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Venture Capital Exits and the Structure of Stock Markets: Lessons from China

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ABSTRACT:

Existing literature suggests a strong relationship between a vibrant venture capital market and an active stock market: venture capital flourishes when venture capitalists can readily exit from successful portfolio companies through initial public offerings (“IPOs”), and IPOs are in turn facilitated by active and efficient stock markets. Despite being relatively new to venture capital investment, China’s concerted government efforts have successfully engineered the second-largest venture capital market (by investment volume) in the world to date. China’s economy has also undergone a drastic transformation from a planned to market economy in the last 20 years. Given these factors, does the positive correlation between an active stock market and vibrant venture capital market hold true in China?

This article uses China as a case study to explore the connection between the stock market and venture capital market. It also seeks to identify major problems for venture capital-backed IPOs and to propose solutions. Through both empirical studies and extensive interviews, this article both confirms and refines the existing literature by demonstrating a close connection between the stock market and venture capital market in China. It also finds that, for venture capital availability, laws and policies indeed matter

in China: strong and sustained law reforms and government policies aimed at improving the institutional structure and regulatory environment of the stock market can facilitate venture capital-backed exits, which in turn lead to an increase in new venture capital availability in China. Nonetheless, numerous IPO closures have led to freeze-ups in China's venture capital market. Also, there remain a multiplicity of institutional impediments to the efficient operation of the stock market and the effective implementation of IPO reforms in China. These may in turn hinder the development of the Chinese venture capital industry.

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Dr. LIN Lin *

Abstract

Existing literature suggests a strong relationship between a vibrant venture capital market and an active stock market: venture capital flourishes when venture capitalists can readily exit from successful portfolio companies through initial public offerings (“IPOs”), and IPOs are in turn facilitated by active and efficient stock markets. Despite being relatively new to venture capital investment, China’s concerted government efforts have successfully engineered the second-largest venture capital market (by investment volume) in the world to date. China’s economy has also undergone a drastic transformation from a planned to market economy in the last 20 years. Given these factors, does the positive correlation between an active stock market and vibrant venture capital market hold true in China?

This article uses China as a case study to explore the connection between the stock market and venture capital market. It also seeks to identify major problems for venture capital-backed IPOs and to propose solutions. Through both empirical studies and extensive interviews, this article both confirms and refines the existing literature by demonstrating a close connection between the stock market and venture capital market in China. It also finds that, for venture capital availability, laws and policies indeed matter in China: strong and sustained law reforms and government policies aimed at improving the institutional structure and regulatory environment of the stock market can facilitate venture capital-backed exits, which in turn lead to an increase in new venture capital availability in China. Nonetheless, numerous IPO closures have led to freeze-ups in China’s venture capital market. Also, there remain a multiplicity of institutional impediments to the efficient operation of the stock market and the

* Assistant Professor, Faculty of Law, National University of Singapore (NUS). Helpful comments on earlier drafts of this article were received from Kon Sik Kim, Hans Tjio, Lan Luh Luh and Florian Gamper. I also thank the participants in the 25th Australia Annual Corporate Law Teachers Association Conference and the 12th Asian Law and Economics Association (AsLEA) Annual Conference. I am grateful to the interviewees from China, who generously shared their knowledge and insights with me. Interviews were conducted on an anonymous, background basis. All errors remain my own.

effective implementation of IPO reforms in China. These may in turn hinder the development of the Chinese venture capital industry.

Key words: Venture Capital, Stock Market, VC-backed Exits, China, NEEQ, IPO Reform

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Venture capital is an important source of financial capital for early-stage, high-potential, high-growth, and high-technology companies. It has been widely recognised as a powerful engine for driving a nation's innovation, job creation and economic growth.¹ Developing a robust venture capital market is a key national strategy of many countries including Australia,² Singapore,³ and China.⁴ After three decades of development, China is now the second-largest country in terms of venture capital investment, ranking only behind the United States ("US").⁵ In 2015 alone, 597 new venture capital funds, collectively raising more than USD 30 billion worth of fresh capital eligible for investment, were set up in China,⁶ and 257 companies invested into by venture capitalists ("VC-backed companies") went public in China.⁷

¹ Ronald J. GILSON, "Engineering a Venture Capital Market: Lessons from the American Experience" (2003) 55 STAN. L. REV. 1067 at 1068. See generally on the importance of venture capital: Marco DA RIN, Ulrich HEGE, Gerard LLOBET and Uwe WALZ, "The Law and Finance of Venture Capital Financing in Europe: Findings from the RICAFE Research Project" (2006) 7 European Business Organization Law Review (EBOR); Brigitte HAAR, "Articles/Impressions of the First RICAFE Conference: Risk Capital and the Financing of European Innovative Firms" (2004) 5:1 European Business Organization Law Review 201.

² The Treasury and the Department of Industry, Innovation, Science, Research and Tertiary Education, Australian Government, "Review of Venture Capital and Entrepreneurial Skills" (2012), online: The Australian Private Equity & Venture Capital Association Ltd. <<https://www.avcal.com.au/documents/item/516>> at para. 4.4., p. 13 ("Australia's venture capital sector is an important component of Australia's innovation system"); at para. 4.18, p. 17 ("In terms of venture capital support, the Australian Government provides a range of equity- and tax-based venture capital programs"). Examples of governmental supports include the Innovation Investment Fund (equity-based) (see para. 4.19, p. 17) and the Early Stage Venture Capital Limited Partnerships program (tax-based) (see para. 4.23, p. 18).

³ Singapore Venture Capital & Private Equity Association (SVCA) and PricewaterhouseCoopers (PwC), "Private Equity: the Marker of a Successful Financial Hub" SVCA & PwC Baseline Survey (11 December 2011), online: SVCA & PwC Baseline Survey <<http://svca.org.sg/wp-content/uploads/2012/12/SVCA-PWC-Article-on-Baseline-Survey-v2-21.pdf>> ("Private equity and venture capital firms ... play an important role in Singapore's financial services sector"). Examples of governmental support include the Early Stage Venture Fund, an initiative of the National Framework for Innovation and Enterprise, which assists venture capital funds to invest in Singapore-based early stage high-tech companies, as well as the SRPING Start-up Enterprise Development Scheme and the Business Angel Scheme, both of which are initiatives by SPRING Singapore. See Colin Ng & Partners, "Venture Capital and Private Equity Initiatives in Singapore" CNPupdate (May 2014) Issue 03/ 2014, online: CNPupdate <<http://www.cnplaw.com/en/cnpupdatev2/Media/Content/Articles/2014/03/VC.pdf>>.

⁴ LIN Lin, "Re-Engineering a Venture Capital Market: The Case of China" (29 July 2015), accepted paper for the Stanford International Junior Faculty Forum 2015; NUS - Centre for Law & Business Working Paper No. 15/04; NUS Law Working Paper No. 2015/007, available at SSRN: <http://ssrn.com/abstract=2643311>

⁵ China in 2013 had the third largest amount of VC investment after the U.S. and Europe (not a country). See Ernst & Young, "Adapting and evolving: Global venture capital insights and trends 2014" (2014), online: E&Y Publication <[http://www.ey.com/Publication/vwLUAssets/Global_venture_capital_insights_and_trends_2014/\\$FILE/EY_Global_VC_insights_and_trends_report_2014.pdf](http://www.ey.com/Publication/vwLUAssets/Global_venture_capital_insights_and_trends_2014/$FILE/EY_Global_VC_insights_and_trends_report_2014.pdf)> at 2.

⁶ Zero2IPO Research Center, "Venture Capital Annual Report 2015" Zero2IPO Publisher (2016).

⁷ See Figure 2 in this article.

IPOs have been a popular venture capital exit vehicle. Extensive academic literature has found a strong correlation between the size and liquidity of a nation's stock market and the extent of its venture capital market.⁸ In particular, Black and Gilson contend that the vibrancy of the venture capital market is dependent on the presence of an active stock market through which the venture capitalists can exit from a successful portfolio company via IPO.⁹ IPOs enable the venture capitalists to exit from the venture capital investment while leaving the entrepreneurs in control of the startup.¹⁰ The option of an IPO exit is necessary for the negotiation of an incentive-compatible implicit contract at the time of the venture capital investment.¹¹ Black and Gilson have also argued that the venture capital industry tends to be stronger and more vibrant in stock market-centered systems like the US, relative to countries like Germany and Japan which are bank-centered.¹²

While previous research has explored the link between the two markets in countries such as the US and the United Kingdom ("UK"), China has not been the subject of theoretical or empirical investigation. Thus, this article seeks to fill the literature gap by exploring the correlation between the stock market and venture capital market in China. It also discusses the major legal and regulatory obstacles faced by venture capital-backed IPOs and suggests solutions. Based on both empirical studies and extensive interviews,¹³ this article finds that there is a close connection between the

⁸ See Bernard S. BLACK and Ronald J. GILSON, "Does Venture Capital Require an Active Stock Market?" (1999) 11 *Journal of Applied Corporate Finance* 36; Edward B. Rock, "Greenhorns, Yankees and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and US Markets" (2001) 2 *Theoretical Inquiries in Law* 711; Paul GOMPERS and Josh LERNER, "The venture capital revolution" (2001) 15 *Journal of Economic Perspectives* 145; Colin MAYER, Koen SCHOORS, and Yishay YAFEH, "Sources of funds and investment activities of venture capital funds: evidence from Germany, Israel, Japan and the UK" (2005) 11 *Journal of Corporate Finance* 586; Marc-Oliver FIEDLER and Thomas HELLMANN, "Against All Odds: The Late but Rapid Development of the German Venture Capital Industry" (2001) *The Journal of Private Equity* 39; Leslie A. JENG and Philippe C. WELLS, "The Determinants of Venture Capital Funding: Evidence Across Countries" (1998), available at SSRN <<http://ssrn.com/abstract=103948>>. They analyse the determinants of venture capital for a sample of 21 countries and find that IPOs are the strongest driver of venture capital investing.

