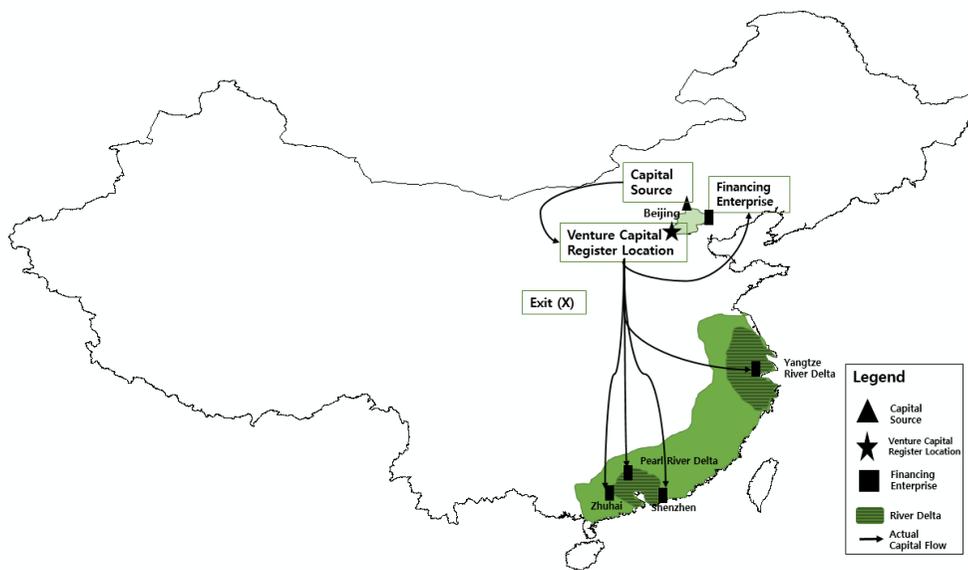


Figure 5-1 Case 1- Direct government intervention – case of China New Technology Venture Investment Company

The state-owned ‘China New Technology Venture Investment Company(中国新技术创业投资公司)’ established in 1985, is one of the earliest venture capital firms in China. The shareholders of the company include the State Science and Technology Commission, which holds 40% of the share (equal to 27 million yuan), and the Ministry of Finance, which holds 23% of the shares. The remaining funds were raised from other state-owned companies like China Metal, CITIC, China Shipping, etc. The initial intention of the company establishment was to foster China’s high-tech industry while supporting the implementation of the ‘Torch Plan’ designed for the high-tech industry (V. C. R. D. C. o. R. U. o. China, 2003). During the earlier period of its development, most of its capital was invested into the Yangtze River Delta,

the Pearl River Delta, several rural and small town enterprises as well as the Zhongguancun Science avenue. Over 230 million yuan was invested and more than 100 projects were carried out during the period of China's "Eighth Five Year Plan." Despite the direct intervention and the full support of the government, the firm's inefficient operating structure made the firm to gradually stray away from investing in high-tech industry, and instead go astray to the road of speculation. In addition, the lacking exit options made it difficult to get back its investment not to mention gaining profit from it. As a consequence, the non-performing asset (NPA) of the firm continued to increase despite the government's full support and China's first venture capital has eventually went bankrupt in 1998.

There are so many reasons for the case's failure, among which the immature legal environment is considered as one of the key reasons for failure that cannot be ignored. For example, when the company was established in 1985, no legal regulation on the subject of corporate law existed. Therefore, the non-standard corporate governance structure and the state ownership, which may have causes severe moral-hazard problems, inevitably led to inefficient investment decision-making (Zoujing, 2014). On the other hand, although this company was a state-owned enterprise, the examination and approval system in China at that time left the company with no choice but to bear the abounding restrictions on its investment project while putting up with the time and costs caused by the complex examination and approval

procedure. Meanwhile, the deficiency of capital markets and related securities acts, as well as the restrictions on overseas listing of Chinese enterprises are the main reasons for the lacking exit channel in this case. It was the difficulties of operating the venture capital project that pushes the company stray away from its main business and eventually fall into the trap of speculation. Therefore, despite the good wills of the enterprise and the government's full support, the bad legal environment led to the company's failure.

However, during the same period, cases using the circumvention strategy to develop their business showed success.

Case 2-1: From complying to circumventing the law – a financing enterprise's perspective

Sina (sina.com) is one of the largest Chinese portal sites, which provides comprehensive news, information, software, and online services in Chinese. Its predecessor was the "Stone Cubic Information Technology Co., Ltd." (SCIT) and was first founded in 1993 at Zhongguancun, Beijing, China with a registered capital of HK \$5million. Its first investors, "Stone Group" and the "Hong Kong Cubic Investment Company" were also located within China. The SCIT mainly engaged in the development, production and sales of computer software in their earlier years. After achieving several years of good

performance, SCIT sought to launch its internationalization strategy. Its founder (Wangzhidong, 王志东) visited the United States several times to make contact with venture capital institutions. In 1995, SCIT liaised with Morgan Stanley and signed a contract with its High-tech investment bank RSCO. In 1997, after a long-term preparation, liaison and two-way selection, SCIT won \$6.5 million investment from the “Bank of America Luo World”, “Walden International Investment Group”, and “Ivanhoe International Group”. In 1998, under the direction of the “Walden International Investment Group”, SCIT merge with “Huayuan Network(华渊网)” and found the “Sina.”

In 2000, “Sina” began to get on the right track, when venture capitalists wanted to get back their investment returns and profit by helping Sina file with the IPO in the capital market. Due to the immature Chinese capital market, it was very difficult and time consuming to go public within China, therefore overseas IPO was the best choice for Sina. However, according to the Chinese telecommunications regulations in 1993, foreign investors were prohibited from intervening in telecommunications operations and telecommunications value-added services. The Chinese Ministry of Information Industry (MII)’s policy guidance was that foreign investors cannot provide Internet Information Services (ICP), but could only provide technical services. If Sina was listed in the overseas capital market, it will turn into a foreign company in China and could not continue the business they

were doing anymore. This made Sina to find an alternative way to bypass the obstacle.

The bypass strategy was that venture capitals invest in an offshore company and make this company the holding company of the Chinese ICT technology service company. This technology service company connected the onshore ICT company with the offshore holding company through an exclusive service cooperation contract. By realizing the offshore company's IPO, the real body of the firm in China consequently achieved the goal of going public in the practical sense. As shown in figure 5-3, the legislative capital flow all fell out of China, while the real capital flow had another route.

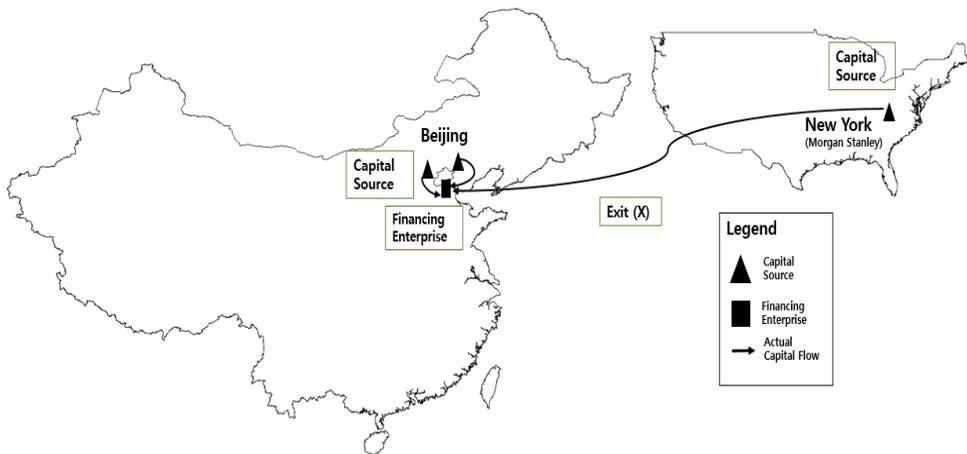


Figure 5-2 Capital flow when complying with the law (early stage of the firm's development)

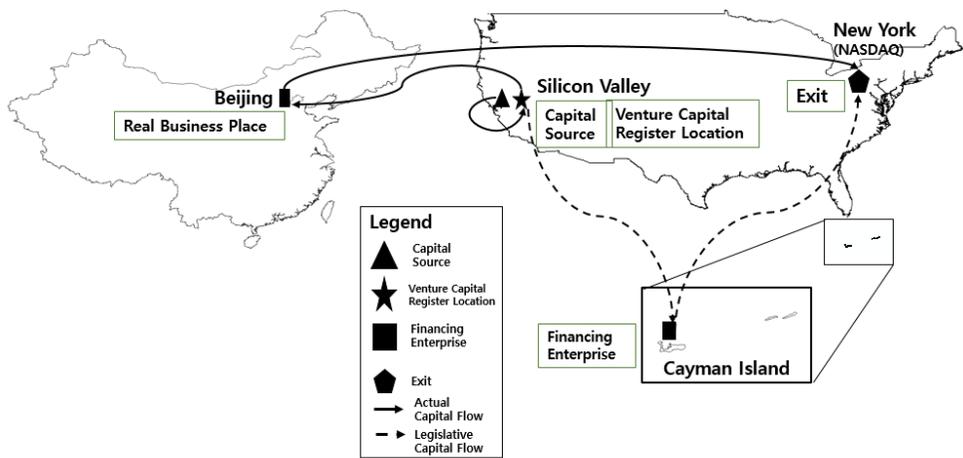


Figure 5-3 Capital flow when circumventing the law (later stage of the firm's development)

In this case, Sina abode by the law at first, but the obstacle caused by the Chinese telecommunications regulations in 1993 forced it to use the Variable Interest Entities (VIE) structure to bypass the law. Moreover, there were no special rules and regulations related to the VIE structure at that time, and there was no need for enterprises to receive approval from the government, in other words, the government, to a certain extent, tacitly consented the activity. Therefore, this approach was widely used during that period until 2006 when the Chinese authorities enacted a regulation to restrict the approach.

