

4 **Guanxi Circle Phenomenon in the Chinese Venture Capital**

Industry

*Luo, Jar-Der*¹

If cited, please cite from:

Luo, Jar-Der, forthcoming. "Guanxi Circle Phenomenon in the Chinese Venture Capital Industry" In Wang, Jenn hwan (Ed.), *Social Capital and entrepreneurship in Greater China*. NY: Routledge.

Abstract

In a transition economy, social relations and networks generally play an important role for an entrepreneur in order to hedge environmental uncertainty. However, unlike other transition economies, China has its unique pattern of networking processes, such as differential modes of association, face and *guanxi* circles, which result in distinct network structures and networking behaviors. In the Chinese VC industry, investors face a highly uncertain environment and serious information asymmetry in transactions, so they tend to group together to defend their interests. The existing studies put more emphasis on the importance of *guanxi*, but few efforts have been spent on the structural characteristics of a network. Based on the existing research, this paper employs in-depth interviews and historical text data from the Chinese venture capital field to explore the structure and the mechanisms of networking

Keywords: Venture Capital, Guanxi Circle, Environmental Uncertainty, Transaction Cost, Balancing Coupling and Decoupling

Introduction: Chinese VC Industry

Beginning in 1986 with state-owned company "China Venturetech Investment Corp," the Chinese venture capital (in brief, VC) industry was born. In the next 30 years, the industry experienced three periods of development. From the mid-1980s to the early stage of the 1990s, it was the central government which actively cultivated VC firms. The Ministry of Science and Technology and Ministry of Finance passed a series of laws to build the institutional base for VC registration. In addition, the central government also provided financial support for these new hi-tech firms, such as

“Torch High Technology Industry Development Plan” and “863 Plan.” In 1987, local governments were also encouraged to support the development of hi-tech firms in local industrial districts, so local government-owned VC firms began to appear. However, the industry had very slow growth during the first decade

In the early 1990s, many industrial-district-based and university-based VC firms started up. The Chinese stock market was established in 1990, and the return investment of VCs could be attributed to their going public. In addition, foreign investors were allowed to enter into the Chinese market, although they were prohibited from collecting money in China. At the same time, the central government passed many laws to build the institutional infrastructure for supporting a market economy, and policies were made to encourage the development of the VC industry. As a result, the number of private VC firms boomed in this period. This industry experienced a surge in the late 1990s, especially during the period of internet investment fever. As shown in Table 1, the number of new entrants was about 10 each year before 1997, but it quickly grew to 121 in 2001. The investment fever declined in later years.

Due to rapid growth of the economy and a series of modifications to business laws in regards to corporations, the stock market, partnerships, and technology development, Chinese venture capital once again boomed after 2004. Each year after 2005 saw more than 200 new investors entering the industry and the growth rate was at least 20%, with the exception of 2009, according to the statistics of SiMuTon database shown in Table 13.1.

<TABLE 13.1 HERE>

However, the industry faced difficulties in development due to its structure. On one hand, the central and local governments make regulations for and provide financial support to VC firms; on the other hand, local governments are major players in this market. Thus, these complications include the insufficiency of governmental regulations, weak implementation of formal rules, interference from local governments, and serious moral hazard, all of which create a highly uncertain environment for investors (Williamson 1985).

Environmental uncertainty creates high transaction costs among trading partners, and market mechanisms will be insufficient to govern a transaction of this sort (Williamson 1996). Instead, actors will use relational contracts to hedge against such

an uncertainty (Granovetter 1985; Williamson 1996). In addition, VC investors often form various types of syndications for sharing risk (Wilson 1968; Lerner 1994), controlling opportunistic behaviors, (Admati and Pfleiderer 1994) and compensating for each other's insufficiency (Lockett and Wright 2001; Tykvov'a 2007). The role of guanxi thus comes into our research agenda.

The purpose of this paper is to use the network approach to study the Chinese VC industry; in this research we propose a type of network structure called "guanxi circle," and in the paper we will analyze how guanxi can work as a governance mechanism of transactions in such an uncertain environment. We employ qualitative methods to collect data, and conduct 8 interviews with 7 experts in the VC industry, as listed in Table 2. We first asked them for a general observation of this industry and their firms' business, and then they delineated the history and major partners of joint ventures. Finally, the interviews focus on why and how they form such syndications. At times, a major investor may introduce its followers to us, so that we can trace different viewpoints from both a centered ego and his or her followers.

<TABLE 13.2 HERE>

In the following, we will first introduce what a guanxi circle is. Subsequently, this paper will illustrate the five types of uncertainties that Chinese VC investors face, and finally discuss how guanxi circles act as governance mechanisms to make joint ventures functioning in such an uncertain environment.