⁹ Black and Gilson, *supra* note 8.

¹⁰ Edward B. ROCK, "Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Market" (2001) *Theoretical Inquiries in Law* 2.2 (2001) at 713; Black and Gilson, *ibid* at 2.

¹¹ *Ibid.*

¹² Bernard S. BLACK and Ronald J. GILSON, "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets" (1998) 47 *Journal of Financial Economics* 243.

¹³ The empirical study consists of three parts. Part A is a study on a sample of fifty venture capital limited partnership agreements. These agreements were obtained from leading Chinese law firms and venture capital firms, i.e. Gaorong Capital, Chengwei Capital, Beijing Fangda Law Firm, Beijing Global Law Firm, Beijing Jincheng Tongda Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm and Shenzhen Huashang Law Firm. Part B is the author's interviews with practitioners. This part consists primarily of venture

stock market and venture capital market in China. This is consistent with the general theory that a link exists between stock markets and venture capital markets.

This article also extends the existing literature by finding that laws and policies indeed matter for venture capital availability in China, impacting the venture capital market both positively and negatively. On the one hand, strong and sustained law reforms and government policies aimed at improving the institutional structure and regulatory environment of the stock market have facilitated venture capital-backed exits, which in turn enhanced new venture capital availability. On the other hand, numerous IPO closures by regulatory authorities have negatively impacted the venture capital market.

At this juncture, it is worth noting that the concept of “stock market” in this article is defined to broadly include the Shanghai Stock Exchange (“SSE”) and the Shenzhen Stock Exchange (“SZSE”) Main Boards, the Small and Medium Enterprises (“SME”) Board of the SZSE, the ChiNext Board of the SZSE, the National Equities Exchange and Quotations System (“NEEQ”)¹⁴, and other regional equity markets that feature in the Chinese multi-tiered capital market system. Additionally, as this article only focuses on the domestic stock market and its implication for the venture capital market, the term “IPO exits” mainly refers to exits by VC-backed companies going public on the Chinese stock market. It does not include exits via overseas markets.¹⁵

The remainder of this article consists of seven parts. Part I critically discusses the importance of exits in venture capital investments. Part II reviews the historical development of the stock market and venture capital market in China. Part III discusses the special features of venture capital exits in China and the legal, economic and cultural reasons for the preference for IPOs in China. Part IV explores the link

capitalists, counsels, and investors from twenty venture capital funds. The interviewees come from the six cities that are the major places of venture capital investments in China, i.e. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, and Guangzhou. Part C comprises a study of data and reports published by two leading service providers and investment institutions in China’s venture capital industry: the *Zero2IPO* Annual Report of the Venture Capital Market in China published by the Zero2IPO Research Centre, and the *China Venture Capital Yearbook* published by the China Venture Capital Research Institution.

¹⁴ NEEQ is not equal to a normal stock exchange like the SSE and the SZSE. See Part VI(A) in this article for detailed discussion on the NEEQ.

¹⁵ However, it must be noted that there is a large number of venture capital-backed companies that have gone overseas for listing, including IT giants such as Alibaba and Baidu. See text accompanying notes 117-118.

between China's stock market and its venture capital market based on both quantitative and qualitative data, and argues that a strong stock market is conducive to a strong venture capital market. Thereafter, Part V analyses the existing deficiencies in the stock market and how they could hinder the venture capital market. Part VI critically examines the major initiatives required to improve the regulatory environment of venture capital-backed exits, and suggests future law reforms, particularly the newly expanded NEEQ and the recently introduced IPO reform. Finally, Part VII concludes by crystallising the lessons to be learnt from China's experience.

I. THE IMPORTANCE OF EXITS VIA IPO IN A VENTURE CAPITAL MARKET

A typical venture capital cycle in China is very much the same as its international counterpart.¹⁶ The cycle consists of three stages: raising a venture capital fund (fund-raising), investing in and adding value to a portfolio company through the venture capital fund (investment), and realising profits and returning them to the venture capital investors (exit).¹⁷ A venture capital project also involves three major parties: (1) investors who provide capital to the venture capital fund; (2) venture capitalists who manage the venture capital fund and who identify and give credibility to their portfolio companies by providing management assistance, intensive performance monitoring, and reputational capital; and (3) entrepreneurs within the portfolio companies.¹⁸

According to Cumming et al., there are five principal venture capital exit vehicles: (1) an initial public offering ("IPO"), in which a significant portion of the portfolio company is sold in the public market; (2) an acquisition exit, in which the entire firm is sold to a third party (an acquisition exit includes a sale of shares, a merger, and also a sale of the firm's assets¹⁹); (3) a secondary sale, in which only the venture

¹⁶ For the international version of the venture capital cycle, see generally, Paul Alan GOMPERS and Joshua LERNER, *The Venture Capital Cycle* (MIT Press, 2004).

¹⁷ See generally Lin, *supra* note 4.

¹⁸ *Ibid.*

¹⁹ Douglas J. CUMMING and Jeffrey G. MACINTOSH, "Venture-Capital Exits in Canada and the United States" (2003) 53 *University of Toronto Law Journal* 101 at 106.

capitalists' shares are sold to a third party (typically a strategic acquirer); (4) a buyback, in which the venture capitalists' shares are purchased by the entrepreneurial firm itself; and (5) a write-off, in which the venture capital walks away from the investment.²⁰ Venture capitalists and entrepreneurs are free to choose the appropriate exit strategy for their investments based on their business needs, the firm's financial condition and the market conditions. There are advantages and disadvantages for each form of venture capital exit.²¹

Venture capital investments are primarily equity investments.²² Venture capitalists need to turn their illiquid stakes in the startup company into realised returns so as to profit from their investments. Many startup firms targeted by venture capitalists are young and lack the cash flow and profits to pay their investors interest or dividends, so most venture capitalists' returns come in the form of capital gains.²³ Therefore, the means by which venture capitalists can exit (i.e., cash out) their investments is vital to the profitability of a venture capital investment.²⁴

There have been many empirical and theoretical attempts to explore the importance of exits, especially exits via IPO, in the development of venture capital markets.²⁵ As observed by Gilson, there are two major legal relationships/contracts within a venture capital cycle: (1) the relationship between the investors (capital providers) and the venture capitalists in the fund-raising stage, and (2) the relationship between the venture capital funds and the portfolio companies in the investment stage.²⁶ In the venture capitalist-investor relationship, apart from the express contract between the venture capitalists and the investors in the form of the limited partnership agreement, there is also an implicit contract in which the investors are expected to reinvest in future venture capital funds that are sponsored by successful venture capitalists.²⁷ As venture capital funds have a limited life span, successful exits are critical to the

²⁰ Douglas J. CUMMING and Jeffrey G. MACINTOSH, "A Cross-Country Comparison of Full and Partial Venture Capital Exits" (2003) 27:3 Journal of Banking and Finance 511 at 512.

²¹ See Cumming and MacIntosh, *supra* note 19 (The paper provides a comprehensive study of the comparative advantages and disadvantages of all forms of VC exits).

²² *Ibid.* at 101.

²³ *Ibid.*

²⁴ *Ibid.*

²⁵ See *infra* text accompanying notes 36-37.

²⁶ See Gilson, *supra* note 1.

²⁷ Black and Gilson, *supra* note 12, at 256-257.

venture capitalists in ensuring attractive returns to the investors, and in turn securing subsequent funds from the investors for future venture capital funds.²⁸ A successful exit is also a central indicator of the venture capitalist's success in the eyes of investors.

In the venture capital fund-portfolio company relationship, the venture capital fund often insists on retaining control of the portfolio company to protect themselves from the high risk that entrepreneurs may mismanage the company or pursue private benefits at the firm's expense.²⁹ Such an arrangement of control is typically reflected in an explicit contract between the venture capital fund and the portfolio company. For instance, contracts often provide that the fund invests in the portfolio company in the form of convertible preferred stock and enjoys significant control over the company via disproportionate board representation and approval rights for important operating decisions.³⁰

On the other hand, entrepreneurs have the opportunity to regain control from the hands of the venture capital fund by exercising their call options on control upon an IPO. The contract denominated in control serves as an important performance incentive to the entrepreneurs.³¹ In order to regain control of the firm, the entrepreneurs need to prove their management skills and provide evidence that they can be trusted with the capital provided by the venture capital fund.³²

The viability of this implicit contract in turn depends on the viability of an IPO exit strategy.³³ Other exit strategies such as a trade sale of the whole portfolio company to another buyer or a secondary sale of a portion of the shares to a third party will not help the entrepreneur regain control of the firm, and thus do not incentivise the entrepreneurs in the same way as the IPO strategy.

²⁸ *Ibid.* at 257.

²⁹ *Ibid.* at 258-259.

³⁰ *Ibid.* at 259-261. Upon IPO, the special control rights given to the venture capital fund would disappear, as the terms of the convertible preferred stocks held by the venture capital fund will be converted to common stocks at the time of the IPO, as stipulated in the contract.

³¹ *Ibid.* at 259 - 260.

³² *Ibid.* at 259.