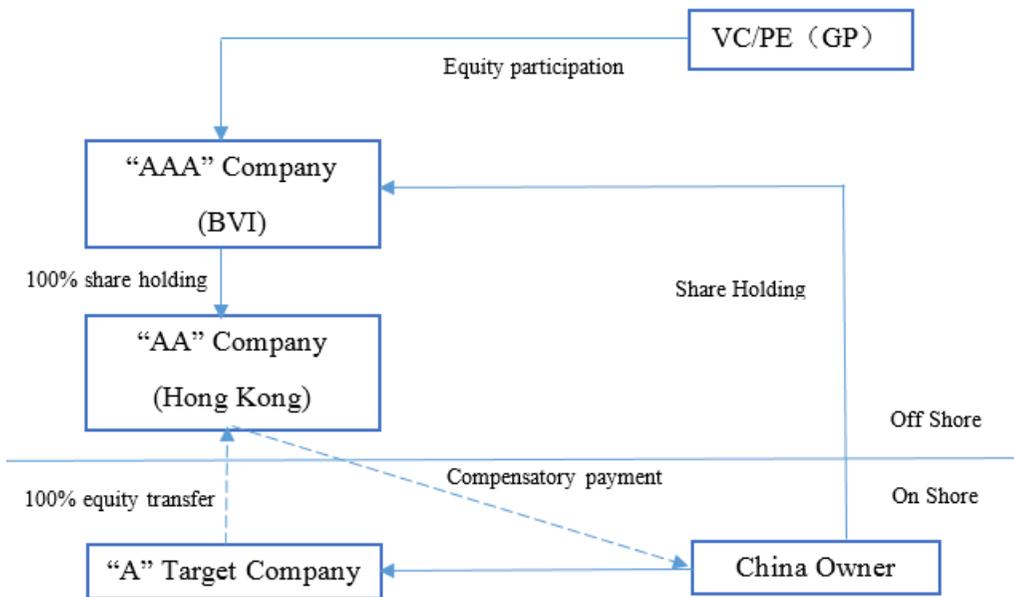


Figure 5-4 Red Chip Structure

Source: <Foreign PE in China>2011, China CITIC press.

Case 2-2: Investing from distance with the help of a liaison office – a venture capital’s perspective

Walden International Investment Group, which was founded in 1974 in San Francisco, started its Chinese venture from 1994. It raised money with the help of Morgan Stanley Bank, International Finance Corporation of the World Bank, Bank of Singapore and so on. Its investment projects in China include Guangdong Kelong Electric, Wuxi Little Swan, and the future of innovation and so on.

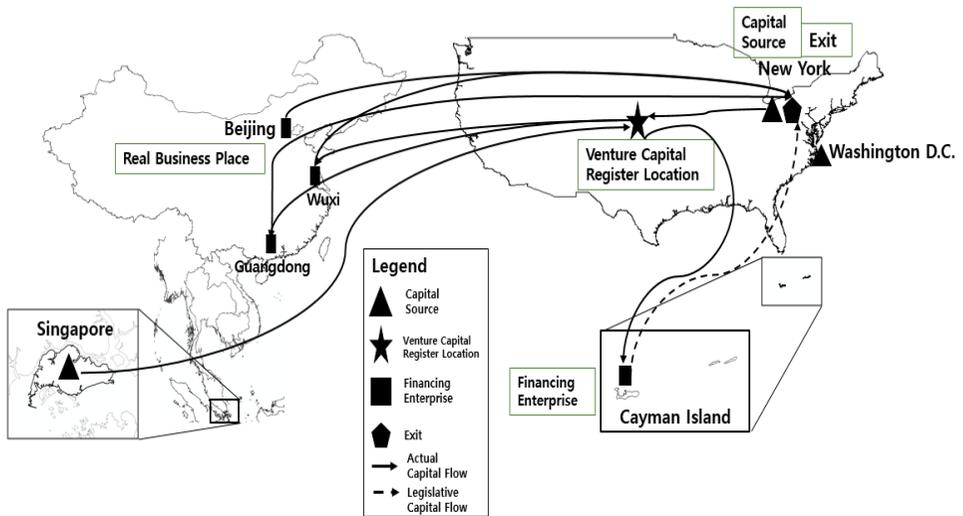


Figure 5-5 Capital Flow of Venture Capital Fund - strategy of the early stage of venture capital investment in China

From this case, we can see that though international venture capitals were greatly interested in China, it did not push forward with a plan to establish a VC institution in it. Instead, it chose to keep a “distant yet close watch” on it either by setting representative offices or by simply doing their investigation with distance research and business trips. When an investable project was detected, Walden took the FDI form to invest in it. While for exiting, using the VIE structure to help the venture firm file with the IPO overseas was the most frequent case

Analog Two: Legislative group taking the incentive strategy

Since 2001, series of laws and regulations relevant to the VC industry were enacted. The real incentive benefit (ic) that VCs can receive increasingly grew, while the decrease uncertainties of the industry lowered the other incurring costs f. Consequently, part of the VC capital stage began to draw back to China. The case from Jiangsu Linyang New Energy Co., Ltd. demonstrates this phenomenon.

Case 3: Partial Venture Capital stage go back to China

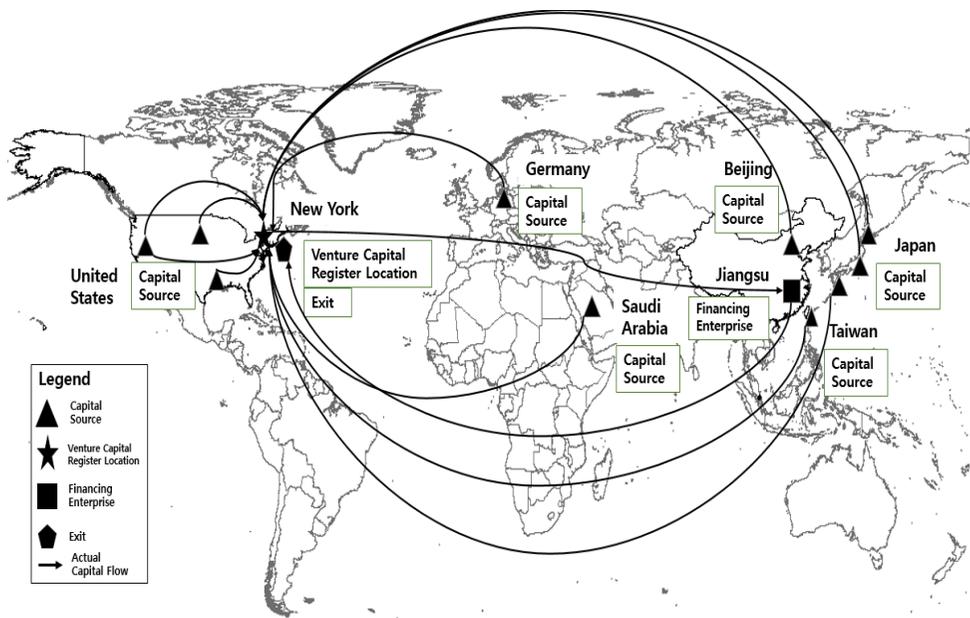


Figure 5-6 Case of Jiangsu Linyang New Energy Co., Ltd.

Jiangsu Linyang New Energy Co., Ltd. is a high-tech enterprise dedicating itself to the R&D, production and sales of solar cells and battery components. The company was established in 2004 and registered in Jiangsu

China. After receiving VC support from the Citigroup Venture Capital, it accelerated its growth and went public in the United States' NASDAQ market in 2006. The LPs of the Citi Ventures includes Mitsubishi Corporation of Japan, FLAG Capital Management, LLC, Miven Venture Partners, Legend Holdings Limited, SBI Holdings Co., Osaka Gas Pension Fund of Japan, The Saudi Economic and Development Company, KPC Venture Capital, Doll Capital Management, Germany Investment and Development Co., Ltd., and so on.

Although in this case, the source of the funds was still dominated by overseas capital and the exit channel was located outside China, partial capital from inside of China (i.e. the Legend Holdings Limited) began to participate in it and the overseas IPO did not use the VIE form. In other words, the real business location and legal registration location of the investment began to be unified.

From 2006, in addition to the incentive legislation encouraging VC play in China, a strict regulation toward the VIE structure was launched⁸⁸. This

⁸⁸ The ministry of Commerce, the State-owned Assets Supervision and Administration Commission of the State Council, the State Administration of Taxation, Administration for Industry and Commerce, China Securities Regulatory Commission and the State Administration of Foreign Exchange together enacted the "Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" (also known as the No. 10 document) on September 8, 2006. This regulation became the legal basis for the acquisition of equity in domestic enterprises by foreign investors and became an obstacle to the overseas listing of red chip models (VIE structure).

regulation almost blocked venture capitals from going public overseas, and therefore, other stages of VC began to draw back to China since then. The case of “Being Mate” demonstrates this pattern.

Case 5: All Stage Back to China

“Bing Mate” is one of the largest baby carrier companies in China. The company was established in November 1992 and registered in Hangzhou Zhejiang, China. Initially, Bing Mate produced instant nutritional rice for infants in the Yangtze River Delta region, and then expanded its business to the national market in 1995. From 1998 to 2009, Bing Mate experienced capital increase 7 times, receiving its support from East Hangzhou High-tech Investment Guarantee Co., Ltd., East Zhejiang Huaqiang Industrial Development Co., Ltd., Haley Overseas Holdings Limited, Hangzhou Zhuorui Investment Co., Ltd., Zhejiang Taiyin Venture Capital Co., Ltd., Shanghai Kailei Investment Co., Ltd. and Beijing Yuanwang Venture Capital Co., JVR International Limited and Manful Worldwide Limited, Hangzhou Zhuo Rui Investment Co., Ltd., Guilin Ruihua Venture Investment Company, PERPETUAL TREASURE LIMITED, CEL Baby Food Investments Limited, Sea Bright China Baby Products Company (Hong Kong) Limited, First Solution Limited and so on. Most of these investors were from China. However, due to the investor’s foreign status, Bing Mate was changed into a foreign direct investment company. Nevertheless, its registration location

remains in China, and the VCs exit their investment through the local Shenzhen Stock Exchange market (SSE).

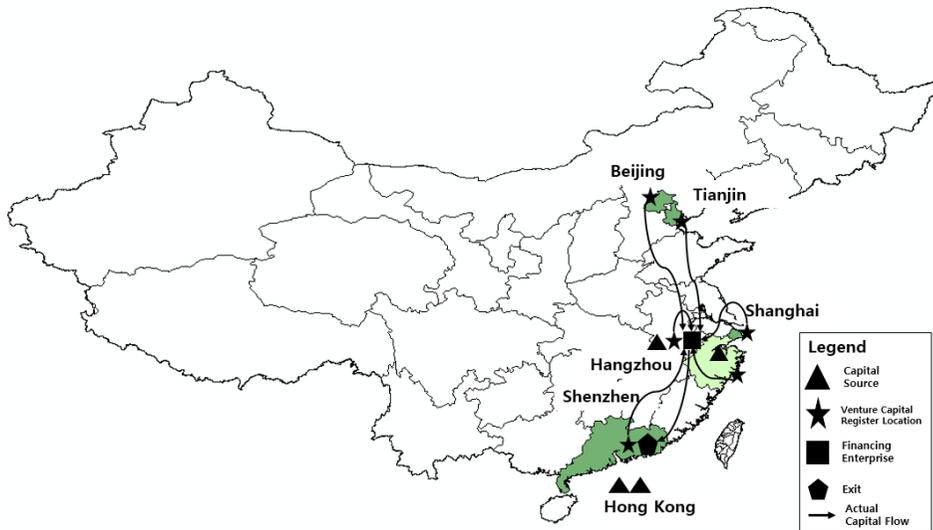


Figure 5-7 Case of Bing Mate

In this case, all the venture capital circulation stages are located within China. The main reasons are as follows. First, the legislation of China's venture capital industry has improved greatly, such as the legislation and revision of the "company law" and "partnership law," which may have a positive effect on VC development. Second, the restriction on foreign direct investment in China was relaxed and enabled foreign VCs to invest in a larger field of industry in China. Third, the restrictions on the VIE structure and the development of China's capital market made the overseas IPO less attractive compares to the Chinese exit channels. Therefore, the stages of VC began to return to China.