What is a Guanxi Circle?

A guanxi circle is a group of people bound together for a common identity and shared interests. It can refer to a large community, such as engineers' circle, lawyers' circle, professors' circle, and so forth. But more often, it refers to a small clique in which group members know and interact with each other. This paper defines the term "guanxi circle" according to its narrow meaning including only small cliques, rather than large communities.

A guanxi circle often has a central person as its leader, so it may be named after someone, such as manager Chang's circle, CEO Lin's circle, etc. That means, a leading person accompanied by his/her strong ties forms a guanxi circle in which members share common interests and struggle for these interests together (Luo and Yeh 2012). Two important Chinese characteristics construct the cultural and

normative bases for guanxi circle phenomenon. First, as indigenous sociologist Fei (1992) called “the differential mode of association” (in Chinese, *cha xu ge ju*), a Chinese ego-centered network is comprised of multiple layers of rings in which different behavioral and moral standards are applied for each of these different guanxi.

Second, family-ethics is the base for a Chinese person to build and maintain his or her guanxi (Bond and Hwang 1986; Liang 1983). Guanxi circles are actually imitated as pseudo-families in his or her working life. Through the process of “family-ization” (i.e. turning an outsider to be a family member; Chua, Morris, and Ingram 2009), a centered ego may recruit outsiders into his or her pseudo-family in the workplace.

Egocentric and the Differential Modes of Association

A Chinese person divides his or her social ties into several rings, and different rings imply different moral standards. It is common for indigenous Chinese research to categorize three types of guanxi. For example, guanxi may be classified as expressive, mixed, or instrumental ties, based on the continuum between expressive and instrumental elements (Hwang 1987; 1988). Or, guanxi may be divided into obligatory, reciprocal, and utilitarian ties, according to the degree of obligation (Zhang and Zhang 2006).

Based on Fei’s framework of differential modes of association (1992) and Yang’s three categories of Chinese social relations (1993), we propose a framework of differential relationships (Luo 2005; 2011). Acquaintance ties fit in the outer-most ring of an ego-centered network under the “rules of equity” (Hwang 1987), and may come to be trusted based on general ethical principles of fairness and the conservative process of repeated exchanges. Guanxi of this sort is defined by its short-term duration and rational-based behaviors.

There are two types of strong ties included in a person’s guanxi circle. The innermost ring generally consists of family members and fictive kin (Chen 1994). Chinese psychologist Yang (1993) calls the most inner ring of an ego-centered social network “chia ren,” which translates as family ties, including real family and pseudo-family ties, since they may include special intimate relations other than family members (Chen 1994; Luo 2005).

Familiar ties, including good friends and persons to whom one feels particularly close,

fit in the next ring under the “rules of favor exchange,” by which relational trust can be built up from frequent exchange of favors (Hwang 1987; Tsui and Farh 1997). Familiar ties generally involve instrumental exchanges, but pure rational-choice account cannot explain the behaviors in this ring well.

An actor’s motivation is mixed (Granovetter 2002), since historical, cultural, and normative factors are intertwined with self-interest calculation (Granovetter 1999). While family ties place emphasis on expressive and normative concerns, and acquaintance ties take care of instrumental interests, familiar ties need to balance the three different motivations—expressive, instrumental, and normative concerns. A familiar tie by definition is a strong tie (Granovetter 1973; Marsden and Campbell 1984). Yet, familiar ties are different from family ties, since they are concerned more with instrumental interests and can be broken if there is a lack of trustworthy behavior.

For a centered ego, the ring of acquaintance ties provides abundant opportunities and resources which may be accessed by weak ties (Granovetter 1973; Burt 1992). However, the resources in this ring are not guaranteed for successful mobilization. So, the acquaintance ties of this sort are outsiders for the guanxi circle’s centered ego.

The ring of family ties constructs the core of a guanxi circle. This core may be called the “basic team” (Chen 1998) or “confidant” (Chi 1996), since it includes the basic forces and most intimate relations for the centered ego.

The ring of familiar ties is the interface between a circle core and the outside world, as shown in Figure 1. They are more flexible and open than the core, but much stronger in mobilizing resources than acquaintance ties. Thus, an important benefit of maintaining familiar ties as the periphery members of a guanxi circle is to keep circle operations flexible and the circle boundary open to the outside world.

<FIGURE 13.1 HERE>

The Open Boundary of a Guanxi Circle

For a circle leader, any acquaintance tie may be a future familiar tie, so preserving the norms of reciprocity is beneficial for expanding a person’s guanxi circle. By the same token, the core of a guanxi circle is not closed either, and familiar ties may join in the focal person’s “basic and confidential” team (Chen 1994; Chi 1996). The institution

of familiar ties makes the boundary of a guanxi circle blurred, and provides more structural room for flexible operations in coupling and decoupling network ties.