³³ *Ibid.*

Further, IPO exits, more than other exit vehicles, incentivise entrepreneurs to ensure the firm succeeds. First, IPOs are the most profitable for a portfolio company.³⁴ Empirical studies also show that innovative and profitable ventures are more likely to go public.³⁵ Thus, entrepreneurs and their investors have good reason to work towards IPOs particularly when faced with a favourable IPO climate. Second, unlike acquisitions or secondary sales which are usually constrained by buyer availability, IPOs are typically always possible provided that the firm is sufficiently successful and profitable to go public. Finally, such success requirements further encourage entrepreneurs to properly manage and grow the company. In contrast, secondary sales and write-offs do not necessarily require a firm to be successful or profitable. In short, the profitability of IPOs, and the fact that the possibility of going public is contingent on the firm's success, foster strong motivations for entrepreneurs and investors to properly manage and grow their companies.

As an IPO exit is naturally contingent upon the presence and vitality of a stock market, the importance of IPOs in both the investor-venture capitalist and venture capital fund-portfolio company relationships indicates a link between the venture capital market and the stock market.³⁶ Indeed, the connection between the two markets has also been observed empirically in Europe³⁷ and more generally around the world.³⁸ The following parts of this article will explore the correlation between VC-backed IPOs and the stock market in the context of China.

II. THE DEVELOPMENT OF THE STOCK MARKET AND THE VENTURE CAPITAL MARKET IN CHINA

The US has over 70 years of experience in venture capital, beginning in the 1940s.³⁹ In contrast, China has a much shorter history of venture capital. Before the reform of

³⁴ Black and Gilson, *supra* note 12, at 257; Armin SCHWIENBACHER, "Innovation and Venture Capital Exits", (2008) 118 (533) *The Economic Journal*, 1888.

³⁵ Schwiendacher, *ibid.*

³⁶ Black and Gilson, *supra* note 12, at 261.

³⁷ Marco DA RIN et al, "Public Policy and the Creation of Active Venture Capital Markets" (2006) 90 *Journal of Public Economics* 1699.

³⁸ See Stefano BONINI and Senem ALKAN, "The Political and Legal Developments of Venture Capital Around the World" (2012) 39 *Small Bus Econ* 997. This study analyses data from 16 countries around the world using new statistical methods and has found evidence confirming LLSV's hypothesis.

³⁹ See Gompers and Lerner, *supra* note 16, at 8.

China's economic system and the opening of its market to the outside world (*gaige kaifang*) in 1978, China was a planned economy. There were no private enterprises, startups or venture capital funds in China.

The concept of venture capital was first officially introduced in China in 1985 through the central government's "Decision to Reform the Science and Technology System".⁴⁰ In the same year, the first venture capital firm, the China New Technology Venture Capital Company (*zhongguo xinjishu chuangye touzi gongsi*) was set up.⁴¹ Thereafter, local governments and government agencies established funds to provide financing to technology companies. However, due to unfamiliarity with the concept of venture capital as well as the lack of a nation-wide capital market, venture capital developed very slowly in the 1980s.

The year 1990 saw the establishment of China's capital market. Two stock exchanges – SSE and SZSE were established that year, offering new exit channels for VC-backed companies. In the short span of time since then, China's stock market has rapidly grown in size and liquidity. As of May 2015, the two main stock exchanges, i.e. the SSE and SZSE, were worth over USD 10 trillion collectively, with the SSE being the second largest stock exchange in Asia and the sixth in the world by market capitalisation.⁴²

Another turning point in the 1990s was the presentation of the so-called "No.1 proposal" at the first meeting of the 9th Chinese People's Political Consultative Conference, which urged the development of venture capital in China.⁴³ After that, continuous law reforms by the State Council, the China Securities Regulatory Commission ("CSRC"), and the stock exchanges were made to gradually develop an underlying legal and regulatory infrastructure to facilitate VC-backed IPO exits. (See

⁴⁰ CPC Central Committee, *The Decision to Reform the Science and Technology Systems [zhonggong zhongyang guanyu kexuejishu tizhigaige de jueding]* (13 Mar 1985), online: CPC News <<http://cpc.people.com.cn/BIG5/64162/134902/8092254.html>>.

⁴¹ For history of the venture capital market in China, see LU Haitian, TAN Yi and CHEN Gongmeng, "Venture Capital and the Law in China" (2007) 37 HKLJ 229.

⁴² See data from the World Federation of Exchanges (data as of end-May 2015): Sophia YAN, "China's Stock Market is Now Worth Over \$10 Trillion" (15 June 2015), online: CNN Money <<http://money.cnn.com/2015/06/15/investing/china-stocks-10-trillion/>>.

⁴³ Xinhuanet, "[The Past and Present of Venture Capital in China] *Zhongguo Fengxian Touzi de Lishi ji Xianzhuang*" (2016), online: Xinhuanet <http://news.xinhuanet.com/theory/2008-05/13/content_8156697.htm>.

Appendix 2 for a detailed list and explanation of key legal developments in China's stock market and their implications for the venture capital market).

In 2002, the planned launch of a National Association of Securities Dealers Automated Quotations (“NASDAQ”)-style secondary board was delayed. This undermined investor confidence in the venture capital market. Nearly a hundred domestic venture capital firms that were based in Shenzhen closed that year.⁴⁴ The decline of venture capital investments in the early 2000s was also exacerbated by the burst of the “dot-com bubble” in 2001 and the global economic slowdown in 2002.

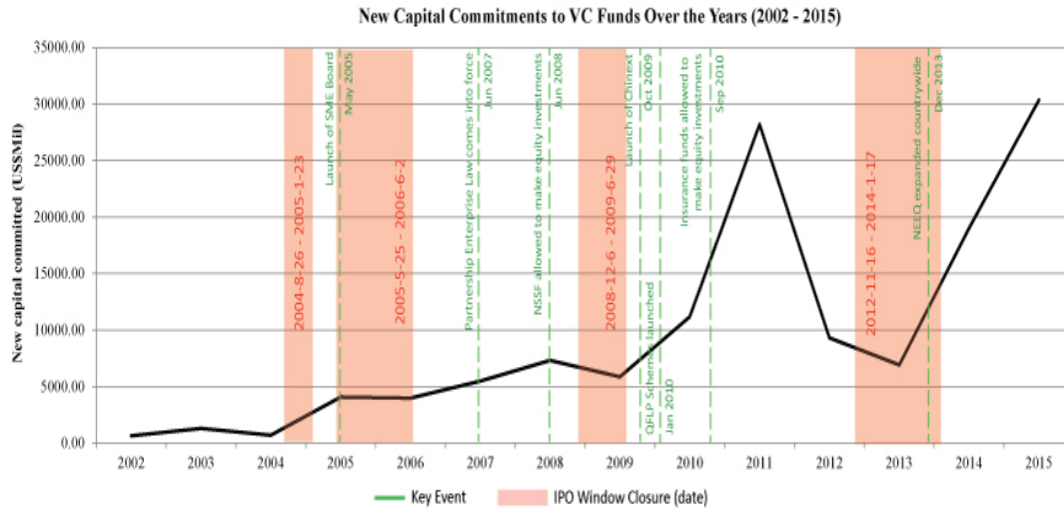
Figure 1 provides a timeline for the development of the venture capital market in China. It illustrates how the development of or constraints on the venture capital market are largely influenced by the development of the domestic stock market. On one hand, continuous improvements to China's stock market since 2008 have contributed significantly to the growth of venture capital fund-raising in China. For example, after the long-awaited secondary board - the ChiNext board - was finally established in October 2009, both the number of newly-established venture capital funds and the amount of funds raised doubled in 2011. On the other hand, as will be discussed later in Part IV, numerous IPO closures (highlighted in red in Figure 1) have led to freeze-ups in China's venture stock market.⁴⁵

Figure 1: New Venture Capital Commitments over the Years and Major Changes to the Stock Market (2002-2015)⁴⁶

⁴⁴ PE Daily, “Review of Venture Capital in China 2002” (16 Nov 2015), online: CVCF 15th Anniversary Special <<http://news.pedaily.cn/zt/20151116390412.shtml>>.

⁴⁵ See Part IV of this article.

⁴⁶ Full figures for 2015 are not available as of the date of this article, thus the data for the year 2015 is not reflected in this table.



III. SPECIAL CHARACTERISTICS OF VENTURE CAPITAL EXITS IN CHINA

A. The IPO as a Preferred Exit Option for Venture Capital Backed Companies

According to Zero2IPO Research Centre, a leading service provider and investment institution in China's private equity industry, there were a total of 2,906 exits by private equity and VC-backed firms in China from 2008 to 2015 (inclusive),⁴⁷ including 1,374 exits via IPO (47.28%), 589 exits via merger and acquisition ("M&A") (20.27%), and 481 exits via share transfer (16.55%). The remaining 462 exits were executed via other means including share buybacks,⁴⁸ write-offs, and other methods.⁴⁹ From 2006 to 2015, a total of 1,504 VC-backed IPO exits took place - almost three times the number of VC-backed M&A exits in the same period (589).

These figures indicate that IPOs have been the most popular exit method for venture capital in China, with far fewer exits via other methods. Share buybacks, for instance, are usually only opted for either when exits cannot be done via IPO or M&A, or when the portfolio company no longer wishes to be controlled by the venture capitalist.⁵⁰ This is unsurprising given that share transfers and share buybacks usually mean

⁴⁷ See Table 1 in this article.

⁴⁸ Share buyback by an entrepreneurial firm is permissible under the *Measures for the Administration of Venture Capital Enterprises* and the *Provisions on the Administration of Foreign-funded Startup Investment Enterprises*.

⁴⁹ See the respective Zero2IPO Annual Reports for the detailed breakdown for each year.