5.3 Summary

The influence of the legal system on spatial allocation of capital is mainly manifested in two aspects: the patterns of spatial distribution of capital and the method they applied to realize this allocation strategy. It is common for the regional legal environment to not synchronize with the actual economic development. This status can be roughly divided into two categories. First, the local economy presents attractive opportunities while the legal system hinders the enterprises' access to the opportunities. This happens when certain regulations are absent in a specific field or existing regulations aim to protect exceptional interest subjects. The other status, on the contrary, is when there are not enough opportunities or room for development when it comes to performing certain economic activity but the local government makes great efforts to offer favorable regulations that encourage economic agents to participate in its scheme of the regional development plan. This happens when the local government aims to develop its lagging industry or alter the path of development. In both cases, the action force imposed on economic agents, which are the economic and legal factors, are in opposite directions and this inevitably compels enterprises to find new ways to avoid the obstructions while taking the advantages. It is these opposite forces that give birth to "financial innovations" and "enterprise structure innovations". These innovations are mainly embodied in two aspects, namely, the spatial distribution patterns of the capital and the new methods they apply to realize

the capital flow in space. New methods include inventing new financing tools, new types of business entities, and new enterprise structures (i.e. new ways of splitting and recombining the whole firm, such as SPV, etc.). While spatial distribution patterns refer to the splitting of the firm's structure or activity process and then allocating parts into different geographical locations.

In the practice of venture capital industry, capital circulation has been divided into four parts, namely, fund raising stage, registration stage, investment stage, and exit stage. Allocating these four stages into different locations to avoid the obstacles of the local legal system and to take advantage of another place's regulation is the manifestation of the legal system's impact on spatial allocation of capital. This manifestation, essentially, has the same motivations and strategic principles used by MNCs to locate their functional departments, like headquarters, factories, research and development centers, subsidiaries, and branches, in different places. The only difference is that the motivation generated by legal factors are not focused on minimizing the costs caused by economic factors, but to focused more on minimizing the invisible extra costs caused by the local legal system.

In addition to the "functional and process division allocation", there is another type of separation and allocation, namely, "registration and actual business activity separation". There are three motivations to separate the registration location with the actual place of business operation. The first motive is to obtain a special status by separating the registration location from

the place of actual operation . Through this separation, enterprises can receive special treatment or privileges that cannot be achieved direct registration in the same place of actual operation. In practice, the most typical example is the case where domestic capital registers offshore while doing their business back onshore. By doing this, domestic capital receives a foreign status, which enables it to obtain special preferential policies and certain privileges that are only provided to foreign investors. The second motive of placing the registration location out of the actual place of operation to circumvent the disadvantages caused by the law followed at the business region. For example, nearly 30% of global foreign direct investments flows through tax havens by pretending that profits generated in one part of the world are in fact made in another(Economist, 2016). The phenomenon of this round-tripping investment based on the motivation to avoid heavy taxation imposed at the actual palce of operation. In the case of China’s venture capital industry, a large number of Chinese Internet companies place their registration locations outside of China while doing businesses inside it. The leading reason for this strategy is to circumvent the ban that the Chinese authority put on foreign investments in its information industries. That is if an Internet company is registered outside China, it is not within the control of the Chinese law and can receive foreign investment. Further, investors can also exit through the global stock market free of China’s regulation and vice versa. The third motivation is to take advantage of the registration location’s regulation while escaping the

responsibilities granted with the preferential policies. The most typical example of this situation is the case of Qingdao in China. Among the regulations provided by local governments within China, the preferential policies provided by the Qingdao authority is particularly favorable for venture capital registration. The preferential policies work well on the ostensible sense that it really attracted a lot of venture capital registration in the region. However, most of the actual investment locations of the registered funds are outside the city. That is, the true purpose of registration in Qingdao city does not coincide with the aim of the local government(i.e. to develop the local venture capital industry and related economies), but only to gain the extra income and privileges that other locations do not provide.

By employing the above two forms of splitting and configuration, VC enterprises effectively resolved problems such as market access barrier problem, reasonable tax avoidance problem, exit channel problem, and other issues that were generated by the regional legal system. By doing so, the implicit costs caused by law was minimized and the ultimate yield was maximized. Following this motivation, the strategy of splitting and configuration varies from place to place and changes according to the transformation of the regional legal environment, which correspondingly forms the variation and transformation of the spatial allocation patterns of capital.

Chapter 6 Conclusion

Based on the empirical research of venture capital invested in China from 1992 to 2012, this paper examined the mechanism of the regional legal systems' influence on geographical distribution of venture capital and further explored the implications of geography in the capital allocation process.

Four sub-questions and corresponding research issues were deduced from the above main research object, namely: the study of the characteristics of venture capital spatial allocation patterns, the interpretation of the reason and process of the venture capital spatial allocation phenomenon, the mechanism of the regional legal systems' influence on venture capital spatial allocation, and the implication of geography in the capital allocation process. Three analysis tools, i.e., the correlation analysis, the qualitative interpretation of legal provisions, and game theory based analysis, were used to discuss the above questions. Accordingly, four sub-conclusions can be summarized as follows.

Firstly, there are two features of the geographical patterns of venture capital spatial allocation, i.e., the feature of geographical separation of business operation places vs legally registered addresses, and the feature of

the capital cycle division while scattered into different locations. In chapter 3 and chapter 4, through observing the location data of the venture capital fund invested in China, the inconsistency between venture capital's legally registered address and the actual business operation place was detected. This phenomenon is not only found in the fund establishment stage but also other stages of the venture investment cycle. For example, capital source and raised fund that is registered outside China may be actively involved in the Chinese domestic venture investment activities as well as the venture exiting market often far away from the financing place. Specifically, for parts of their portfolio, companies even change their legal register addresses in order to get another legal status.

On the other hand, as demonstrated in chapter 4, when examining the capital location of the individual part of the venture investment cycle, i.e., fundraising, registration, investment, and exit, different geographical patterns appeared according to the corresponding activities. However, the patterns changed over time. Generally, there are three geographical patterns of the venture capital invested in China. The first pattern is the 'head-tail outside pattern'. In this pattern the fundraising, registration, and exiting locations are all located outside China, while only the investment activity remained within China. This pattern mainly appeared during the time before 2000. The second pattern is the 'mix location pattern', which means venture capitalist chose to locate the stages in a mix way according to the specific objectives and cases.

This pattern appeared most during 2001-2006. The third pattern is the ‘all stage bake in situ pattern’ that all stages go back to their register place inside China. The above phenomenon cannot be fully explained by merely applying the economic factors which indicated the existence of other influential factors.

To find out whether legislation factors have a relation to the phenomena above, a correlation analysis was conducted in 4.1. The result of the correlation analysis confirms that both legislation factors and economic factors are closely related with the venture capital spatial allocation. Later, in 4.2, by scrutinizing the relevant legal provisions, the fact that extra costs may occur to venture capital when applying different laws and regulations was demonstrated. These analysis, combined with the study of the characteristics of the legal and venture capital, induced the second sub-conclusion of the paper: reasons for capital spatial allocation come from the mismatch of the regional legal signal and the economic signal, as well as the ‘hidden costs’ that induced by the legislation. Here, the regional legal system influences the venture capital spatial allocation through by way of acting as a ‘road map’ as well as an indicator of ‘hidden costs’. It is the combination of the legal scope characteristic and the capital dividable characteristic that enables the function of the influence.

Third, the mechanism of the legal impact on venture capital spatial allocation is virtually a game between government and enterprises that choose different strategies as regards to law and place to maximize their own profits. In this game, the governments and the enterprises have different positions, understandings and behavior strategies toward geography. Geography is an option for enterprise that it can choose to settle in or choose to leave. While geography for government is an inherent attribute of its own that cannot be detached from it. Meanwhile, the government is the legislation provider while the enterprise is the acceptor. The purpose of the government is to provide a series of legislations which guide as well as regulate economic behaviors to achieve the goal of the regional economic development. On the other hand, the goal of the enterprise is applying or bypassing certain regulations which may enable them to obtain certain protection or benefit from the government to achieve the goal of maximizing a firm's comprehensive income. When a regional legal system is well designed to match the goal of the two parties together, both sides will maximize their profit. Reversely, when a regional legal system hinders the goal of the enterprise to maximize their profit, the enterprise will find ways to avoid the disadvantages that may result. From a geographical perspective, there are two ways to circumvent the laws, namely, changing legal status and registration location. In the case of changing status, both the registration location and actual business operation location remain within the region. While in the case of changing registration address, the

registration location will be separate from the actual business operation location to escape the geographical scope of the regulation. As a consequent, the phenomenon of capital geographical distribution, and the features mentioned in issue 1 appears.

Here, it is worth noting that, although there are several patterns of the capital spatial allocation, they are sharing one common principle: Regardless of the pattern or location that they are taking on, the outcome of the firm's 'hidden costs' caused by the law must be the lowest one when compared with all other possible spatial allocation combinations. In other words, pursuing the maximized comprehensive income is the fundamental principle of the mechanism.

Fourth, there is a dual role of geography in the process of the capital spatial allocation, i.e., the role of 'place' and 'space'. In the process of the legally influenced capital spatial allocation, when the enterprise chooses to change their legal status to bypass the law, the actual business operation location and the firm's registration location still remain within the region. In this situation, the reason that the firm remains in the same region is because the extra benefits that it derives from the inherent attributes of the region are greater than the extra costs that are caused by the formal institutions, i.e., the regional legal systems. The inherent attributes including the informal institutions - history, culture, customs, norms, moral, religious constrains of the region - as well as other attributes that are embedded in the region such as

the external economic benefits and social networks are ones that the region may supply to the firm. In this case, the region for the firm is an irreplaceable 'place'.

On the contrary, when 'hidden costs' caused by the law exceed the extra benefits provided by the inherent attributes of the region, the firm will separate the registration location from the actual business operation location for the sake of survive and development. The pro forma legal registration address will be placed in an indiscriminate 'space' that is concerned only with the location as a legal factor for the firm. In other words, in this case, the newly chosen location for the detached registration address is merely an indiscriminate legal space for the firm.