In Chinese daily life, the principle of similarity introduces a stranger into a person's ring of acquaintance ties. Tsui and Farh (1997) assert that Chinese form trust networks based on social demographic factors, in which the principle of similarity is applied to profession, work tenure, socio-economic class, sex, cohort group, birthplace, and family name. Similarity of Chinese role-identities signals trustworthiness. Perceiving similarity is the first step for a Chinese person to build guanxi. Guanxi of this sort may not lead to engagement in a long-term favor exchange, but may lead to being treated more fairly. The rule of equity (Hwang 1987) emphasizes the morality of fairness through exchange among members of one's ring of acquaintance ties.

Familiar ties construct the main base of a Chinese's guanxi circle. Carrying valuable exchange relations from the outer group into an inner guanxi circle is a central part of Chinese culture. Most Chinese tend to dynamically shift their guanxi into or out of these categories of guanxi. A valuable and trustworthy acquaintance can be brought into the ring of familiar ties. As a result, the principles guiding social interaction are "upgraded" to a new standard.

The reciprocity of favor exchanges introduces an acquaintance tie into a person's ring of familiar ties. Favor exchanges have several features. First, it is personalized important help for the favor receiver. Second, a favor giver asks no payment under the name of "brotherhood," but the favor receiver will not forget the favor done for him and needs to pay back whenever an opportunity to do so is found. Third, there must be a "favor account" for a pair of familiar ties, and this account will remain as long as the friendship continues.

Some role-identities introduce a familiar tie into a person's inner-most guanxi circle of family ties. Chinese societies treat many identity-counter-identity relationships as family ties (Chen 1994). Persons who would be considered outsiders in Western societies might be more easily introduced into a family tie in Chinese societies through salient pseudo-family role-identities (Chen 1994; Luo 2005), which create strong ties with such bases as fictive kin, blood brothers and adopted relatives. This category is not limited to family members, and that is why it can be named "pseudo-family ties" (Chen 1994; Luo 2005).

Finding similarity to initiate guanxi, demonstrate trustworthy behaviors in repeated exchanges, return favors to fulfill the expectation of partners, and show brotherhood

to maintain intimacy are all a part of daily life for Chinese in the workplace. As a result, a guanxi circle is possibly open to acquaintance ties.

Through this dynamic process, a Chinese person will learn who can be included in his or her guanxi circle and what kind of resources can be mobilized from circle members. A person with good guanxi generally mobilizes a group to achieve his/her goals, and he or she certainly needs to help group members to accomplish their goals in return. How to maintain the mutual trust within this guanxi circle is often the chief concern of a circle leader in his or her workplace.

Summarizing the arguments stated above, there are some static features of a guanxi circle. First, a guanxi circle is centered on an ego. Second, it has a structure with differential modes of association, including an innermost core, which is indicated by loyal, unbreakable, and intimate relationships, and periphery members, mainly composed of long-term relations with limited liability in frequent favor exchanges. Third, the boundary of a guanxi circle is usually open, and thus there may be overlapping areas among several guanxi circles. In the dynamic process, a guanxi circle may absorb outsiders into the inner group and also move trustworthy periphery members into the core. In other words, the boundaries within and outside a guanxi circle are blurred.

Guanxi and Uncertainty in the Chinese VC Industry

The Uncertainty of Finding Investment Opportunities

Network theories insist that business opportunities come from structural holes (Burt 1992), in which a bridging tie connecting two originally separated groups can utilize information asymmetry to broker the trades between the two groups. It is especially true for VC investors. Even in a mature market environment, VC investors still face much information asymmetry between investors and investees, and social connections indeed aid in overcoming the information gap.

In China, the problem of information asymmetry is especially serious, since many investees do not reveal information honestly, and government regulations are insufficient in regulating these opportunistic behaviors. In addition, the institutional designs, including accounting systems, auditing methods, government inspections, and mutual monitoring in the industrial community are not able to guarantee trustworthy information provided by the investees. Utilizing guanxi to obtain accurate information is thus a good way of discovering valuable investment opportunities. As a

partner of VC investor, Mr. Z, stated:

“[good projects] all come from the mediation of good friends.”