⁵⁰ Interview with Ms S, Gaorong Capital, 29 October 2015 (on file with author) and Ms K, Global Law Firm, 29 October 2015 (on file with author).

relatively lower rates of return on the investments. Moreover, there are also relatively more legal restrictions and requirements placed on share buybacks under Chinese law.⁵¹ Finally, write-offs are naturally reserved as a method of last resort for venture capital funds, only used reluctantly when the portfolio company’s performance is unsatisfactory, to say the least.

That IPOs are the preferred exit option reinforces the link between China’s venture capital market and stock market. As argued above, the primary mechanism through which a stock market encourages venture capital investments is the provision of exit options. A useful contrast can be made with the US, where a greater proportion of venture capital exits occur via M&A as opposed to IPO. In 2015, the US venture capital industry saw 77 exits via IPO and 372 exits via M&A (see Table 2 below).⁵² From 2006 to 2015, only 616 VC-backed IPOs took place – roughly one-seventh of the 4,448 VC-backed M&A exits in the same period.⁵³

Consequently, it is suggested that Chinese stock markets play an even larger role in encouraging venture capital availability than their US counterparts.

Table 1: China Venture Capital Exits via IPO⁵⁴ and M&A

Number of exits via IPO, M&A, and share transfer for VC-backed companies, as well as the corresponding amount of new capital committed to VC funds (2006-2015)

Source: Zero2IPO⁵⁵ & ChinaVenture⁵⁶

Year	Methods of Exit	Total number	Amount of New
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⁵¹ Article 142 of the *Companies Law of the People’s Republic of China* provides the situations under which a company can buy back their own shares. Also, in practice, it is difficult for unlisted companies to obtain bank loans for share buybacks.

⁵² National Venture Capital Association, *2015 National Venture Capital Association Yearbook*, 18th ed (Thomson Reuters, 2015) at 75.

⁵³ In the US, one reason for the preference of US venture capitalists for M&A exits as opposed to IPO exits is the booming merger business, in contrast to the volatility of the capital markets. Recent IPOs have performed poorly, with many VC-backed companies receiving better offers from potential acquirers, including financial firms and strategic rivals, than the value from IPOs. As a result, in the US, where financial intermediaries are sophisticated and financial infrastructure is well developed, exits through M&A have emerged as the better way to grow earnings, especially where synergies and cost-cutting are achieved.

⁵⁴ In this table, the IPO figure only refers to exits by VC-backed companies going public on the Chinese stock market. It does not include IPO exits via overseas markets.

⁵⁵ For the data from 2008 to 2015.

⁵⁶ For the data from 2006 to 2007.

	IPO	M&A	Share Transfer ⁵⁹	of exits ⁵⁷	Capital Committed to VC Funds (in US\$ Mil) ⁵⁸
2015	257	280	197	884	30,355.97
2014	172	111	70	444	19,021.78
2013	33	76	58	230	6,919.07
2012	144	31	44	246	9,311.55
2011	312	55	41	456	28,201.99
2010	331	24	20	388	11,169.00
2009	82	6	24	123	5,855.86
2008	43	6	27	135	7,310.07
2007	100	13	-	142	5,484.98
2006	30	25	12	99	3,973.12

Table 2: US Venture Capital Exits via IPO and M&A

Number of exits via IPO and M&A for VC-backed companies, as well as the corresponding amount of new capital committed to VC funds (2004-2015)

Source: National Venture Capital Association⁶⁰

Year	Methods of Exit		Amount of New Capital Committed to VC Funds (in US\$ Mil)
	IPO	M&A	
2015 ⁶¹	77	372	Not Available
2014	115	459	29,969.7
2013	81	385	17,702.0
2012	49	477	19,838.2
2011	50	493	19,060.5
2010	67	525	13,272.0

⁵⁹ “Share transfer” excludes management buyouts and share buybacks.

⁵⁷ This total figure includes management buyouts and share buybacks but *excludes* the NEEQ listings.

⁵⁸ Data from Annual Research Reports On Venture Capital In China, published by Zero2IPO.

⁶⁰ See National Venture Capital Association of the United States, *supra* note 52 at 27, 77 and 81.

⁶¹ As the National Venture Capital Association (NVCA) Yearbook 2016 was not available at the time of this article, the figures for 2015 were obtained from the press release of the National Venture Capital Association. See National Venture Capital Association, “Seventy-Seven Venture-Backed Companies Went Public in 2015 - Fourth Quarter IPO Volume Up Slightly from Previous Quarter” (2016), online: NVCA <<http://nvca.org/pressreleases/seventy-seven-venture-backed-companies-went-public-in-2015/>>.

2009	13	351	16,087.2
2008	7	416	25,054.9
2007	90	488	29,993.7
2006	67	482	31,107.6
2005	58	446	30,071.9
2004	81	402	17,884.6

B. Reasons for the Preference for IPOs in China

Five legal, economic and cultural reasons can be proffered to explain the investor preference for IPO over M&A as an exit option in China, particularly during 2011 and 2012.

First, IPO exits in China tend to give high returns on investments. As of December 31, 2015, the average price-earnings ratio (P/E ratio) of A-shares on the SSE and SZSE were 17.61 and 53.34 respectively - far higher than the average P/E ratio of 9.88 achieved on shares listed on the Hong Kong Exchange (HKEx) Main Board.⁶² The P/E ratio for the SME Board and ChiNext were even higher, at 68.06⁶³ and 109.01⁶⁴ respectively. In fact, the SME Board's highest P/E ratio in 2015 was 85.65,⁶⁵ while ChiNext's was a staggering 146.57.⁶⁶ Also, a study of Chinese IPO initial returns found that the average IPO initial return was 66%, with 14-22% being attributed to under-pricing, and 44-53% due to overvaluation.⁶⁷ It was also found that initial returns and overvaluations have no relevance to post-IPO stock performance in the long-term.⁶⁸ Thus, the high returns from selling shares after listing make IPOs an attractive option.

⁶² Hong Kong Stock Exchange, "Market Highlights" (2016), online: China Stock Markets Web <<http://www.hkex.com.hk/eng/csm/highlight.asp?LangCode=en>>.

⁶³ Shenzhen Stock Exchange, "Small and Medium Enterprise Board" (2015), online: Shenzhen Stock Exchange <<http://sme.szse.cn/>> [SZSE, *SME Board*].

⁶⁴ Shenzhen Stock Exchange, "ChiNext" (2015), online: Shenzhen Stock Exchange <<http://chinext.szse.cn/>> [SZSE, *ChiNext*].

⁶⁵ SZSE, *SME Board*, *supra* note 63.

⁶⁶ SZSE, *ChiNext*, *supra* note 64. There are various reasons for the high P/E ratio in China, including the merit-based system of IPO and speculation by the investors.

⁶⁷ Shunlin SONG, Jinsong TAN and Yang YI, "IPO Initial returns in China: Underpricing or Overvaluation?" (2014) *China Journal of Accounting Research* 31 at 47.

⁶⁸ *Ibid.*

Second, M&As are less feasible as an alternative exit option in China. The M&A market in China is plagued by the primary difficulty of obtaining approval for M&A activities. Listed⁶⁹ and non-listed⁷⁰ public companies must seek approval from relevant authorities when the acquisition and/or relevant equity changes pertain to issues such as national industrial policies, industry access, transfer of state-owned shares, and foreign investments. This requirement renders M&A activities and corporate reorganisation in China exceedingly uncertain and risky. A prolonged approval timeline also compromises M&A efficiency, resulting in multiple negative implications including employee brain drain and variations in acquisition pricing. Also, local governments in China have been known to use their administrative powers to obstruct M&A activities, especially those involving state-owned enterprises, thereby posing significant risks to corporate M&A deals.⁷¹

In addition, there are also tight regulations over foreign M&A activities. Under the *Provisions on Foreign Investors' Merger and Acquisition of Domestic Enterprises*,⁷² any M&A activity by foreign-invested enterprises requires approval from the Ministry of Commerce (MOFCOM) or a provincial department in charge of commerce.⁷³

Faced with these institutional obstacles, it is unsurprising that the scale of the M&A and corporate reorganisation businesses in the investment banking arms of securities companies is still very small. In 2011, M&A and corporate reorganisation work took up only 5% of the investment banking businesses of securities companies. In 2012, the percentage had only increased to 5.7%.⁷⁴

Third, the Chinese government has exerted stringent control over debt financing. Banks in China are known to have very conservative lending practices, making it

⁶⁹ CSRC, *Measures for the Administration of the Takeover of Listed Companies [shangshi gongsi shougou guanli banfa]* (promulgated in 2006 and amended in 2012), Article 4.

⁷⁰ See CSRC, *Measures for the Administration of the Takeover of Non-listed Public Companies [feishangshi gongsi shougou guanli banfa]* Zhongguozhengquanjianduguanliweiuyuanhuiling No. 102 (promulgated on 5 May 2014), Article 4.

⁷¹ Telephone Interview with Mr. Y, senior associate of Zhonglun Law Firm in Shenzhen, 28 February 2016 (on file with author).

⁷² *Provisions on Foreign Investors' Merger and Acquisition of Domestic Enterprises, [shangwubu guanyu waiguo touzizhe bingou jingnei qiye de guiding]* Ministry of Commerce, Order No. 6 [2009] (promulgated and effective on 22 June 2009).

⁷³ *Id.*, Article 10.