In short, in the process of capital spatial allocation, there are two implications of geography for the enterprise. That is, when the influence of the regional legal system profits the firm within a bearable range, the enterprise will remain in the region, and the region will act as a 'place' role. Conversely, when the impact of the legal system exceeds the bearable scope of the firm, it will find another 'space' to ease the adverse effects caused by the law. This role of geography also contributed to the emergence of the above phenomenon mentioned in issue 1.

To summarize the above findings, the regional legal system affects the capital spatial allocation through a dual mechanism of explicit regulations on economic behaviors and the implicit influence on the comprehensive income of the firm. Geography has two implications in this dual mechanism: One, when the impact of the regional legal system on the activity and the comprehensive income of the firm is less than the benefits that the firm gains from the regional inherence attributes, the region is an irreplaceable 'place' for the firm, Otherwise, the corresponding region will merely be an indiscriminate legal 'space'.

In this paper, the phenomenon of circumvent law has been mentioned multiple times. However, the purpose of the study is not to encourage this behavior nor to place any blame. The only purpose is to know it, face it, and find solutions for it. Legal institutions is not a naturally existing law; it is an enforced common sense designed by man along with human's history. However, this common sense is not always in accordance with the objective of laws. Taoism, the philosophy of ancient China, advocated that 'human follows earth, earth follows sky, sky follows Taoism, and Taoism follows nature ' which means it is the laws of nature that serves as the superior law above all laws. In this study, the nature of the profit-seeking characteristics of the capital can be seen as one of the nature laws. When human regulation breaches nature's law, varied and imbalanced phenomena will inevitably

occur. The anomaly that appears in venture capital spatial allocation can be seen as one of the varied and imbalanced phenomena mentioned above. Therefore, the implication of this study lies on the understanding of nature's law of the capital allocation by examining the actual goal of both the enterprise and government. Through the understanding of the relations between nature's law of capital spatial allocation and the human designed laws, i.e., the regional legal system, sustainable development and maintenance of proper legislation and law-abiding activities are expected.

Specifically, this paper may have following implications for legislatures to be aware of.

Firstly, legislatures should always bear in mind that there will always be a gap between economic system and legal system. Therefore, rather than constrain everything through immature laws, it is better to leave some room for firms to find their own ways and rules to develop themselves.

Second, legislatures also have to remember that pursuing high profits, as well as maximize it, is the nature law of the capital. Therefore, when formulating regulations, legislatures need to fully discuss the potential influence that the provision may impose on enterprise's comprehensive income. Here, the 'impose on enterprise's comprehensive income' means considering the overall impact of the regulation on enterprise's overall income

from the perspective of corporate financial statements point of view. Although no single law can cover all aspects of business activities just in one piece of legislation, and only partial regulations can be made on specific aspects of the firm, it is necessary to take full consideration of the impact of the individual provision on the overall income of the firm. That's because, nowadays, the economic activities become more and more flexible. Therefore, even only one part of the firm receives negative effect from the local legal system, the nature of maximizing the overall profit of the capital will impose enterprise to find bypass ways to ease the disadvantages. As a consequence, the so called 'enterprise structure or institution innovation' and 'financial innovation', as well as the forbidden methods of circumventions will inevitably emerge. The emergence of the spatial allocation of the venture capital discussed in this paper is just one example among them. At this point, both the government and enterprise's benefit will be adversely affected. Therefore, the consideration of legislation's impact on enterprise financial statements perspective's income is needed. This consideration will help legislatures adjusting the provisions of the law to harmonize the goal of government with the goal of enterprises. Through this way the win-win situation will be achieve.

Third, keep in mind that the positions of the government and the enterprises on geography are different, i.e. local government have no choice but to stay within the place while enterprises can choose other places as long as they wish. Therefore, if local government wants to attract certain economic

agencies or stimulate certain activities, it should be well aware that legislation is only one part of the institutions. There are other institutions and inherent attributes embedded in region which distinguish it from the other regions. If the local government want to be an irreplaceable 'place' rather than an indiscriminate 'space', it should actively establish the other regional embedded attributes, as well as facilitating the development of it.

At last, although the present study offered an initial contribution to the literature from the geographical perspective concerning legislation's role on capital spatial allocation and the possibility of applying game theory on contemporary geography studies, the tentative conclusions of the study leave more to be investigated and answered by future researches. At the very least, the following two aspects should be further discussed. First, as the present paper was limited in the national's scope, further studies on different geographical scales, such as, local, regional, as well as international, are needed. Second, more comprehensive international comparative studies will certainly help the understanding of the issues, as well as getting more constructive suggestion and policy implications from it.

Appendix 1 Venture Capital Legal Systems of China

1. Before 2000

Registered On Shore			Stage	Registered Off Shore		
Tax	Related Legal System	Legitimated form		Legitimated form	Related Legal System	Tax
"Notice on collection of value added tax for good transfer between enterprise agencies" (1998)	Ad-1: Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises"	Enterprise Government Policy Bank ¹¹⁰	Capital Source (LP)	All forms	Af-1: No regulation	"Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises"
"Law of foreign capital enterprises" (2000)	Domestic : "Company Law" (1993,1999)					
"Law of China-foreign cooperation joint ventures" (2000)	Bd-1: Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises"	Foreign: Sino-foreign Companies	VC's Registration	No entity in China (direct investment in the form of FDI	Bf-1: "Measures for the administration of registration of permanent representative of foreign enterprises" approved by State Council on March 5th 1983 and published by National Bureau of Administration for Commerce and Industries on March 15th 1983	
"Law of Sino-foreign	"Interim measures on the establishment of limited companies with foreign investment" (1995 ¹¹¹)	Domestic: State-owned companies		Liaison offices	" Measures for the administration of economic	

¹¹⁰ There is no legal barriers for policy banks in addition to the approval of Ministry of Finance. The "Commercial Bank Law" (2003) regulated that commercial banks is not allowed to invest in VC. There are two methods for offsetting regulations.

¹¹¹ Regulations on the establishment of foreign investment limited enterprises.

enterprises"	<p>"Interim measures on the establishment of foreign investment companies" (1995)</p> <p>Domestic: "Company Law" (1993,1999)</p>	<p>(sole state-owned, state-holding, state-owned shares) Collective companies Enterprise</p>		<p>in China Branch offices in China</p>	<p>activities of foreign enterprises in China" (1992) "Company Law" (1993,1999) "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Regulations on the administration of company registration" (1994) "Measures for the administration of the establishment of overseas Chinese industrial investment funds" (1995¹¹²)</p>	
	<p>Cd-1: Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Regulations on equity change of investors of foreign investment enterprises" (1997¹¹³) "Interim measures for domestic investment of foreign investment enterprises" (2000¹¹⁴)</p>	<p>Equity investment company</p>	<p>Enterprise</p>		<p>Cf-1: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Regulations on equity change of investors of foreign investment enterprises" (1997¹¹⁵) "Interim measures for domestic investment of</p>	

¹¹² Regulations on the establishment of equity investment funds and investment in domestic companies by domestic agencies

¹¹³ Regulations on the investment of foreign capital in foreign equity of domestic enterprises (overseas to overseas)

¹¹⁴ Regulations on domestic equity investment of foreign investment enterprises

¹¹⁵ Regulations on the investment of foreign capital in foreign equity of domestic enterprises (overseas to overseas)

	Domestic : "Company Law" (1993,1999)				foreign investment enterprises" (2000 ¹¹⁶)	
	Dd-1: ¹¹⁷ "regulations on the domestic listing of limited liability companies" (1998 ⁸) "Regulations on equity change of investors of foreign investment enterprises" (1997 ¹¹⁸)	Equity transfer of domestic main board listing	Exit	Overseas listing Transfer of overseas equity	Df-1: "Special regulations on the overseas fundraising and listing of limited liability enterprises" (1994 ¹¹⁹) "Notice on the application of overseas listing of enterprises" (1999 ¹²⁰)	

¹¹⁶ Regulations on domestic equity investment of foreign investment enterprises

¹¹⁷ Regulations on the domestic listing of foreign investment limited enterprises

¹¹⁸ Regulations on the equity transfer of foreign investment companies.

¹¹⁹ Regulations on the overseas listing of domestic companies

¹²⁰ Regulations on the overseas listing of domestic companies

2. 2001-2006

Registered On Shore			Stage	Registered Off Shore		
Tax	Related Legal System	Legitimated form		Legitimated form	Related Legal System	Tax
Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Notice on the tax issues for investing domestic companies of overseas investors" (2003 ¹²¹) "Notice on the enterprise gains tax of venture investment companies with foreign investment" (2003 ¹²²)	Ad-2: Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Interim measures for the establishment of venture investment companies with foreign investment" (2001) "Regulations on the administration of venture investment companies with foreign investment" (2003) Domestic : "Trust Law" (2001) "Company Law" 2004、 2005 "Interim measures for the administration of venture investment enterprises" (2005)	Enterprise Government Policy bank individual	Capital Source (LP)	All forms	Af-2: No regulations	"Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Notice on the tax issues for investing domestic companies of overseas investors" (2003) "Notice on the enterprise gains tax of venture investment companies with foreign investment" (2003) "Notice on the tax of the

¹²¹ The tax policy for the domestic investment by overseas investors.

¹²² The tax policy for venture investment enterprises with foreign investment

<p>"Notice on the tax of the development of venture investment enterprises" (2006)¹²³</p> <p>Domestic: "Notice on the tax of the development of venture investment enterprises" (2006)</p>	<p>Bd-2: Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" (2001) "Interim measures for the establishment of venture investment companies with foreign investment" (2001) "Regulations on the administration of venture investment companies with foreign investment" (2003)) Domestic: "Trust Law" (2001) "Company Law" (2004, 2005) "Interim measures for the administration of venture investment enterprises" (2005)</p>	<p>Foreign: Sino-foreign investment Venture investment companies with foreign investment Domestic: companies (sole state-owned, state-holding, state-owned shares) Collective companies Enterprise Investment consultation/Management company ; Trust company ; Trust system Venture investment enterprise</p>	<p>VC's Registration</p>	<p>No entity in China (direct investment in the form of FDI Liaison offices in China Branch offices in China</p>	<p>Bf-2: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Regulations on the registration of enterprises" (2005)</p>	<p>development of venture investment enterprises" (2006)</p>
	<p>Cd-2: Foreign:</p>	<p>Equity investment between enterprises</p>	<p>Enterprise</p>		<p>Cf-2: (the domestically registered overseas capital is regarded as overseas capital for the</p>	

¹²³ The tax benefit regulation for venture investment companies in the 5th article of "Methods for the administration of venture investment companies of foreign investors also applies to foreign venture investment.