Uncertainty of Zero-Sum Games

Due to the highly uncertain environment, VC investments have a high possibility of failing and losing money. If the main investor in the syndication wishes to have a fallback in a bad joint venture, then the other side of the partnership could be sacrificed for the interest of the main investor. In other words, it is a zero-sum game in the case of this sort, in which it is better to incorporate new and unfamiliar partners into the syndication. That is why it is found in our field studies that familiar ties are not always welcome, and at times, friends of friends are the best choices. For the sake of maintaining a friendship, the focal person will at times avoid inviting familiar partners to join in a new high-risk investment, as a senior partner of a VC investor, Mr. Y, puts it:

“The familiar partners [those who have joint venture with the interviewee in the past] are hard to negotiate with; sometimes, we disagree with each other due to self-interest, but it is hard to talk straight ... we are friends, you know.... One side may need to be sacrificed for the other side's interest ... in the cooperation of Eastern type [i.e. zero-sum game]. [My habit is]... don't cooperate with familiar partners in one industry twice.”

The Insufficiency of Credible Commitment

In addition to the highly uncertain environment, a transaction itself in the VC industry, either among cooperating VC investors or between an investor and an investee, has the features of a long-term contract, with high asset specification and high behavioral uncertainty (Williamson 1985; 1996). In such a risky transaction, hostage listing in a formal contract is often offered as a credible commitment for hedging against possible opportunistic behaviors (Williamson 1996). However, such a deterrence method is often not accepted by Chinese actors. On the one hand, it hurts face and feelings of syndication partners. On the other hand, seizing hostage as a punishment is also generally not possible due to the weak implementation of formal regulations.

An alternative credible commitment is a person's reputation based on the mutual monitoring in a small community. Closure, dense network structure, intimate internal relations, and frequent interactions create a small social network full of committed relations (Coleman 1990; Yamagishi, Cook and Watabe 1998). Such a network accompanied by strong community norms will provide mutual monitoring, which

ensures community members comply with group norms (Yamagishi and Yamagishi 1994). An actor with high centrality in such a network earns a reputation as a credible commitment, which enlarges his or her scale of cooperation and successfully reduces risk as a return. As a senior partner of private VC investor, Mr. Y, puts it:

“[for a successful VC investor] it is not good to make any one side unhappy. ... since someone sometime loses money, the centered person [those who have high degree centrality in VC community] can balance [the gain and loss; in other words, peripheral persons may not be able to find opportunities to balance the loss].... In China, we earn reputation due to cooperation, rather than acquisition and merging.”

The Lack of a Trustworthy Third Party

In a complex transaction like the VC investor's, contracts are often incomplete (Macaulay 1963), so information asymmetry and moral hazards bring about many disputes. In what Williamson (1985) called the “neoclassical contract,” such a transaction needs the trustworthy third party as an arbitrator for the safety of trading. However, the Chinese legal system often cannot bear the burden to arbitrate the disputes in the VC industry. Even worse, local governments generally take the role of players in the market, rather than arbitrators. As a result, formal contracts are far from protecting transaction safety.

Chinese VC investors generally bring these complex transactions into a small group so that mutual monitoring in such a closed and dense network can play the role of arbitrator. Especially, those central persons with good reputations in the group are the trustworthy third parties for most group members, and they may take on the burden to settle disputes. Mr. Y comments on this type of intimate network in the following way:

“First of all, firms [Chinese VCs] generally get bored with these [too detailed contract and too calculative financial arrangements].... Foreign investors pay too much attention on short-term profit... We are not like this. In China, we tends to foster something [in a long period], especially friendship.”

The Frequent Changes in Public Policy

There are some reasons which leave room for rent-seeking behavior from government

officers. First, the Chinese government continues to modify its policies so as to follow the fast-changing societal and economic environments in a transition economy. Second, local governments often interrupt investment activities for the purpose of developing local economies, so the state-owned VC investors often directly subsidize certain industries or products. Third, the special designs of public administration in China often ask a private start-up to obtain many licenses from government before it can operate (Wu, Wu and Rui, 2009).

A VC investor thus needs to seek strong governmental relations so as to hedge against these rent-seeking behaviors on the one hand, and benefit from timely information about changing policies on the other hand. A senior investor in the field of green energy, Mr. S, stated the governmental relations are as follows:

“In this field [green energy]... we would like to invite government officers provide us with consultation, and help studying the investees. If it helps [the policy encourages]... then we will go on investing on the firm. The risk is small. If they don't favorite it, then we must be careful, since the governmental policies don't care this area.”

Guanxi Circles Phenomenon

Summarizing the above-stated, we find that a successful Chinese VC needs to establish four types of guanxi. Firstly, familiar ties are important for finding good investment opportunities. Secondly, bonding ties are necessary to build up a closed and dense network so as to provide credible commitment and trustworthy third parties in hedging the uncertainty in a transaction. Thirdly, new weak ties are at times very useful in a zero-sum game. Finally, governmental ties are the key to avoiding the risk caused by fast-changing policies.