⁷⁴ ZHENG Xiaobo, "When the Chinese M&A wave arrival is uncertain" (27 May 2013), [*Zhengquan Shibao*] Securities Times.

difficult to finance both venture capital and M&A deals with debt. According to Article 20(3) of the General Rules for Loans issued by the People's Bank of China in 1996, a borrower is not permitted to use bank loans to fund equity investments. This restriction has created an enormous obstacle for venture capital firms seeking debt financing in M&A activities. To remedy this, the China Banking Regulatory Commission ("CBRC") issued a *Notice on the Risk Management of M&A Loans of Commercial Banks* in December 2008 ("2008 Guidelines"),⁷⁵ allowing commercial banks to provide acquisition finance to certain companies. The 2008 Guideline was later replaced by a new guideline issued in February 2015 ("2015 Guideline"),⁷⁶ which expanded the potential sources of funding by allowing not only commercial banks, but also policy banks and branches of foreign banks, to provide acquisition finance.⁷⁷ However, the CBRC is still taking a cautious approach towards acquisition finance under the new 2015 Guideline. For instance, the term of any loan is limited to 7 years,⁷⁸ and the total value of a loan must not exceed 60% of the total acquisition price.⁷⁹

Fourth, the preference for IPOs may further be explained by cultural factors. Chinese entrepreneurs can frequently be very attached to their companies, and are thus unwilling to completely let go of their companies via M&A.⁸⁰ This situation is particularly prevalent in VC-backed startups, in which the shareholding structure is relatively concentrated, in contrast to the diversified shareholding of large public companies. It is thus more difficult for outsiders to acquire the whole startup by a tender offer. Moreover, in acquisition situations, a strategic buyer would usually make the target company a wholly-owned subsidiary or a separate division of the strategic

⁷⁵ *Notice of China Banking Regulatory Commission on Issuing the Guidelines on the Risk Management of M&A Loans of Commercial Banks*, [zhongguo yinjianhui guanyu yinfa shangye yinhang binggou daiguan fengxianguanli zhiyin de tongzhi] (No.84 [2008] of the CBRC).

⁷⁶ *Notice of the China Banking Regulatory Commission on Issuing the Guidelines on Risk Management for M&A Loans by Commercial Banks* [zhongguo yinjianhui guanyu yinfa shangye yinhang binggou daiguan fengxianguanli zhiyin de tongzhi] (2015 Revision) (No.5 [2015] of the CBRC) [CBRC 2015 Notice]

⁷⁷ Notable changes include: (1) extending the guidelines to policy banks, PRC branches of foreign banks, or finance companies of business groups, (2) extending the term of the loan to not exceed 7 years, (3) increasing the cap of the loan, such that it now cannot account for more than 60% of the acquisition value, and (4) relaxing the security requirements for M&A loans. See King & Wood Mallesons, "CBRC amends Guidelines for Risk Management of M&A loans granted by Commercial Banks" (24 March 2015), online: King & Wood Mallesons Insights <<http://www.kwm.com/en/knowledge/insights/cbrc-amends-mergers-and-acquisitions-loans-guidelines-20150324>>.

⁷⁸ CBRC 2015 Notice, *supra* note 76, Article 22.

⁷⁹ *Ibid*, Article 21.

⁸⁰ Telephone interview with Mr. S, partner of Yuantai Law Firm in Shanghai, 22 December 2015 (on file with author).

buyer in order to produce synergistic gains,⁸¹ such as by integrating the target company's products and technologies.⁸² In doing so, the strategic acquirer faces difficulties in reconciling the target company's corporate culture with that of the parent company. The acquirer may also find it difficult to exert influence on the existing employees of the target company. Considering these difficulties, it has been opined that the number of strategic buyers who wish to acquire VC-backed companies in China is limited.⁸³

Fifth, the institutional infrastructure for M&As is underdeveloped. Specifically, in an M&A exit, a potential buyer will face difficulties getting direct access to the information of non-listed target startup companies whose financial information is not publicly available. M&A transactions thus tend to require a high level of professional assistance, such as that offered by sophisticated M&A practitioners. However, statistics show that in China, there is a shortage of such sophisticated financial intermediaries who have the relevant expertise, due to the short history of China's capital market.⁸⁴ Given the limited domestic talent pool, banks have also struggled to find enough talent to sustain their operations.⁸⁵ Therefore, few M&A transactions have been entered into and these deals often do not succeed.⁸⁶

⁸¹ Cumming and MacIntosh, *supra* note 19 at 106-107.

⁸² *Ibid.*

⁸³ Telephone interview with Ms. K, partner of Global Law Firm in Beijing, 22 December 2015 (on file with author).

⁸⁴ See, e.g. The Boston Consulting Group, "The 2012 BCG 50 Chinese Global Challengers: End of Easy Growth" (2012), online: Boston Consulting Group Perspectives <https://www.bcgperspectives.com/content/articles/globalization_2012_chinese_global_challengers_end_of_easy_growth/?chapter=4> (that "few Chinese companies have developed a mastery of the M&A and postmerger integration processes ... for many Chinese executives, dealmaking and deal integration are still foreign concepts. Their deals frequently fall short of their original goals. ... they [Chinese companies] suffer from a lack of experience. Many Western companies have spent 30 or more years developing capabilities in evaluating, executing, and integrating deals.")

⁸⁵ See, e.g. Pricewaterhouse Coopers, "PwC Foreign Banks in China 2013 Report" (2014), online: Pricewaterhouse Coopers China <http://www.pwccn.com/webmedia/doc/635253186547653351_fbic_2013.pdf> at 28 that ("Nearly all foreign banks struggle to find and retain sufficient talent to support the continued growth of their mainland operation. Most foreign banks in China said their staff were overwhelmingly Chinese, but given the limited number of years of reform, the existing domestic talent supply is still limited").

⁸⁶ In a 2010 survey done by KPMG on Chinese companies, "fifty-six percent of survey respondents cited failure to identify important financial, operational and management issues in due diligence as a key reason for the failure of a deal and this is one particular area where the experience of external advisors can help." See KPMG, "World class aspirations: The perceptions and the reality of China outbound investment" (2010), online: KPMG <<https://www.kpmg.de/docs/china-outbound-investment-201010.pdf>> at 12.

Nonetheless, it is worth noting that there appears to be a trend towards exits via M&A in recent years, especially in the venture capital industry. The quantity of M&A transactions has experienced a large increase from 76 in 2013 to 111 in 2014 (See Table 2 above). M&A exits doubled again to 280 in 2015, making 2015 the first year since 2006 where M&A exits exceeded VC-backed IPOs (257) in China, if one excludes 2013 when the IPO window was suspended for the year. Likewise, the total value of M&A exits in China doubled from USD 34,660 million in 2013 to USD 68,829 million in 2014.⁸⁷

Arguably, the suspension of the IPO market in 2013 contributed to the increased popularity of M&As, by introducing greater uncertainty and risk into the IPO process. The riskiness of IPO exits has been further exacerbated by the volatility of stock markets in recent years.⁸⁸ Additionally, the growing experience and improving attitudes of investors have contributed to a smoother M&A exit channel for venture capital investments. Deloitte has found that Chinese investors are increasingly more optimistic about market dynamics with respect to M&A and are developing an appetite for larger M&A transactions.⁸⁹ With these heightened expectations, Chinese investors have become more willing to involve professional advisors in their transactions. Notably, this includes engaging professionals to resolve issues pertaining to post-merger integration – an aspect widely accepted in China as crucial to a successful M&A transaction.⁹⁰

⁸⁷ Zero2IPO Research Centre, “[*Qingke Zhongguo Guquan Touzishichang 2014 Nian Quannian Huigu*] China Equity Investment Market Year-in-Review 2014” (2015) at 42.

⁸⁸ See Josh NOBLE, “Why are China’s Stock Markets so Volatile?”, *CNBC*, (July 2, 2015) online: <<http://www.cnbc.com/2015/07/02/why-are-chinas-stock-markets-so-volatile.html>>.

⁸⁹ See Deloitte, “More experienced buyers, higher return expectations: 2014 Greater China outbound M&A spotlight” (2014), online: Deloitte <http://www2.deloitte.com/content/dam/Deloitte/xs/Documents/About-Deloitte/me_csg_2014-china-outbound.pdf> at 31. Note though that this Deloitte study was conducted in relation to *outbound* M&A. (“Respondents are more optimistic about the market dynamics in the coming year compared with those in the 2013 survey”; “Large M&A transactions will probably happen more frequently. Chinese M&A investors expect mid- and large-sized M&A transactions (US\$150 million-US\$500 million) will happen more frequently in the coming year. The expectations of small-sized M&A transactions (US\$5 million-US\$50 million) dropped significantly in the 2014 survey, showing Chinese investors were developing an appetite for larger transactions, especially for targets with higher valuations or with a leading position in their particular industry.”)

⁹⁰ *Ibid.*

Furthermore, on 7 March 2014, the State Council promulgated a new Opinion⁹¹ which aimed to reduce the scope of projects that are subject to examination and approval, and cancel the pre-examination procedure for takeover reports of listed companies, so as to simplify the examination and approval process. Pursuant to the Opinion, the CSRC issued a new regulation to cancel the examination and approval procedure for major purchases, sales, and replacement of assets by companies that do not constitute back-door listings, and the prior examination and approval procedure for tender offers.⁹² In addition, a mandatory 75% loan-to-deposit ratio has been recently abolished under the 2015 amendments to the *Law of the People's Republic of China on Commercial Banks*,⁹³ and this may encourage Chinese banks to lend more. This author believes that with the improvements of the regulatory environment in the M&A market, M&A will gradually evolve into an important exit option for VC-backed companies.

IV. THE CORRELATION BETWEEN THE STOCK MARKET AND THE VENTURE CAPITAL MARKET IN CHINA

The amount of venture capital raised in China is directly influenced by the health of the Chinese stock market. To show this, Figure 2 plots the number of VC-backed IPOs against new capital commitments to venture capital funds in China in the same year. It will also be shown later in Table 3 that a significant positive correlation seems to exist between the number of IPOs and the amount of venture capital raised the following year.