	<p>"Foreign Enterprise Law" (2000)</p> <p>"Law of China-foreign cooperation joint ventures" (2000)</p> <p>"Law of Sino-foreign enterprises"</p> <p>"Regulations on equity change of investors of foreign investment enterprises"(1997¹²⁴)</p> <p>"Interim measures for domestic investment of foreign investment enterprises" (2000¹²⁵)</p> <p>"Interim measures for the approval of foreign investment projects" (2004)</p> <p>"Regulations for investing domestic enterprises by foreign investors" (2006) (No. 10 document) ¹²⁶</p> <p>Domestic: "Company Law" (2004)</p>	<p>M&A</p> <p>Equity investment of VC foreign capital</p> <p>Equity investment of VC domestic capital</p>			<p>next investment)</p> <p>"Foreign Enterprise Law" (2000)</p> <p>"Law of China-foreign cooperation joint ventures" (2000)</p> <p>"Law of Sino-foreign enterprises"</p> <p>"Regulations on equity change of investors of foreign investment enterprises" (1997)</p> <p>"Interim measures for domestic investment of foreign investment enterprises" (2000)</p> <p>"Interim measures for the approval of foreign investment projects" (2004)</p> <p>"Regulations for investing domestic enterprises by foreign investors" (2006) (No. 10 document)</p> <p>"Category guidance for investing foreign industries" ("Category one to three were published in 2004, 2005, 2007, respectively.</p> <p>"Guide policy of foreign investment industries" and "Guide category of foreign investment industries" (2006)</p> <p>"Regulations on the approval of establishment</p>	
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¹²⁴ Regulations on the investment of foreign capital in foreign equity of domestic enterprises (overseas to overseas)

¹²⁵ Regulations on domestic equity investment of general foreign investment enterprises

¹²⁶ Legal reference for the investment in domestic enterprise equity by foreign capital (domestic to overseas). The No. 10 document becomes the barrier of overseas listing by means of red chip model.

					of enterprise by foreign investment" (2004)	
					" Regulations on the approval of establishment of enterprise for mainland enterprise to Hongkong and Macon" (2004)	
	Dd-2: "Regulations on domestic listing and overseas capital of limited liability enterprises" (1995) "Regulations on equity change of investors of foreign investment enterprises"(1997) "Notice on the foreign investment liability enterprises" (2001 ¹²⁷) "Securities Law" (2005 ¹²⁸) "Measures for the administration of first public offering shares and listing" (2006 ¹²⁹)	listing of domestic main board Listing of domestic small and medium board Equity transfer M&A	Exit	overseas listing Equity transfer M&A	Df-2: "Special regulations on overseas fundraising and listing of limited liability enterprises" (1994) "Notice on the application of overseas listing of enterprises" (1999) "Notice on the financing through special fundraising company and round-trip investment in exchange management" (2005 ¹³⁰)	

¹²⁷ Regulations on the domestic listing of foreign investment liability enterprises.

¹²⁸ The fundamental reference for VC investors to exit through the listing of funded companies.

¹²⁹ Regulate how the funded companies firstly issue stocks and list.

¹³⁰ It replaces the No. 11 and 29 documents and regulates that the round-trip investment in domestic assets should satisfy the strict approval requirements for foreign exchange registration.

3. 2007-2012

Registered On Shore			Stage	Registered Off Shore		
Tax	Related Legal System	Legitimated form		Legitimated form	Related Legal System	Tax
Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Notice on the tax issues for investing domestic companies of overseas investors" (2003) "Notice on the enterprise gains tax of venture investment companies with foreign investment" (2003) "Notice on the tax of the development of venture	Ad-3: Foreign: "Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Interim measures for the establishment of venture investment companies with foreign investment" (2001) "Regulations on the administration of venture investment companies with foreign investment" (2003) Domestic : "Trust Law" (2001) "Company Law" 2004 "Interim measures of the administration of venture investment enterprises" (2005) (cases approved by Securities Commission)	Enterprise Government Policy bank Individual Securities enterprise Guidance fund Social security fund Insurance fund Sovereign wealth fund	Capital Source (LP)	All forms	Af-3: No regulations	"Foreign Enterprise Law" (2000) "Law of China-foreign cooperation joint ventures" (2000) "Law of Sino-foreign enterprises" "Notice on the tax issues for investing domestic companies of overseas investors" 2003 "Notice on the enterprise gains tax of venture investment companies with foreign investment"2003 "Notice on the tax of the development of venture investment

<p>investment enterprises" (2006)</p> <p>"Enterprise gains tax Law" (2008)</p> <p>Domestic:</p> <p>"Notice on the tax of the development of venture investment enterprises" (2006¹³¹)</p> <p>"Enterprise gains tax Law" (2008¹³²)</p> <p>"regulations on the implementation of the enterprise income tax law" (2008)</p> <p>"Notice on the partner income tax of partnership enterprises"</p>	<p>(2007)</p> <p>"Interim measures for the administration of venture investment guide funds of technology small and medium enterprises" (2007)</p> <p>"Guidance on the establishment and operation of regulations on venture investment guide funds" (2008)</p> <p>"National social security funds equity investment funds" (2008)</p> <p>"Interim measures for the administration of national social security funds" (2008¹³⁴)</p> <p>"Interim measures for investment equity of insurance capital" (2010¹³⁵)</p> <p>"China investment limited liability enterprise-China wealth fund" (2007)</p>					<p>enterprises"2006</p> <p>"Enterprise Income Law" (2008)</p> <p>"Notice on the strengthened administration of enterprise gains tax through equity transfer" (2008¹³⁶)</p>
	<p>Bd-3:</p> <p>Foreign:</p> <p>"Foreign Enterprise Law" (2000)</p> <p>"Law of China-foreign cooperation joint ventures"</p>	<p>Foreign:</p> <p>Sino-foreign enterprises (2008)</p>	<p>VC's Registration</p>	<p>No entity in China (direct investment in the form of FDI</p>	<p>Bf-3:</p> <p>"Regulations on the registration of enterprises"</p> <p>"Foreign Enterprise Law" (2000)</p> <p>"Law of China-foreign cooperation joint</p>	

¹³¹ It regulated the detailed implementation of tax for venture investment enterprise. It was allowed to subtract income tax from the 70% of small and medium high-tech enterprises.

¹³² The same tax rates are used for overseas investment enterprises and domestic capital industries. There is tax benefit for investing small and medium high-tech enterprises.

¹³⁴ From April 2008, the national social security funds were allowed to invest in approved industrial funds and market-based equity investment fund.

(2008 ¹³³)	(2000) "Law of Sino-foreign enterprises" "Interim measures for the establishment of venture investment companies with foreign investment" (2001) "Regulations on the administration of venture investment companies with foreign investment" (2003) "Notice on approval of investment of venture investment enterprises and venture investment management enterprises" (2009 ¹³⁷) "Measures for administration of the establishment of domestic partnership enterprise by foreign enterprise or individual" (2010) "Regulations on the registration management of foreign investment partnership enterprises" (2010)	Venture investment companies invested by foreign capital Foreign limited partnership Domestic: State-owned companies (sole state-owned, state-holding, state-owned shares)		Liaison offices in China Branch offices in China	ventures" (2000) "Law of Sino-foreign enterprises" "Regulations on the registration of enterprises" (2005) Regulations on the administration of registration of resident representative offices "Measures for the administration of resident representative offices for the People's bank of China.	
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135 On September 5th 2010, the "Interim measures for investment equity of insurance capital. The second article stated that the range of equity is the equity of corporation limited companies and limited liability companies which are established and registered domestically and list in securities exchange. The third article stated that insurance fund can directly or indirectly invest in enterprise equity. The direct investment in equity is regarded as the behavior to invest and hold enterprise equity as investors. While the indirect investment assessment is for insurance companies to establishment financial products such as equity investment funds. The insurance companies approved by the regulation can be used as private fundraising agency investors.

¹³⁶ The regulations on income tax from equity transfer.

133 The partnership enterprises take each partner as tax payer.

¹³⁷The foreign investment includes establishment, approve, operation and investment.

	<p>Domestic:</p> <p>"Trust Law" (2001)</p> <p>"Company Law" (2004, 2005)</p> <p>"Interim measures of the administration of venture investment enterprises" (2005)</p> <p>"Partnership Enterprise Law" (2007¹³⁸)</p> <p>"Measures for the administration of trust plan of Trust enterprises" (2007¹³⁹)</p> <p>"Guidance on the operation of PE investment trust business" (2008¹⁴⁰)</p>	<p>Collective companies</p> <p>Enterprise</p> <p>Venture investment enterprises</p> <p>Limited partnership</p>				
	<p>Cd-3:</p> <p>Foreign:</p> <p>"Foreign Enterprise Law" (2000)</p> <p>"Law of China-foreign cooperation joint ventures" (2000)</p> <p>"Law of Sino-foreign enterprises"</p> <p>"Regulations on equity change of investors of foreign investment enterprises"(1997)</p> <p>"Interim measures for domestic investment of foreign investment enterprises" (2000)</p> <p>"Interim measures for the approval of foreign</p>	<p>Equity investment between enterprises M&A</p> <p>Equity investment of VC foreign capital</p>	Enterprise		<p>Cf-3:</p> <p>Foreign:</p> <p>"Foreign Enterprise Law" (2000)</p> <p>"Law of China-foreign cooperation joint ventures" (2000)</p> <p>"Law of Sino-foreign enterprises"</p> <p>"Regulations on equity change of investors of foreign investment enterprises" (1997¹⁴⁴)</p> <p>"Interim measures for domestic investment of foreign investment enterprises" (2000¹⁴⁵)</p> <p>"Interim measures for the approval of foreign</p>	

¹³⁸ Limited partnership occurs for the first time (not apply to foreign investors)

¹³⁹ Legal reference for the investment of trust PE and equity funds.

¹⁴⁰ It regulated the trust PE fund include the requirement for trust companies and consultant.

	<p>investment projects" (2004¹⁴¹)</p> <p>"Regulations for investing domestic enterprises by foreign investors" (2006) (No. 10 document) ¹⁴²</p> <p>"Notice on the strengthen and regulate the administration of foreign investment projects" (2008¹⁴³)</p> <p>"Notice on the delegated approval authority of foreign investment projects" (2010)</p> <p>"Category guidance on foreign investment industries"</p> <p>Domestic: "Company Law"2004</p>	<p>Equity investment of VC domestic capital</p>			<p>investment projects" (2004¹⁴⁶)</p> <p>"Regulations for investing domestic enterprises by foreign investors" (2006) (No. 10 document) ¹⁴⁷</p> <p>"Notice on the strengthen and regulate the administration of foreign investment projects" (2008¹⁴⁸)</p> <p>"Notice on the delegated approval authority of foreign investment projects" (2010)</p> <p>"Category guidance on foreign investment industries"</p> <p>"Guidance on the investment industries" (2001).</p> <p>"Measures for the administration of overseas investment"</p>	
Dd-3:		listing of	Exit	overseas listing	Df-3:	

¹⁴⁴ Regulations on the investment of foreign capital in foreign equity of domestic enterprises (overseas to overseas)

¹⁴⁵ Regulations on domestic equity investment of foreign investment enterprises

¹⁴¹ The approval system for investing domestic enterprises by overseas enterprises and investors.