How does a successful VC leader, generally the owner of a successful VC firm, organize these types of guanxi? What is the structure of his or her ego-centered network? In our interviews with the senior investor Mr. Y, we find that there is a three-layer network structure. As he puts it:

“There are few investors in the first layer [in terms of power and number of projects]... they have unique resources.... In the second layer, some famous PE [private equity] are in this layer.... Those in the third layer are generally not famous nationwide, but even some globally famous investors sometime need

their cooperation, [since they may have special resources] such as local government relations, local market knowledge, etc.”

The most powerful VC leaders in the first layer are often the centers of various groups of investors. Each of these investors controls many good investment opportunities and generally by itself launches a series of investment projects. An investor organizes various types of guanxi to form a network structure shown in Figure 1. The center may or may not have a group of brotherhood partners, who are confidants and always bound together to find all possible investment opportunities. The second ring is composed of frequent cooperators, who follow the center’s investment projects. In general, they invest money rather than participate in decision-making. As Mr. Y said:

“[Investors in the second ring] just ask me to take their money. Many VC investors are like this.... Money sellers [what he called those frequent followers] invest for only investment.”

Those in the third ring are new weak ties for the center. They may have suitable resources for a certain project, such as money, local knowledge, local governmental relations, and industrial tacit knowledge, etc., and thus occasionally engage in instrumental exchanges with the center. This type of network structure is typically a sort of “guanxi circle” as stated above (Luo and Yeh 2012).

<FIGURE 13.2 HERE>

How Guanxi Circles Work in the Chinese VC Industry

Just as a guanxi circle is composed of three rings, i.e. pseudo-family ties, familiar ties, and acquaintance ties, a successful Chinese VC leader organizes its various types of guanxi in the same way, i.e. the brother-like confidants, frequent cooperators composed of familiar ties, and general partners coming from new weak ties. Thus, how can such a static structure accompanied by network dynamics of guanxi circles help a Chinese VC investor hedge against the five types of uncertainties stated in the third section?

The Importance of Closure

First of all, a successful VC investor organizes his or her confidants and frequent cooperators into a closed and dense network. As stated above, such a network provides trustworthy third-parties as arbitrators in disputes and guarantees credible

commitment for a complex and risky transaction in joint ventures. It is not easy to build up partnership relations among strangers in such a highly risky environment created by moral hazard. Good friends are thus the trustworthy third parties to provide secret and valuable information. As a result, most VCs search for investment opportunities in a group composed familiar ties, rather than engage in joint venture directly with strangers, as a junior partner of VC investor Mr. Z puts it:

“We (Mr. Z and another VC investor) met together several times in different projects but we are not familiar with each other that time.... One day, a common friend of ours invited us to have a dinner... then we decide to invest jointly.”

A successful VC leader knows how to organize those confidants and frequent cooperators into such a closed and dense group. He or she, as the center in a syndication network, thus needs to play the role of a trustworthy third party, and enforce strong mutual monitoring as credible commitment in the group. In return, this centered person garners a good reputation and further opportunities (Podolny 1993; Tykvov'a 2007). Reputation helps attract more members to join in the circle, and they may bring in more resources and investment opportunities. In addition, the central position can exercise influence on circle members so as to have more investment opportunities to choose and more control on investment projects. These benefits guarantee the profit and survival of the center.

Struggling for the center position in a syndication network tends to be an important target; this means a Chinese VC is equipped with a certain attitude, what we call “guanxi-orientation thinking,” toward joint ventures. The VC may sacrifice the profit in one or two transactions for the sake of maintaining relations, so that it can harvest a better position in the network. If this focal person forms a small guanxi circle of his or her own, or he or she gains the center position in a sub-field community, then the safety and profit will follow this position. One single transaction is fragile, but a series of investments in the collective actions of a network is robust. As a junior partner of a Chinese VC Mr. Z stated:

“Guanxi is indeed important... some projects fail, but it is O.K., since guanxi is there. It [a successful project] is the result of process of collective actions... some things are good for guanxi building.”

The Importance of an Open Boundary

However, cooperation in a small closed and dense network is not enough, especially when a new joint venture may be a zero-sum game in a highly uncertain environment. At this moment, the familiar partners may not be a good choice in some joint ventures, and new partners should be introduced by friends.

But why does a Chinese VC tend to cooperate with new entrants? In a joint venture, a powerful centered person in a circle in general initiates an investment project and other members follow. So he or she may control the whole process of investment and make the decision to distribute earned profit or the burden of loss. The new entrants always play the role of silent partners, who often contribute more money and share less profit in the project.