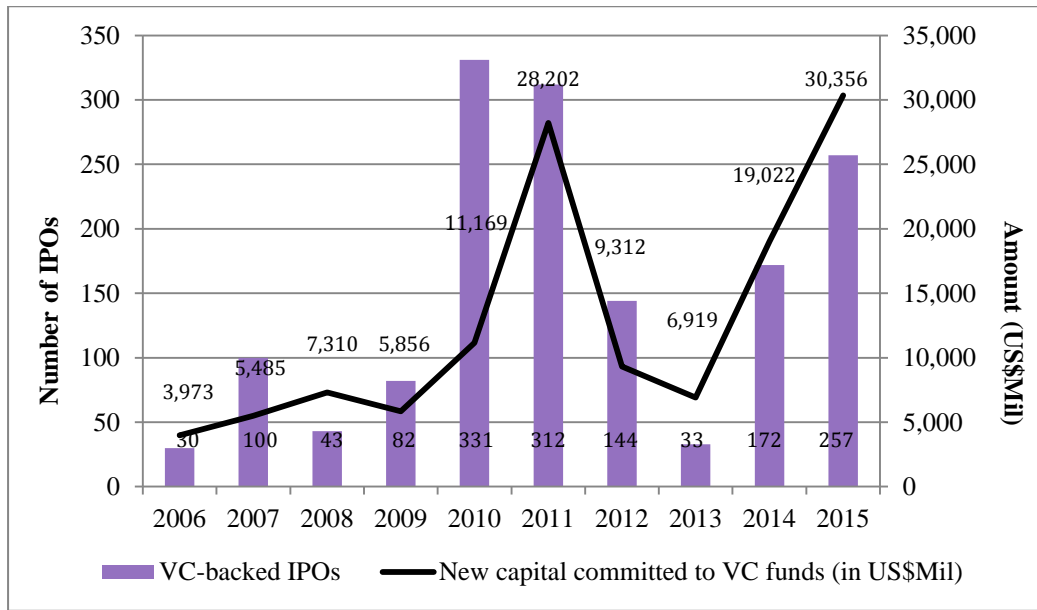
Figure 2: VC-backed IPOs and New Capital Commitments to Venture Capital Funds in China 2006 – 2015⁹⁴

⁹¹ State Council, the Opinions on Further Optimising the Market Environment for Mergers and the Restructuring of Enterprises, [*guowuyuan guanyu jinyibu youhua qiye jianbing chongzu shichanghuanjing de yijian*] Guofa [2014] No.14

⁹² CSRC, the Administrative Measures for the Material Asset Reorganisation of Listed Companies and the Administrative Measures for the Takeover of Listed Companies [*shangshi gongsi zhongda zichan chongzu guanli banfa*] Zhengjianhui Ling No. 109 (2014) (The measures was first promulgated in 2008 and revised in 2011 and 2014. The 2014 version became effective on 23 November 2014.)

⁹³ *Law of the People's Republic of China on Commercial Banks* [*shangye yinhangfa*] (The law was first promulgated on 10 May 1995, amended on 27 December 2003 and 29 August 2015.)

⁹⁴ Source: Annual Research Reports On Venture Capital In China, published by Zero2IPO. Figures representing the number of “VC-backed IPOs” (represented by the bar graph) and the amount of “New capital committed to VC



Immediately noticeable from Figure 2 above is the sheer volume of exits via IPOs by VC-backed Chinese firms from 2006 to 2015. In 2015 alone, 257 VC-backed companies went public in China. Further, there seems to be a positive correlation between the number of IPOs and the funds raised. Except in 2008 and 2010, the investors' willingness to invest in venture capital funds moved in tandem with the number of VC-backed IPOs.

As Figure 2 demonstrates, from 2006 to 2015, China's venture capital market has experienced steady growth in the total amount of funds raised, albeit with dips in 2008, 2012 and 2013.

The peaks shown in 2010 and 2011 can largely be attributed to the establishment of ChiNext in 2009 and the expansion of qualified limited partners in 2010, which increased the ease of exit through IPOs. Other figures also reveal that in the first quarter of 2010, the average rate of return ("ARR") of the SME Board and the ChiNext was more than 10%. In the second quarter of 2010, the ARR of IPOs on the

funds" (represented by the line graph) can also be found in Table 1 in Part III(A), under the second column ("Methods of Exit: IPO") and last column ("Amount of New Capital Committed to VC Funds") respectively.

ChiNext was 23.31%.⁹⁵ Such developments significantly encouraged the growth of venture capital fund-raising and investments.

However, the closures of the IPO process during the periods of December 2008 to June 2009 (approximately 7 months) and November 2012 to January 2014 (approximately 14 months) were followed by substantial decreases in venture capital fund-raising activities in the following years, as venture capitalists became concerned about the viability of IPO as an exit option. In 2011, the fact that many US-listed Chinese firms suffered from fraud allegations negatively affected the overseas listing of Chinese companies in general,⁹⁶ as well as venture capital fund raising in the year 2012. When the CSRC resumed its approval of IPOs in early 2014, venture capital financing experienced growth once again, and continued to grow throughout 2015. In the third quarter of 2015, 192 Chinese enterprises were listed on the three domestic stock exchange platforms, a 37% increase compared to the same period in the previous year.⁹⁷ Funds raised from these 192 listings amounted to USD 23.173 billion, a 72% increase from the previous year.⁹⁸ Finally, a larger growth in the number of listings and the amount of funds raised was observed in the first half of 2015, which could be partly attributed to the bull market in the A-share market. After the CSRC suspended new listings in July 2015, there were only 5 listings on the domestic stock market in the third quarter of 2015, a sharp decrease as compared to previous quarters.⁹⁹ The stock market's slowdown in the latter half of 2015 was accompanied by a fall in the number and volume of venture capital investments from the third to the fourth quarter in 2015.¹⁰⁰

⁹⁵ FU Bilian, “[2010 *Zhongguo VC/PE shichang lichuang xingao*] China’s VC/PE markets hit record high in 2010” (9 December 2010), [*Guoji Jinrong Bao*] International Finance News.

⁹⁶ Robert COOKSON “China foreign listings dogged by scandal” (June 5, 2011), online: <<http://www.ft.com/cms/s/0/9b70a976-8f8a-11e0-954d-00144feab49a.html>>.

⁹⁷ PE Data, “Research Report of Chinese Listed Companies in the Third Quarter of 2015” (25 Nov 2015), online: PE Data Report <<http://www.pedata.cn/report/1448429811704012.html>>.

⁹⁸ *Ibid.*

⁹⁹ These companies were approved for listing by the CSRC before the suspension of new listings in July 2015. See Zero2IPO Research Centre, “[*Qingke Shuju: 2015Q3 jin 22 jia zhongqi shangshi, xinsanban huobao yue qianjia guapai*] Zero2IPO Figures: Only 22 medium-sized listings in 2015Q3, New Third Board hotly expands to a thousand listings” (2015), online: Pedaily <<http://research.pedaily.cn/201510/20151010389097.shtml>> (Data as of 10 October 2015).

¹⁰⁰ Zero2IPO Research Centre, “[*Qingke Nianbao: 2015 nian VC touzi chonggaohou zhoujiang, shichangchuanglishi dan dujiaoshou rizi buhaoguo*] Zero2IPO Annual Report: VC investments in 2015 dips after rushing to a peak, market makes history but the unicorns are not finding things easy” (2015), online: Pedaily <<http://research.pedaily.cn/201601/20160112392433.shtml>>.

There is some statistical evidence reinforcing the correlation between the number of venture-backed IPOs and the amount of new capital commitments to venture capital funds. An ordinary least squares linear regression based on the 2006-2014 data (see Table 3 below) of newly-raised venture capital in each year (X) on the number of VC-backed IPOs the year before (X-1) yields a relationship significant at the 10% level, with a p-value of 0.0533, when controlled for the number of months that the IPO window was suspended in year X.¹⁰¹

Table 3: VC-backed IPOs, New Capital Committed to Venture Capital Funds in China, and IPO Window Closure (months) 2006 – 2014¹⁰²

Year	VC-backed IPOs in Current Year	New Capital Committed to VC Funds in the Next Year (US\$ Million)	IPO Closure (months)
2006	30	5,484.98	5
2007	100	7,310.07	0
2008	43	5,855.86	1
2009	82	11,169.00	6
2010	331	28,201.99	0
2011	312	9,311.55	0
2012	144	6,919.07	2
2013	33	19,021.78	12
2014	172	30,355.97	0

Despite the trends illustrated by the data above, it must be noted that an IPO is just one type of exit strategy for VC-backed companies. As will be discussed below, venture capitalists in countries such as the US and China also frequently exit via the sale of the portfolio company to a strategic buyer.

¹⁰¹ Note though that this is very preliminary statistical evidence. A more complex model which accounts for the time effect and developments of the venture capital market and stock market, such as the introduction of the NEEQ in 2010 was not done as there were insufficient (only 9) observations at the time of this paper to justify such a complex model. See also Black and Gilson, *supra* note 13 for a similar regression model built on US stock market and VC data.

¹⁰² Source: Annual Research Reports On Venture Capital In China, published by Zero2IPO.