¹⁴² Regulations on investment process of overseas investors, approval, and anti-monopoly.

¹⁴³ The approval system for investing domestic enterprises by overseas enterprises and investors

¹⁴⁶ The approval system for investing domestic enterprises by overseas enterprises and investors

¹⁴⁷ Regulations on investment process of overseas investors, approval, and anti-monopoly.

¹⁴⁸ The approval system for investing domestic enterprises by overseas enterprises and investors

	<p>"Regulations on domestic listing and overseas capital of limited liability enterprises" (1995)</p> <p>"Regulations on equity change of investors of foreign investment enterprises" (1997)</p> <p>"Notice on the foreign investment liability enterprises" (2001¹⁴⁹)</p> <p>"Securities Law" 2005¹⁵⁰</p> <p>"Measures for the administration of first public offering shares and listing" (2006¹⁵¹)</p> <p>"Enterprise bankruptcy law" 2007¹⁵²</p>	<p>domestic main board</p> <p>Listing of domestic small and medium models.</p> <p>listing of domestic venture investment</p> <p>M&A</p> <p>Guidance</p> <p>transfer</p> <p>Settlement</p>		<p>overseas equity transfer</p> <p>Overseas M&A</p>	<p>"Special regulations on overseas fundraising and listing of limited liability enterprises" (1994)</p> <p>"Notice on the application of overseas listing of enterprises" (1999)</p> <p>"Notice on the financing through special fundraising company and round-trip investment in exchange management " (2005¹⁵³)</p>		
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¹⁴⁹ Regulations on domestically listing of foreign investment companies

¹⁵⁰ Basic reference for the exit of funded investment.

¹⁵¹ It regulated how the funded companies experience the first public issuing of stocks and listing.

¹⁵² If the funded companies fail to pay off the debt, insolvency or lacking paying capacity, the debtors and creditors can put forward the bankruptcy liquidation to the people's court.

¹⁵³ It replaces the No. 11 and 29 documents and regulates that the round-trip investment in domestic assets should satisfy the strict approval requirements for foreign exchange registration.

Appendix 2 Venture Capital Legal Systems of China (Chinese Version)¹⁵⁴

1. Before 2000

Registered On Shore			Stage	Registered Off Shore		
Tax	Related Legal System	Legitimated form		Legitimated form	Related Legal System	Tax
《关于企业所属机构间移送货物征收增值税问题的通知》（国税发[1998] 13号） 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》	Ad-1: Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 Domestic: 《公司法》1993、1999	公司 政府 政策银行 ¹⁵⁵	Capital Source (LP)	所有形式	Af-1: 无限制	《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》
	Bd-1: Foreign: 三资企业	Foreign: 三资企业	VC/PE's Registration	在中国境内无实体（投资时以外资 FDI 形	Bf-1: 《关于外国企业常驻代表机构登记管理办法》1983年3月5日经国务院批准，1983年3月15	

¹⁵⁴ 为方便其他学者对相关领域进行后续研究时便于查找相关法规，本文特添加中文参照版本。这一造福后续研究学者的提议需感谢首尔大学地理系金荣仓教授的提议。

¹⁵⁵ 政策性银行无法律上的障碍，但需财政部同意。2003年的商业银行法，使得商业银行不可投资 VC/PE 领域，但实际操作中，有 2 种规避法规的方式。

<p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《关于设立外商投资股份有限公司若干问题的暂行规定》1995¹⁵⁶</p> <p>《关于外商投资举办投资性公司的暂行规定》(1995)</p> <p>Domestic:</p> <p>《公司法》1993、1999</p>	<p>Domestic:</p> <p>国有企业（国有独资、国有控股、国有参股）</p> <p>集体企业</p> <p>公司制</p>			<p>式直接投资）</p> <p>在中国境内设立联络处</p> <p>在中国境内设立分公司？（需重新查看相关税法！）</p>	<p>日原国家工商行政管理局发布</p> <p>《外国（地区）企业在中国境内从事生产经营活动登记管理办法》1992</p> <p>《公司法》1993,1999¹⁵⁷</p> <p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《中华人民共和国公司登记管理条例》1994</p> <p>《设立境外中国产业投资基金管理办法》1995¹⁵⁸</p>	
Cd-1:	公司间股权投资	Enterprise			Cf-1:	

¹⁵⁶ 在中国设立外商投资股份有限公司规则。

¹⁵⁷ 依据《中华人民共和国公司法》和国家工商行政管理局《外国（地区）企业在中国境内从事生产经营活动登记管理办法》（1992）第三条之规定，国家并不限制外国企业来中国设分公司。

但在实际作业过程，目前来中国开立分公司的外国企业实际上只有以下几种类型的企业可以得到审批机关批准：

1. 外国石油勘探公司中国分公司；
2. 外国银行中国分行；
3. 外国工程公司中国分公司；
4. 外国保险公司中国分公司。

因此，外国公司要在中国境内设立分分公司，必须是在中国政府批准后方可成立。具体取决于该外国公司的实际情况和行业别。

¹⁵⁸ 境内机构在境外发起设立股权投资基金并投资于境内企业的相关规定。

	<p>Foreign: 《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《外商投资企业投资者股权变更的若干规定》1997¹⁵⁹</p> <p>《关于外商投资企业境内投资的暂行规定》2000¹⁶⁰</p> <p>Domestic: 《公司法》1993、1999</p>	<p>资</p>			<p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《外商投资企业投资者股权变更的若干规定》1997</p> <p>《关于外商投资企业境内投资的暂行规定》2000¹⁶¹</p>	
	<p>Dd-1:</p> <p>《关于股份有限公司境内上市外资股的规定》1995¹⁶²</p> <p>《外商投资企业投资者股权变更的若干规定》1997¹⁶³</p>	<p>境内主板上市</p> <p>股权转让</p>	<p>Exit</p>	<p>境外上市</p> <p>境外股权转让</p>	<p>Df-1:</p> <p>《关于股份有限公司境外募集股份及上市的特别规定》1994¹⁶⁴</p> <p>《关于企业申请境外上市有关问题的通知》1999¹⁶⁵</p>	

¹⁵⁹ 是外资收购境内企业外资股权（外转外）的法律依据。

¹⁶⁰ 一般外商投资企业境内股权投资规则。

¹⁶¹ 一般外商投资企业境内股权投资规则。

¹⁶² 外商投资股份公司境内上市相关规定。

¹⁶³ 外商投资企业股权转让相关规定。

¹⁶⁴ 境内企业境外上市相关规定。

¹⁶⁵ 境内企业境外上市相关规定。

2. 2001-2006

Registered On Shore			Stage	Registered Off Shore		
Tax	Related Legal System	Legitimated form		Legitimated form	Related Legal System	Tax
Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《关于外国投资者并购境内企业股权有关税收问题的通知》2003 ¹⁶⁶ 《关于外商投资创业投资公司缴纳企业所得税有关税收问题的	Ad-2: Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《关于设立外商投资创业投资企业的暂行规定》(2001) 《外商投资创业投资企业管理规定》(2003) Domestic: 《信托法》(2001)	公司 政府 政策银行 个人	Capital Source (LP) 所有形式	Af-2: 无限制	《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《关于外国投资者并购境内企业股权有关税收问题的通知》2003 《关于外商投资创业投资公司缴纳企业所得税有关税收问题的通知》2003 《关于促进创业投资企	

¹⁶⁶ 境外投资者从事境内并购项目是的税收政策。

<p>通知》2003¹⁶⁷</p> <p>《关于促进创业投资企业发展有关税收问题的通知》2006¹⁶⁸</p> <p>Domestic:</p> <p>《关于促进创业投资企业发展有关税收问题的通知》2006</p>	<p>《公司法》2004、2005</p> <p>《创业投资企业管理暂行办法》（2005）</p> <p>Bd-2:</p> <p>Foreign:</p> <p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《关于设立外商投资创业投资企业的暂行规定》（2001）</p> <p>《外商投资创业投资企业管理规定》（2003）</p> <p>Domestic:</p> <p>《信托法》（2001）</p> <p>《公司法》2004、2005</p> <p>《创业投资企业管理暂行办法》（2005）</p>	<p>Foreign:</p> <p>三资企业（WFOE倍受欢迎）</p> <p>外商投资创业投资企业¹⁶⁹</p> <p>Domestic:</p> <p>国有企业（国有独资、国有参股）</p> <p>集体企业</p> <p>公司制（股权投资公司、投资咨询/管理公司；</p> <p>信托公司；</p> <p>信托制</p> <p>创业投资企业</p>	<p>VC/PE's Registration</p>	<p>在中国境内无实体（投资时以外资FDI形式直接投资）</p> <p>在中国境内设立联络处</p> <p>在中国境内设立分公司？（需重新查看相关税法！）</p>	<p>Bf-2:</p> <p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《中华人民共和国公司登记管理条例》2005</p>	<p>业发展有关税收问题的通知》2006</p>
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¹⁶⁷外商投资创业投资企业的税收政策。

¹⁶⁸ 创业投资企业税收优惠规定，根据《外商投资创业投资管理办法》第五条的规定，也同样适用于外资创投企业。

¹⁶⁹ 仍受2004年之前的《公司法》的制约，受限与注册资金50%以内的投资金额的限制？（须重新查实！）

	<p>Cd-2:</p> <p>Foreign:</p> <p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《外商投资企业投资者股权变更的若干规定》1997¹⁷⁰</p> <p>《关于外商投资企业境内投资的暂行规定》2000¹⁷¹</p> <p>《外商投资项目核准暂行管理办法》2004</p> <p>《关于外国投资者并购境内企业的规定》2006（10号文）¹⁷²</p> <p>Domestic: 《公司法》2004</p>	<p>公司间股权投资</p> <p>M&A</p> <p>外资以 VC/PE 身份进行股权投资</p> <p>本土资本以 VC/PE 身份进行股权投资</p>	<p>Enterprise</p>		<p>Cf-2:（与境内注册外资一样，因境内注册的外资在再投资时仍被视为外资）</p> <p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《外商投资企业投资者股权变更的若干规定》1997</p> <p>《关于外商投资企业境内投资的暂行规定》2000</p> <p>《外商投资项目核准暂行管理办法》2004</p> <p>《关于外国投资者并购境内企业的规定》2006（10号文）</p> <p>商务部、外交部发布《对外投资国别产业导向目录》（2004年7月发布《目录一》，2005年10月发布《目录二》，2007年1月发布《目录三》）</p> <p>《境外投资产业指导政策》和《境外投资产业指导目录》（发改外资[2006]1312号）</p> <p>《关于境外投资开办企业核准事项的规定》（商务部2004年16号令）和《商务部、国务院港澳办关于印发〈关于内地企业赴香</p>	
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¹⁷⁰ 是外资收购境内企业外资股权（外转外）的法律依据。