In addition to providing “surplus money” to the centered VCs in a network, new entrants may also bring new information, local governmental relations, local knowledge, and new opportunities into a network. These resources are keys for forming new projects. As a manager of a VC investor, Mr. X, articulated:

Cooperation with new VCs for sure is profitable. Money, local knowledge, new information of projects... but I will not allow them to say too much [new VCs can't manage the project].

Then why does a new entrant wish to cooperate with the already closed and dense network? The dynamics of guanxi circles propose the possible answer, which will be discussed in the following section.

The Importance of Balancing Openness and Closure

There is a dilemma that a centered ego faces in his or her guanxi circle. On one hand, a successful VC leader needs to build up a closed and dense network, but on the other hand, new entrants and new necessary governmental ties always make this network open to the outside world. If a centered leader opens his or her guanxi circle to the outside too quickly and widely, this strategy will dilute the interests of old circle members and the circle may fall apart. On the contrary, if this successful VC pays too little attention to the needs of these new weak ties, then he or she will sooner or later lose his or her reputation and no new entrants will want to participate in such an ego-centered network. How to balance the openness and closure of this network is a challenge for the centered person, and requires the art of balancing the interests within and outside a guanxi circle.

In the practice of guanxi circle operations, the centered person knows how to convince the new partners to sacrifice their short-term profit, but in return, he or she will offer long-term benefits to the sacrificed sides. As a CEO of a state-owned VC firm, Mr. C, said:

“A big brother has reputation and good investment portfolio to support this reputation.... A little brother likes the big brother, because he can use money to exchange reputation. He directly gets reputation from cooperating with a big name.... In addition, a little brother may manipulate guanxi [in the big brother’s guanxi circle], and gradually move into the inner rings. It is possible for the little brother someday somehow to become a big brother [the center of his own guanxi circle].”

In other words, a successful VC leader recognizes the long-term interests of a new entrant, i.e. entering into a trustworthy guanxi circle, moving to the inner rings of the network gradually, building up his or her own guanxi, finding good opportunities to launch investment projects, and finally forming a guanxi circle of his or her own. Mr. Y stated as follows:

“For example, VC firm H focuses in one industry, which is in fashion now. H originally is only a follower.... But after the cooperation with some big guys... he chooses cases very carefully, so the investment performance is pretty good. Now, G launches some investment projects of his own. His harsh time has gone.”

In the dynamics of guanxi operations, a smart centered person knows how to attract new partners to join his or her guanxi circle and keep old circle members profitable, even at the cost of sacrificing the new partners. But at the same time, the circle leader helps the sacrificed sides move into inner rings so as to build up their own guanxi as a return. In this way, a VC leader may solve the dilemma of openness and closure of a guanxi circle.

Conclusions and Discussions

Many Chinese psychological studies have illustrated some special behavioral patterns of the Chinese (Yang 1993), such as *Ren-Ching* (favor; favor-exchanges are long-term intensive expressive and instrumental exchanges; Hwang 1987; 1988), *Guanxi* (social ties; networking is the behavior for expanding one’s social capital), and *Mian-Zi* (face; maintaining face is the process to build status; Zhai 2012), etc. The question is what

are the structural outcomes of these behaviors? All of these studies help us to better understand the features of Chinese behavior, but the answer to the above-mentioned question should rely on the analysis of network structure and its dynamic process.

This paper reveals the structural dimension of guanxi and describes a special structural phenomenon “guanxi circle” in the Chinese VC industry. The circle is a comparatively closed and dense social network (generally a sub-network of the whole VC industrial network) centered on one or several persons. On the one hand, a smart VC investor knows to build a guanxi circle so that he or she can provide credible commitment and trustworthy third parties for joint ventures in the network, since the formal institutions in China can hardly be used to hedge against the high uncertainty caused by opportunistic behavior and business disputes. In addition, those familiar ties in the network also help mobilize more partners to join in and introduce good investment opportunities. On the other hand, the boundary of a circle is not closed, so new entrants can enter into this network by networking with circle members, especially those in central roles. Since new entrants bring in money, local knowledge, emergent-needed governmental ties, and industrial knowledge, openness is also necessary for a healthy guanxi circle.

How can a circle leader balance the closure and openness of a guanxi circle? In the process of balancing the interests within and outside the guanxi circle, he or she generally sacrifices new entrants’ short-term profits but provides long-term interests as a return. As shown in Figure 1, new entrants may move from outsiders to the peripheral rings of a circle, and then to the core in a series of favor exchanges. By sacrificing short-term profit in single transactions, this new entrant may build up his or her own network of partners and even form a circle centered on him or her. A successful leader of a syndication network uses this way to open his or her circle boundary to new entrants. At the same time, the “surplus” extracted from new entrants’ short-term profits can be used to subsidize old partners, so that the leader can maintain a comparatively closed and dense core of the circle. That is why the centered person in a guanxi circle can balance openness and closure of a circle.