Moreover, it should be noted that a well-developed stock market is not, in itself, determinative of a successful venture capital market. As Gilson's three-factor simultaneity theory posits, what remains crucial is the simultaneous presence of: (1) capital funding; (2) suitable contractual vehicles; and (3) entrepreneurs.¹⁰³ In the context of China, this issue has been comprehensively examined by this author in another article,¹⁰⁴ which argued that the Chinese government has played a major and positive role in developing these three factors.¹⁰⁵ Other determinants of a venture capital market briefly discussed in that article include tax considerations and bankruptcy law.¹⁰⁶ In addition, in the context of China, it is clear that the continuous law reforms by the State Council, the CSRC and the stock exchanges have been a key factor in the creation and growth of China's stock market.¹⁰⁷

Accordingly, this article does not revisit those areas, but instead empirically explores the connection between the venture capital market and the stock market in the context of China, and examines the role of law in developing the two markets.

V. THE EXISTING PROBLEMS OF AND IMPEDIMENTS TO VC-BACKED IPOs

Given the importance of IPO for VC-backed companies, it is imperative to examine the IPO environment¹⁰⁸ in China, identify the major regulatory obstacles faced by VC-backed companies in the IPO process and propose solutions to them.

A. Main Board

The primary concern for venture capitalists in China is the merits-based regulatory

¹⁰³ Gilson, *supra* note 1 at 1093.

¹⁰⁴ Lin, *supra* note 4.

¹⁰⁵ *Ibid.* at 53.

¹⁰⁶ *Ibid.* at 46, 48-50.

¹⁰⁷ See Appendix 2. For instance, the launch and reform of the national-level NEEQ in 2014, as well as the initiation of the IPO reform in 2015 have increased the confidence of the venture capital market despite the crash of the stock market in the later part of 2015.

¹⁰⁸ Some of the problems on stock markets identified in this article have indeed persisted for a long time. See WANG Jiangyu, *Company Law in China: Regulation of Business Organizations in a Socialist Market Economy* (Edward Elgar, 2014), at 32-44, as well as Victor YEO, "China's Equity Markets: A Legal and Regulatory Perspective of Foreign Participation" (1995) 7 *Asian Business Law Review* 20 at 26-29, for earlier critiques of the Chinese stock market.

regime that sets up stringent financial requirements for would-be issuers.¹⁰⁹ Under the current merits-based system, share offerings are subject to tight administrative controls.¹¹⁰ The *Securities Law of the People's Republic of China* specifies certain substantive requirements (*shizhi yaojian*) for the public issuance of stocks: a company must have “sustainable profitability” (*chixuyingli nengli*) and be “financially sound”. It also needs to “meet other requirements as prescribed by the securities regulatory authority under the State Council and as approved by the State Council.”¹¹¹ In accordance with this statutory requirement, the Main Board has stipulated various requirements for an issuer, such as the minimum duration that an issuer must have conducted continuous business operations for, profitability levels, cash flow, and net asset ratios.¹¹² To be listed on the Main Board, a prospective issuer must have, within the past three accounting years:

- Either generated a cumulative cash flow exceeding RMB 50 million (approximately USD 7.5 million) or earned a cumulative business revenue exceeding RMB 300 million (approximately USD 45 million); and
- Reported profits with an aggregate amount exceeding RMB 30 million.

These requirements are extremely high for young entrepreneurial firms and thus represent formidable obstacles that prevent these firms from listing their shares on the Main Board.¹¹³

Moreover, under the merits-based regulatory system, the CSRC controls the listing process, which incontrovertibly increases inefficiency and time costs for IPOs. The whole listing process on China's Main Board usually takes an average of 1 to 3

¹⁰⁹ Interview with Ms. S, Vice President of Gaorong Capital, 29 October 2015; Mr. G, Vice President, Chengwei Capital, 11 November 2015 (on file with author).

¹¹⁰ For more on the merits-based system, see HUANG Hui, “The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis” (2011) 41(10) *Hong Kong Law Journal* 261.

¹¹¹ *Securities Law of the People's Republic of China [zhengquanfa]* (first promulgated on 29 December 1998, amended in 2005 and 2013) Article 13.

¹¹² See Appendix 1 for detailed requirements.

¹¹³ A recent survey also found that a major reason for the CSRC to object listings is the “sustainable profitability”: Tangxin and Weijun, “[*gupiaogongkai faxing zhuceshenhemoshi jiqijiejian: meiguo, xianggang, yu dalu*] IPO Module and Lessons from the U.S., Hong Kong and Mainland China”, *Tsinghua 21st Century Commercial Law Forum, Conference Proceeding* at 17.

years.¹¹⁴ This is considerably longer than the same process on the New York Stock Exchange (“NYSE”), which clocks an average of 12 to 16 weeks from start to finish,¹¹⁵ or the NASDAQ which only requires an average of 5 to 6 weeks for listing.¹¹⁶

Indeed, the listing process could be even longer if the CSRC suspends the IPO window altogether. In fact, from January 1994 to December 2015, the IPO window was suspended 9 times for a total of 52 months.¹¹⁷ This amounted to almost 20% of the 264 calendar months in that period. Consequently, many pre-IPO firms missed strategic IPO timings, a problem particularly acute considering how high-technology companies are often dependent on high growth and agility. Therefore, a number of firms in the Technology, Media & Telecommunications (“TMT”) industry have chosen to list their shares on overseas stock markets instead of the domestic ones. As of December 31, 2014, 168 Chinese enterprises with combined market capitalisation of RMB 3.99 trillion have chosen to list themselves in the US, including top IT giants Alibaba, Tencent, JD.com, Baidu, Sohu, and NetEase.¹¹⁸

Further, for a long period of time, stock pricing (especially in relation to the P/E ratio) in China had been strictly controlled by the CSRC.¹¹⁹ Although there have been improvements to the CSRC’s pricing control system over the years, the CSRC still indirectly controls the pricing of stocks. For instance, additional disclosure and approval requirements are required where the P/E ratio of the newly issued shares is

¹¹⁴ Shanghai Stock Exchange, “IPO Guide” [qiyegaizhishangshi shiwu] (2012), online: SSE Publications <<http://www.sse.com.cn/marketservices/listing/tobelisted/publication/a/20130112/53d1313c2d0450a0e94f4350be588c2a.pdf>> at 23.

¹¹⁵ KPMG, “New York Stock Exchange IPO Guide” (2010), online: KPMG Publications <<https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/kpmg-ipo-guide-july-2010.pdf>> at 34.

¹¹⁶ NASDAQ’s Initial Listing Guide - Nasdaq Listing Center, at 3.

¹¹⁷ See Table 3 in this article for the data for 2007-2014.

¹¹⁸ WU Xinchun and XING Mei, “[*Chengren Shuangceng Guquan Jiegou, Shiying Xinxing Gongsu Zhili Shijian*] Recognition of the Dual Class Structure in China”, (2015) 50 Shanghai Stock Exchange Research Report, online: Shanghai Stock Exchange Publications <http://www.sse.com.cn/researchpublications/research/c/c_20150902_3975141.pdf> at 12.

¹¹⁹ China Securities Regulatory Commission, “[*Woguo xingu dingjia he peishou zhidiyanjin*] The Evolution of China’s Share Pricing and Placement Regime” (2013), online: CSRC Publications <http://www.csrc.gov.cn/pub/newsite/ztl/xgftzgg/xgfbjcl/201307/t20130703_230248.html>.

25% higher than the industry average.¹²⁰ The assumption that industry averages exist and are instructive seems somewhat unrealistic for high-technology startups that typically market themselves as being in a class of their own, with unique and innovative products. Further, the CSRC may require the issuer and the underwriter to re-conduct a pricing enquiry or to re-submit an IPO application to the CSRC under certain circumstances,¹²¹ especially when they deem the price too high. Given these artificial controls on IPO pricing, the price of a stock may not objectively reflect the value of the company. In turn, such price distortions have undermined the market's ability to efficiently allocate capital.

In addition, unlike the US where a typical lock-up period usually lasts for 90 to 180 days,¹²² the IPO lock-up period under the SSE listing rules is 12 to 36 months.¹²³ According to Rule 4.1.5 of the SSE listing rules, the venture capitalists or the venture capital fund holding controlling stakes in the company are forbidden from selling any of their shares within 36 months after the company goes public. While an IPO lock-up period is arguably necessary to prevent the market from being flooded with a large number of shares that would depress the stock's price, the lock-up period under SSE listing rules is nonetheless too long and has created enormous obstacles impeding venture capitalists from disposing of their investments after the company goes public.

B. SME Board

In light of how difficult it has been for the SMEs to be listed on the Main Boards, the SME Board was launched on 17 May 2004 to provide a new financing channel for the SMEs in China.¹²⁴ However, in the ten years of the SME Board's operation, it has not proven to be a suitable exit channel for venture capitalists.¹²⁵ This could be attributed to one of its major drawbacks – stringent listing requirements are almost the same as those of the Main Boards. For example, the issuer must have reported profits in the

¹²⁰ Guiding Opinions on Further Reforming the Issue System of New Shares, [*guanyu jinyibu shenhua xingtu faxing tizhigaige de zhidao yijian*], Announcement No. 10 [2012] of the China Securities Regulatory Commission (promulgated on 28 April 2012), Article 3(2).

¹²¹ *Ibid.* Article 3.

¹²² See Rule 144 of the *Securities Act*, United States.

¹²³ *Listing Rules of Shanghai Stock Exchange 2013*, Rules 5.1.4 and 5.1.5.

¹²⁴ The listing of COSHIP Ltd Co. on the SME Board in 2006 was the first VC-backed exit on China's SME Board. See Shenzhen Capital Group Co., Ltd, "COSHIP, The result of Venture Capital", online: <<http://www.szvc.com.cn/mgdetail.aspx?id=4134>>.