¹⁷¹ 一般外商投资企业境内股权投资规则。

¹⁷² 是外资收购境内企业股权（内转外）的法律依据，10号文成为以红筹模式进行境外上市的阻碍。

					港、澳门特别行政区投资开办企业核准事项的规定)的通知》(商合发〔2004〕452号)
	Dd-2: 《关于股份有限公司境内上市外资股的规定》1995 《外商投资企业投资者股权变更的若干规定》1997 《外商投资股份公司有关问题的通知》2001 ¹⁷³ 《中华人民共和国证券法》2005 ¹⁷⁴ 《首次公开发行股票并上市管理办法》2006 ¹⁷⁵	境内主板上市 境内中小板上市 股权转让 M&A	Exit	境外上市 股权转让 M&A	Df-2: 《关于股份有限公司境外募集股份及上市的特别规定》1994 《关于企业申请境外上市有关问题的通知》1999 《关于境内居民通过境外特殊穆迪公司融资及返程投资外汇管理有关问题的通知》2005 ¹⁷⁶

¹⁷³ 外商投资股份公司境内上市相关规定。

¹⁷⁴ VC/PE 投资人通过被投资企业上市退出的基本依据。

¹⁷⁵ 具体规定了被投资企业如何完场首次公开发行股票并上市。

¹⁷⁶ 取代外管局 11 号文和 29 号文，明确规定通过返程投资控制境内资产的方式要收到严格的外汇登记审批要求。

3. 2007-2012

Registered On Shore			Stage	Registered Off Shore		
Tax	Related Legal System	Legitimated form		Legitimated form	Related Legal System	Tax
Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《关于外国投资者并购境内企业股权有关税收问题的通知》2003 《关于外商投资创业投资公司缴纳企业所得税有关税收问题的通知》2003 《关于促进创业投资企业发展有关税收问题的通知》2006 《企业所得税法》2008	Ad-3: Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《关于设立外商投资创业投资企业的暂行规定》(2001) 《外商投资创业投资企业管理规定》(2003) Domestic: 《信托法》(2001) 《公司法》2004 《创业投资企业管理暂行办法》(2005) (证监会批准的案例)(2007) 《科技型中小企业创业投资引导基金管理暂行办	公司 政府 政策银行 个人 证券公司 引导基金 社保基金 保险资金 国家主权基金	Capital Source (LP)	所有形式	Af-3: 无限制	《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《关于外国投资者并购境内企业股权有关税收问题的通知》2003 《关于外商投资创业投资公司缴纳企业所得税有关税收问题的通知》2003 《关于促进创业投资企业发展有关税收问题的通知》2006 《企业所得税法》2008 《关于加强非居民企业股权转让所得企业所得

<p>Domestic:</p> <p>《关于促进创业投资企业发展有关税收问题的通知》2006¹⁷⁷</p> <p>《企业所得税法》2008¹⁷⁸</p> <p>《企业所得税法实施条例》2008</p> <p>《关于合伙企业合伙人所得税问题的通知》2008¹⁷⁹</p>	<p>法》（2007）</p> <p>《关于创业投资引导基金规范设立与运作的指导意见》（2008）</p> <p>（财政部、人保部批复同意全国社保基金投资股权基金）（2008）</p> <p>全国社会保障基金投资管理暂行办法（2008 国务院）¹⁸⁰</p> <p>《保险资金投资股权暂行办法》2010¹⁸¹</p> <p>（中国投资有限责任公司-中国财富主权基金）（2007）</p>	<p>Bd-3:</p>	<p>Foreign:</p>	<p>VC/PE's</p> <p>在中国境内无实体（投资时以外</p>	<p>Bf-3:</p>	<p>税管理的通知》2008¹⁸²</p>
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¹⁷⁷ 规定有关税收优惠的具体实施细则。主要是对部分符合条件的创投在企业，允许其按对中小高新技术企业投资额的 70% 抵扣应纳税所得额。

¹⁷⁸ 对外商投资企业和内资企业使用同种税率；投资于未上市中小高新技术企业的公司享有税收优惠。

¹⁷⁹ 合伙企业以每一合伙人为纳税义务人。

¹⁸⁰ 经国务院批准，2008 年 4 月起，全国社保基金被允许投资经发改委批准的产业基金和在发改委备案的市场化股权投资基金。

¹⁸¹ 2010 年 9 月 5 日，中国保监会发布了《保险资金投资股权暂行办法》，其中第二条界定了股权投资中“股权的范围是指在境内依法设立和注册登记，且未在中国境内证券交易所公开上市的股份有限公司和有限责任公司的股权。第三条，”保险资金可以直接投资企业股权或间接投资企业股权。直接投资股权，是指保险公司（含保险集团（控股）公司，以出资人名义投资并持有企业股权的行为；间接投资估算，是指保险公司投资股权投资管理机构发起设立的股权投资基金等相关金融产品的行为“。致辞，符合《保险资金投资股权暂行办法》规定的保险公司，都可以称为私募股权基金的机构投资者。

¹⁸² 非居民企业股权转让所得税政策。

	<p>Foreign:</p> <p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《关于设立外商投资创业投资企业的暂行规定》(2001)</p> <p>《外商投资创业投资企业管理规定》(2003)</p> <p>《关于外商投资创业投资企业、创业投资管理企业审批事项的通知》2009¹⁸³</p> <p>《外国企业或者个人在中国境内设立合伙企业管理办法》2010</p> <p>《外商投资合伙企业登记管理规定》2010</p> <p>Domestic:</p> <p>《信托法》(2001)</p> <p>《公司法》2004、2005</p> <p>《创业投资企业管理暂行办法》(2005)</p> <p>《合伙企业法》2007¹⁸⁴</p>	<p>三资企业 (WFOE 于 2008 年被终结)</p> <p>外商投资创业投资企业</p> <p>外商有限合伙</p> <p>Domestic:</p> <p>国有企业 (国有独资、国有控股、国有参股)</p> <p>公司制</p> <p>创业投资企业</p> <p>有限合伙</p>	<p>Registration</p>	<p>资 FDI 形式直接投资)</p> <p>在中国境内设立联络处</p> <p>在中国境内设立分公司? (需重新查看相关税法!)</p>	<p>《外资企业法》2000</p> <p>《中外合作经营企业法》2000</p> <p>《中外合资经营企业法》</p> <p>《中华人民共和国公司登记管理条例》2005</p> <p>《外国企业常驻代表机构登记管理条例》2010 年 11 月 10 日国务院第 132 次常务会议通过, 自 2011 年 3 月 1 日起施行。</p> <p>《中国人民银行关于外资金融机构在中国设立常驻代表机构的管理办法》</p>	
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¹⁸³ 外商投资创业投资企业的设立、审批、经营、投资方向等。

¹⁸⁴ 有限合伙制度首次出现 (外商投资者不适用)

	《信托公司集合资金信托计划管理办法》2007 ¹⁸⁵ 《信托公司私人股权投资信托业务操作指引》2008 ¹⁸⁶				
Cd-3: Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《外商投资企业投资者股权变更的若干规定》1997 《关于外商投资企业境内投资的暂行规定》2000 《外商投资项目核准暂行管理办法》2004 ¹⁸⁷ 《关于外国投资者并购境内企业的规定》2006（10号文） ¹⁸⁸ 《关于进一步加强和规范外商投资项目管理的通知》2008 ¹⁸⁹	公司间股权投资 M&A 外资以 VC/PE 身份进行股权投资 本土资本以 VC/PE 身份进行股权投资	Enterprise		Cf-3: Foreign: 《外资企业法》2000 《中外合作经营企业法》2000 《中外合资经营企业法》 《外商投资企业投资者股权变更的若干规定》1997 ¹⁹⁰ 《关于外商投资企业境内投资的暂行规定》2000 ¹⁹¹ 《外商投资项目核准暂行管理办法》2004 ¹⁹² 《关于外国投资者并购境内企业的规定》2006（10号文） ¹⁹³	

¹⁸⁵ 设立信托之私募股权基金的法律依据。按照该部法规，信托公司可以将两个以上委托人教父的资金进行集中管理、运营。

¹⁸⁶ 对于信托只私募股权基金的设立进行了详细约定，包括对信托公司的要求、对咨询顾问的要求等。

¹⁸⁷ 外商投资企业及境外投资者对境内企业的投资项目的批准制度。

¹⁸⁸ 外国投资者的并购程序、审批及反垄断等方面的规定。

¹⁸⁹ 外商投资企业及境外投资者对境内企业的投资项目的批准制度。

¹⁹⁰ 是外资收购境内企业外资股权（外转外）的法律依据。

¹⁹¹ 一般外商投资企业境内股权投资规则。

	<p>《关于做好外商投资项目下放核准权限工作的通知》2010</p> <p>《外商投资产业指导目录》</p> <p>Domestic: 《公司法》2004</p>				<p>《关于进一步加强和规范外商投资项目管理的通知》2008¹⁹⁴</p> <p>《关于做好外商投资项目下放核准权限工作的通知》2010</p> <p>《外商投资产业指导目录》</p> <p>商务部、发展改革委、外交部关于发布《对外投资国别产业指引（2011版）》的通知（商合函[2011]767号）</p> <p>中华人民共和国商务部令 2009年第5号《境外投资管理办法》</p>	
	<p>Dd-3:</p> <p>《关于股份有限公司境内上市外资股的规定》1995</p> <p>《外商投资企业投资者股权变更的若干规定》1997</p> <p>《外商投资股份公司有关问题的通知》2001¹⁹⁵</p> <p>《中华人民共和国证券法》2005¹⁹⁶</p> <p>《首次公开发行股票并上市管理办法》2006¹⁹⁷</p>	<p>境内主板上市</p> <p>境内中小板上市</p> <p>境内创业板上市</p> <p>M&A</p> <p>股权转让</p>	<p>Exit</p>	<p>境外上市</p> <p>境外股权转让</p> <p>境外 M&A</p>	<p>Df-3:</p> <p>《关于股份有限公司境外募集股份及上市的特别规定》1994</p> <p>《关于企业申请境外上市有关问题的通知》1999</p> <p>《关于境内居民通过境外特殊穆迪公司融资及返程投资外汇管理有关问题的通知》2005¹⁹⁹</p>	

¹⁹² 外商投资企业及境外投资者对境内企业的投资项目的批准制度。

¹⁹³ 外国投资者的并购程序、审批及反垄断等方面的规定。

¹⁹⁴ 外商投资企业及境外投资者对境内企业的投资项目的批准制度。

¹⁹⁵ 外商投资股份公司境内上市相关规定。

¹⁹⁶ VC/PE 投资人通过被投资企业上市退出的基本依据。

¹⁹⁷ 具体规定了被投资企业如何完场首次公开发行股票并上市。

	《中华人民共和国企业破产法》2007 ¹⁹⁸	清算					
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¹⁹⁹ 取代外管局 11 号文和 29 号文，明确规定通过返程投资控制境内资产的方式要收到严格的外汇登记审批要求。

¹⁹⁸ 如果被投资企业法人不能清偿到期债务，并且资不抵债或者明显缺乏清偿能力的，债务人自身及债权人均可以向人民法院提出破产清算。

Appendix 3 Coding Method for Legal Documents

This study aims to transform the regulations to digital index by dividing the legal environment into 5 levels of friendly degrees. The friendly degrees of regulations for domestic and overseas capital are distinguished. The time period studied is '1992-2012.' For the "model", there were 8 legal variables, Ad, Af, Bd, Bf, Cd, Cf, Dd, Df. As mentioned before, the published regulations occur depending on the feasibility and infeasibility of capital flow. Zero is recorded for infeasibility and increment of 1 was used for feasibility.