This is only an initial study touching on this structural phenomenon of the Chinese VC industry. More issues deserve our attention in the future. In the dynamic guanxi circle operations, a circle leader at times needs to couple more networks in, and decouple some relations (Granovetter 1995). A successful entrepreneur should be skilled at balancing coupling and decoupling (Granovetter 2002). How and when a centered person decouples relations challenges our future studies, since this paper touches only the issue of coupling.

In the long-term operation of a guanxi circle, some formal and informal rules as governance mechanisms may appear in the syndication network (Ostrom 1990; 2008). What are these governance mechanisms in the Chinese VC community?

Political and societal environments in a changing China deeply influence the way to balance openness and closure and the model of internal governance mechanisms in a guanxi circle. The interactions between outside macro-level factors and micro-level behaviors in a circle thus come into the spotlight of our research. This paper initiates the analysis of a structural phenomenon called “guanxi circle” in the Chinese VC industry, but leaves many questions awaiting future studies.

¹ Corresponding author; Professor, sociology dept., Tsinghua U.; E-mail: jdluo@mail.tsinghua.edu.cn, Address: 100084, Dept. of Sociology, Xiong Zhixing Hall, TsingHua University, Beijing, China. We are grateful for the financial support of Center for Social Network Research, Tsinghua University and Tsinghua’s research project “Trust and Guanxi Studies on Internet”, Project Number: 20121088015, as well as the support of Chinese Natural Science Foundation Project “Social Network in Big Data Analysis: A Case in Investment Network”, Project number: 71372053 .

Reference

- Admati, A., and P. Pfleiderer. 1994. "Robust Financial Contracting and the Role of Venture Capitalists." *Journal of Finance* 49(2): 371-403.
- Bond, M. H., and K. K. Hwang. 1986. "The Social Psychology of Chinese People." In *The Psychology of the Chinese People*, edited by M. H. Bond, 213-266. Hong Kong: Oxford University Press.
- Burt, R.. 1992. *Structural Holes: The Social Structure of Competition*. Cambridge: Harvard University Press.
- Chen, Chieh-Hsuan. 1994. *Subcontracting Networks and Social Life*. Taipei: Lien-Jin Press (In Chinese).
- Chen, Chieh-Hsuan. 1998. *Sociological Perspectives on Taiwan's Industries--Transformation of Small and Medium-sized Firms*. Taipei: Lien-Jin Press (In Chinese).
- Chi, S. C.. 1996. "The Empirical Study in Roles of Leader's Confidant." *Management Review* 15(1): 37-59.
- Chua, R., M. Morris, and P. Ingram. 2009. "Guanxi vs. Networking: Distinctive Configurations of Affect- and Cognition-based Trust in the Networks of Chinese vs. American Managers." *Journal of International Business Studies* 40: 490-508.
- Coleman, James. 1990. *Foundations of Social Theory*. Cambridge: The Belknap Press.
- Fei, H. T.. 1992. *From the Soil: The Foundations of Chinese Society*. Berkeley: University of California Press.
- Granovetter, Mark. 1973. "The Strength of Weak Tie." *American Journal of Sociology* 78: 1360-1380.
- Granovetter, Mark. 1985. "Economic Action and Social Structure: The Problem of Embeddedness." *American Journal of Sociology* 91: 481- 510.

- Granovetter, Mark. 1995. "The Economic Sociology of Firms and Entrepreneurs." In *The Economic Sociology of Immigration: Essays in Networks, Ethnicity and Entrepreneurship*, edited by A. Portes, 128-165. New York: Russell Sage Foundation.
- Granovetter, Mark. 1999. "Coase Encounters and Formal Models: Taking Gibbons Seriously." *Administrative Science Quarterly* 44: 158-162.
- Granovetter, Mark. 2002. "A Theoretical Agenda for Economic Sociology." In *The New Economic Sociology: Developments in An Emerging Field*, edited by M. Guillen, R. Collins, P. England and M. Meyer, 35-59. New York: Russell Sage Foundation.
- Hwang, K. K. 1987. "Face and Favor: The Chinese Power Game." *American Journal of Sociology* 92: 944-974.
- Hwang, K. K. 1988. *The Chinese Power Game*. Taipei: Lien-Jin Press (In Chinese).
- Lerner, J.. 1994. "The Syndication of Venture Capital Investments." *Financial Management* 23(3): 16-27.
- Liang, Shu-Ming. 1983. *The Comparison between Chinese and Western Cultures*. Taipei: Li-Ren Publishing House (In Chinese).
- Lockett, A., and M. Wright. 2001. "The Syndication of Venture Capital Investments." *Omega* 29: 375-390.
- Luo, Jar-Der. 2005. "Particularistic Trust and General Trust—A Network Analysis in Chinese Organizations." *Management and Organizational Review* 3: 437-458.
- Luo, Jar-Der. 2011. "Guanxi Revisited--An Exploratory Study of Familiar Ties in a Chinese Workplace." *Management and Organizational Review* 7(2): 329-351.
- Luo, Jar-Der, and Kevin Yeh. 2012. "Neither Collectivism Nor Individualism--Trust in Chinese Guanxi Circles." *Journal of Trust Research* 2(1): 53-70.
- Macaulay, Steward. 1963. "Non-Contractual Relations in Business: A Preliminary

- Study.” *American Sociological Review* 28(1): 55-67.
- Marsden, P., and K. Campbell. 1984. “Measuring Tie Strength.” *Social Forces* 63 (2): 483-501.
- Ostrom, E. 1990. *Governing the Commons: The Evolution of Institutions for Collective Action*. New York: Cambridge University Press.
- Ostrom, E. 2008. “Building Trust to Solve Commons Dilemmas: Taking Small Steps to Test an Evolving Theory of Collective Action.” In *Games, Groups, and the Global Goody*, edited by S. Levin, 211-216. New York: Springer.
- Podolny, J. M.. 1993. “A Status-based Model of Market Competition.” *American Journal of Sociology* 98: 829–72.
- Tsui, Anne S., and Jiing-Lih Farh. 1997. “Where Guanxi Matters--Relational Demography and Guanxi and Technology.” *Work and Occupations* 24(1): 57-79.
- Tykvov’a, T.. 2007. “Who Chooses Whom? Syndication, Skills and Reputation.” *Review of Financial Economics* 16(1): 5-28.
- Williamson, Oliver. 1985. *The Economic Institutions of Capitalism*. New York: The Free Press.
- Williamson, Oliver. 1996. *The Mechanisms of Governance*. New York: Oxford University Press.
- Wilson, R.. 1968. “The Theory of Syndicates.” *Econometrica* 36(1): 119–132.
- Wu, W. F., C. F. Wu, and M. Rui. "Between the Special Connections that High-ranking Managers of Some of China's Listed Companies Have with Government and Tax Preference Afforded to them." *Management World* 3:134-142 (in Chinese).
- Yamagishi, T., and M. Yamagishi. 1994. “Trust and Commitment in the United States and Japan.” *Motivation and Emotion* 18(2): 129-166.

- Yamagishi, T., K. Cook, and M. Watabe. 1998. "Uncertainty, Trust, and Commitment Formation in the United States and Japan." *American Journal of Sociology* 104: 165-195.
- Yang, G. S.. 1993. "Chinese Social Orientation." In *Chinese Psychology and Behavior*, edited by G. S. Yang, and A. B. Yu, 87-142. Taipei: Laureate Press.
- Zhai, X. W.. 2012. *Favors, Face, and the Reproduction of Power*. Beijing: Beijing University Press.
- Zhang, Y., and Z. Zhang. 2006. "Guanxi and Organizational Dynamics in China: A Link between Individual and Organizational Levels." *Journal of Business Ethics* 67(4): 375-392.

Table 13.1 Number of New Venture Capital Firm in Every Year

Year	Number of New Investor	Accumulative Number of Investors
1995	15	15
1996	8	18
1997	12	25
1998	26	48
1999	68	89
2000	117	164
2001	121	221
2002	98	261
2003	131	314
2004	168	377
2005	208	470
2006	266	657
2007	401	895
2008	541	1158
2009	512	1386
2010	635	1678
2011	757	2078

Table 13.2 The list of Interviewees

Interviewee	Occupation	Reviewing Time	Location	
Mrs. X	An entrepreneur of star-up VC firm	July 2012	ChengDu	
Mr. L	An junior manager in state-owned VC firm	Aug. 2012	Beijing	With recording
Mr. Z	An junior partner of private VC investor	July 2012	Tianjing	
Mr. Y	A senior partner of a private VC investor	July 2012 and April 2013	Beijing	With recording
Mr. C	A CEO of a state-owned VC firm	Oct. 2013	Tianjing	With recording
Mr. X	A general manager of a branch of a large VC investor	Dec. 2012	Tianjing	
Mr. S	A senior manager of local government-owned VC in the field of green energy	Aug 2012	Tianjing	

Figure 13.1 The Diagram of A Guanxi Circle