1. Ad correlation ²⁰⁰ (the friendly degree of legal environment for domestic fundraising in China, i.e. the regulatory feasibility);

0: There is no way to raise VC capital.

1-8 means the number of the domestic capital source that can become a part of VC industries.

The obtained scores are then transformed into friendly degrees by multiply a coefficient of *5/8.

2. Af correlation (the friendly degree of legal environment for overseas fundraising in China, i.e. the regulatory feasibility)

0 : means unable to raise money from foreign funds

²⁰⁰ The eight capital sources include Enterprise & Government; Insurance Company; Pension Fund (enterprise, public, national pension funds); Endowment fund (donation and University fund), Bank, Asset Management Company & Other Fund (FOFS, VC agencies, trust, investment company, asset management companies), government guide fund. Wealthy families and individuals are excluded. Others include listing company and real estate development enterprise.

1-8: means there is at least (1-8) foreign capital source that can be raised for China's VC industries

The obtained scores are then transformed into friendly degrees by multiply a coefficient of $\frac{5}{8}$.

3. Bd correlation. (the friendly degree of legal environment for domestic establishment, i.e. the regulatory feasibility))²⁰¹

0: means unable to register VC in China for domestic capital source

1: means there is at least (1-4) legal form for domestic capital source to register within China

The obtained scores are then transformed into friendly degrees by multiply a coefficient of $\frac{5}{4}$.

4. Bf correlation.²⁰² (the friendly degree of legal environment for foreign fund register within China, i.e. the regulatory feasibility))

²⁰¹ The available legal forms are as follows:

1: Trust company/investment company (with restrictions of investment amount should under 50% of its registered capital + one-time payment system of registered capital)

2: Trust company/investment company (with restrictions of investment amount should under 50% of its registered capital + one-time payment system of registered capital)/partnership

3: Trust company/investment company (relieve of the restrictions of investment amount should under 50% of its registered capital + installment payment system of registered capital)/partnership

4: Trust company/investment company (relieve of the restrictions of investment amount should under 50% of its registered capital + installment payment system of registered capital)/limited partnership

²⁰² The available forms are:

0: means unable for foreign fund to register in China

1: means there is at least (1-4) legal form for foreign capital source to register within China

5. Cd correlation. (the friendly degree of legal environment for domestic venture fund investing in China enterprises, i.e. the regulatory feasibility)

0: means unable for domestic fund investing in Chinese venture companies

1: means no restriction exist for domestic fund investing in China venture company

The obtained scores are then transformed into friendly degrees by multiply a coefficient of $\ast 5/1$.

6. Cf correlation²⁰³. (the friendly degree of legal environment for foreign fund investing in China enterprises, i.e. the regulatory feasibility)

1: Foreign-funded enterprises/Sino-Foreign joint venture enterprises/Sino-Foreign cooperate enterprises

2: Foreign-funded enterprises/Sino-Foreign joint venture enterprises/Sino-Foreign cooperate enterprises/Representative offices

3: Foreign-funded enterprises/Sino-Foreign joint venture enterprises/Sino-Foreign cooperate enterprises/Representative offices/Foreign investment company

4: Foreign-funded enterprises/Sino-Foreign joint venture enterprises/Sino-Foreign cooperate enterprises/Representative offices/Foreign partnership enterprise

²⁰³ The available methods are:

0: pre-red-chip mode (before 2003 with strict examination and approval system)

1: red-chip mode (from 2006)

2: post-red-chip mode (from 2009)

3: red-chip backflow mode

0: means unable for foreign fund investing in China venture company

1: means at least (1-3) form exist for foreign fund investing in China

The obtained scores are then transformed into friendly degrees by multiply a coefficient of $\frac{5}{3}$.

7. Dd correlation²⁰⁴. (the friendly degree of legal environment for domestic exit, i.e. the regulatory feasibility)

0: means no way to exit in China

1: means there is at least 1 channel for venture capital exit in China

2: means there is at least 2 channel for venture capital exit in China

3: means there is at least 3 channel for venture capital exit in China

The obtained scores are then transformed into friendly degrees by multiply a coefficient of $\frac{5}{3}$.

8. Df correlation. (the friendly degree of legal environment for overseas exit, i.e. the regulatory feasibility)

²⁰⁴ The available exit channels are:

0: IPO through oversea capital market

1: IPO through oversea capital market /mainboard of China stock market (from 1990)

2: IPO through oversea capital market /mainboard of China stock market (from 1990) /small and medium enterprise board (2004)

3: IPO through oversea capital market /mainboard of China stock market(from 1990) /small and medium enterprise board(from 2004) /growth enterprise market (from 2009)

(the M&A market, MBO/MBI, and equity transfer forms of venture capital exit channels are excluded in this correlation analysis due to the limitations of the quality of the database available)

0: means unable for venture capital exit outside China

1: means no restriction for venture capital exit outside China

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국 문 초 록

중국 투자 벤처자본의 공간배치 메커니즘

- 지역 법제시스템의 역할을 중심으로 -

서울대학교 대학원 지리학과

김소미

본 연구는 1992년부터 2012년까지 중국에 투자 벤처자본에 대한 실증적 연구를 통해 지역의 법제가 자본의 공간배치에 미치는 영향과 그 메커니즘을 밝히고 이와 관련한 지리적 함의를 도출하고자 하였다.

위 연구목적을 달성하기 위해 아래와 같이 네 가지의 연구주제로 나누어 논의를 진행하였다. (1) 벤처자본 공간배치 패턴의 특성, (2) 벤처자본 공간배치가 나타나게 된 원인 및 전개 과정, (3) 지역 법제시스템이 자본의 공간배치에 영향을 미치는 메커니즘, (4) 이를 통해 얻을 수 있는 지리적인 함의이다.

본 연구의 수행을 위해 상관관계분석, 법 조항에 대한 해석 및 검토 등 질적인 연구, 그리고 게임 이론을 이용한 분석 등 세 가지 분석 방법을 이용하였다. 연구의 내용과 결과를 정리하면 다음과 같다.

첫째, 벤처자본 공간배치의 지리적인 패턴은 크게 두 가지 특성을 가진다. 우선 기업 법적 사업자 등록지역과 실질 경영지역이 분리되는 특징을 보인다. 이러한 분리는 벤처기업의 경영주체에게만 발생하는

현상이 아니라, 벤처투자 과정 중에서의 펀드 모집, 펀드 설립, 벤처기업에 대한 투자, 그리고 자본의 회수 등 모든 단계에서 나타나는 현상이다. 두 번째 특성으로는 벤처자본 투자과정을 세부적인 단계로 나누어 서로 다른 지역에 배치하는 모습을 보인다. 이러한 배치는 공간상에서 주로 세 가지 패턴으로 나타난다. (1) 2000 년 이전에 지배적으로 나타난 “두(头)미(尾)재외”의 패턴이다. 이 패턴에서는 펀드의 모집, 펀드 등록, 그리고 자본 회수의 단계가 모두 중국의 국경 밖에서 이루어지는 반면에 피투자기업의 입지는 중국 내에 배치되어 있다. (2) 2001 년부터 2006 년 동안 나타난 패턴은 “혼합 입지 패턴”이다. 이 패턴에서 벤처자본 투자 과정의 각 단계는 중국 국경 내외에 혼합되어 단계별로 조합된 형식으로 배치되어 있다. (3) 2007 년 이후 주된 패턴은 “모든 단계 국내 회귀”이다. 이 패턴에서 벤처자본의 모든 투자 단계는 중국 국내로 회귀하며 사업자 등록지역과 실질 경영지역이 일치된다.

둘째, 위 현상이 발생하게 된 근본적인 원인은 지역 법제시스템이 기업이 부담해야 하는 추가비용을 발생시키는데, 기업은 위험을 회피하고 이윤을 최대화하고자 하는 동기를 가지고 있기 때문이다. 즉, 항상 존재하고 있는 지역 경제 신호와 지역 법제 신호의 불일치가 나타나는 경우 법으로 인해 발생하는 추가비용에 대응하기 위하여 기업들은 법제의 지역적 경계를 활용하는 범주적 특성과 분리가 가능한 자본 투자 과정의 특성을 이용하여 자본을 공간상에서 분리하여 배치한다.

셋째, 법제가 벤처자본 공간배치에 영향을 미치는 메커니즘은 정부와 기업 간의 법제와 공간을 둘러싼 이익 최대화의 게임으로 볼 수 있다. 지역 법제시스템으로 인해 기업이 부담하게 된 추가비용과 기업의 최종 수익 극대화가 이 메커니즘을 작동시키는 근본 원리이다.

넷째, 지역 법제시스템으로 인해 나타나는 자본의 공간배치 과정 속에서 지리는 “장소”와 “공간”의 두 가지 역할을 동시에 가진다. 기업에게 지역의 비공식적 제도와 고유 자원으로 획득할 수 있는 이익이 지역 법제시스템으로 발생하는 비용을 초과하는 경우 기업은 법적으로 지역 내에서만 활동하며 해당 지역은 기업에게 대체할 수 없는 경제활동의 “장소”를 의미한다. 반면에 지역 법제로 인해 기업이 부담하게 된 비용이 기업이 감당할 수 있는 범위를 초과하면 기업은 경영 활동의 분리 및 공간배치와 같은 방법을 통해 법제로 인한 비용을 회피하며 새로 선정된 지역은 기업에게 단순히 법제적 특성만 가지고 있는 무차별한 법제 “공간”이다.

본 연구의 결과를 종합정리하면 다음과 같다. 지역 법제시스템은 기업에게 명시적인 행동 규율과 암시적인 비용 부담이라는 이중적인 영향을 끼치는 메커니즘을 통해 기업의 자본 공간배치 패턴에 영향을 미친다. 이러한 과정 속에서 지역은 기업에게 대체할 수 없는 활동의 “장”이 되기도 하고 법적 특성만 중시되는 무차별적 법제 “공간”이 되기도 한다.

주요어: 자본 공간배치 메커니즘, 지역 법제시스템, 벤처자본, 간접비용,
공간 및 장소, 게임 분석

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