¹²⁵ LAO Jiadi, "Why We Don't Like SME Board?" (2014) *China Economic Weekly*, Vol 23.

last three consecutive years; its net profits for the last three years cannot be less than RMB 30 million; the issuer must either have an overall cash flow exceeding RMB 50 million in aggregate or annual revenue exceeding RMB 300 million in the past three accounting years.¹²⁶ These stringent requirements would price out most VC-backed firms, given the nature of small portfolio startup companies as earlier described.

C. *ChiNext*

In a bid to build a multi-layered capital market by setting up a new secondary board in China, the “ChiNext” (a portmanteau of the phrase “China Next”, also known as the Growth Enterprise Board or *chuangyeban*), was officially launched on October 30, 2009 on the SZSE. ChiNext specifically aims to attract firms in the high-growth and high-tech sectors and meet pent-up demand from SMEs facing difficulties in securing financing. ChiNext provides more relaxed listing requirements compared to the Main Boards and the SME Board. For example, a company is only required to have a share capital of not less than RMB 30 million post-IPO, in contrast to the RMB 50 million requirement for the Main Boards and the SME Board. ChiNext’s profit requirements are also lower than the Main Boards and the SME Board.¹²⁷

The launch of ChiNext has indeed facilitated VC-backed exits. In the five-year span after ChiNext’s launch, 519 exits were made via ChiNext, with a market return of RMB 743.4 billion.¹²⁸ As of October 23, 2014, 519 companies that were backed by venture capital/private equity were listed on ChiNext.¹²⁹

Nonetheless, compared to NASDAQ, which is an important exit venue for high-tech firms in the US, the financial requirements of ChiNext are stricter and less flexible. The NASDAQ adopts 11 sets of standards for three different market tiers (i.e. NASDAQ Capital Market for firms with small market capitalisation, NASDAQ Global Market for those with medium market capitalisation and NASDAQ Global

¹²⁶ See Appendix 1, text accompanying note 230.

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

¹²⁹ See ZUO Yong Gang, “[*Chuangyeban Wunian, VC/PE Cheng Zuida Yingjia*] Five Year’s ChiNext: VC/PE is the Biggest Winner” (23 Oct 2014), online: [*Zhengquan Ribao*] Securities Daily <<http://finance.people.com.cn/stock/n/2014/1023/c67815-25891706.html>>.

Select Market for those with large market capitalisation). In contrast, ChiNext adopts only two standards for profitability, which are as follows:¹³⁰

1. Either:

- a. The issuer must have been profitable for the last two consecutive years, and
- b. The issuer's net profits in that period must have increased continuously, and
- c. The issuer's net profits in that period must have exceeded RMB 10 million;

2. Or:

- a. The issuer must have been profitable in the year immediately preceding; and
- b. The issuer's net profits in that period must have exceeded RMB 5 million.

In addition to the above requirements, the firm's revenue for the most recent year must have been over RMB 50 million and with a growth rate of at least 30% in the last two years.¹³¹

While a high financial standard is necessary for relatively young exchanges in order to reduce speculation and enhance investor protection, it is argued that the stringent listing requirements of ChiNext make it difficult for startups that have yet to be profitable to be listed on the ChiNext. In turn, the very purpose of setting up ChiNext – to facilitate equity financing for startup firms and to help upgrade China's economic model – is not met. As the listing requirements for ChiNext are similar to those for the SME Board, the role of the two boards are hardly distinguishable, and as a result, more traditional companies are listed on ChiNext, as opposed to the high-tech companies that were initially targeted. As of December 31, 2015, manufacturing companies accounted for 52.78% of all Shanghai registered companies listed on ChiNext whereas companies engaging in information, technology and software only

¹³⁰ See Appendix 1, text accompanying note 224.

¹³¹ Art 11 of the Administrative Measures for Initial Public Offerings and Listing on the Secondary Board [*shouci gongkai faxing gupiao bing zai chuangyeban shangshi guanli zhanxing banfa*] Zhengjianhui Ling No. 61 (2009).

constituted 38.89%, and companies involved in technology, research and service a mere 2.78%.¹³²

D. The Lack of a Dual-Class Share Structure

Dual-class share structures are typically characterised by one class of shares with only one vote per share (i.e., the common shares which are usually offered to public investors) and another class of shares with multiple votes per share (i.e., the superior class of shares that are usually issued to founders).¹³³ Dual-class share structures are commonly used in VC-backed firms when they seek listings as they enable entrepreneurs to maintain control of the firm even after listing.

Nevertheless, unlike in the US where dual-class share structures are permissible, companies incorporated in China are generally not allowed to offer shares with multiple voting rights and can only offer one class of shares – ordinary shares. The Chinese stock market has long been constrained by the “one share one vote” system.¹³⁴ Arguably, the lack of the dual-class share structure has led a sizeable and increasing number of Chinese enterprises to list on overseas stock exchanges instead. In the year of 2014, 11 out of 15 Chinese companies, including the two largest Chinese e-commerce companies Alibaba and JD.com, were listed on the NYSE and the NASDAQ, both of which adopt the dual-class structure.¹³⁵

With the overseas listing of these high-growth and high-potential companies, China’s stock markets have lost these IT giants as valuable potential applicants. This reduces the attractiveness of China’s domestic stock exchanges, as many domestic investors would miss out on the considerable investment returns that could be brought about by the rapid growth of these companies.

¹³² CSRC, “The Development of the Companies registered in Shanghai and Listed on ChiNext Venture Capital” (29 Jan 2016), online: CSRC Publications <http://www.csrc.gov.cn/pub/shanghai/gzdt/201601/t20160129_290496.htm>.

¹³³ D.C. ASHTON, “Revisiting Dual Class Stock” (1994) 68 *St. John’s Law Review* 4 863 at 866; Frank H. EASTERBROOK and Daniel R. FISCHER, “Voting in Corporate Law” (1983) 26 *Journal of Law and Economics* 395.

¹³⁴ The “one share, one vote” principle is specified under Article 126 of the *Companies Law of the People’s Republic of China*. In Chinese academia, there are arguments that while non-listed limited liability companies are theoretically not prevented from issuing dual-class shares, in practice, these companies are unable to issue dual-class shares.

¹³⁵ GAO Fei and ZHOU Linbin, “Dual-class Stock Structure and Investor Protection”, *Tsinghua 21st Century Commercial Law Conference Proceeding* at 22.

Meanwhile, with improving IT infrastructure, there are a considerable number of high-tech companies in China. For instance, the “Chinese Silicon Valley” – *Zhongguanchun* – birthed 49 startups daily in 2014.¹³⁶ With the expansion and urgent financing needs of these high-growth startups, there is demand from the founders of these firms for a dual-class share structure that would allow them to raise capital while still preserving controlling interests in their companies. Arguably, the adoption of a dual-class share structure in China would give domestic entrepreneurial firms greater flexibility in terms of capital structures and provide domestic investors with a wider range of investment opportunities.¹³⁷

VI. MAJOR STEPS TOWARD A BETTER EXIT ENVIRONMENT AND THE WAY FORWARD

Given the increasing demands from a large number of SMEs, startups and entrepreneurs, the CSRC has taken substantive steps to improve the regulatory environment of the stock market, particularly in creating a multi-layered capital market (*duocengci ziben shichang*) (see Figure 3). This part critically examines the major steps taken and their implications for the Chinese venture capital market. It also provides suggestions for future law reform.

Figure 3: China’s Multi-layered Capital Markets

¹³⁶ Edmond LOCOCO and Yuling YANG, “China’s Silicon Valley Sparking 49 Technology Startups a Day”, Bloomberg Business (11 Mar 2015), online: Bloomberg News <<http://www.bloomberg.com/news/articles/2015-03-11/china-s-silicon-valley-sparking-49-technology-startups-a-day>>, quoting Wan Gang, the Minister of Science and Technology in China, at a briefing for the National People’s Congress in Beijing: see China.org.cn, “[*keji buzhang wangang da jizhewen*] Science and Technology Minister Wan Gang answers reporters' questions” (30 May 2015), online: China Net <http://www.china.com.cn/zhibo/zhuantu/2015lianghui/2015-03/11/content_34996059.htm>.

¹³⁷ While the dual-class share structure is beneficial to entrepreneurial management, numerous problems could also arise from the use of this structure, such as the potential risk of corporate abuse by the management. Since listed companies in China typically have a concentrated shareholding structure, there could be a major corporate governance issue within such companies, which is the conflict between the controlling shareholder and the minority shareholders. The adoption of a dual-class share structure may exacerbate the conflict. The adoption of dual class stock in China is controversial and complicated. This issue will be discussed in another paper by this author.



A. The Launch and Expansion of the NEEQ

1. The Special Features of the NEEQ

The National Equities Exchange and Quotation (“NEEQ”) system, more commonly known as the New Third Board (*xinsanban*), is a national over-the-counter (“OTC”) market.¹³⁸ The NEEQ differs from the other Chinese stock exchanges in terms of the targeted companies, trading rules and eligible investors (see Appendix 1). In particular, the NEEQ is targeted at “innovation-oriented, entrepreneurial, and growing medium, small and micro-sized businesses (*zhongxiaowei qiye*)”,¹³⁹ instead of more mature companies like the other stock exchanges¹⁴⁰. Further, NEEQ has a much higher investor requirement – companies quoted on the NEEQ are unable to offer securities to the public, but only to specific qualified investors only.¹⁴¹

The NEEQ’s origins can be traced back to 2001 when the “Proxy Equities Exchange and Quotation system” (“PEEQ”, *guquan daiban zhuanrang xitong*) was set up to provide a platform for companies delisted from the main board as well as for former Securities Trading Automated Quotation (“STAQ”) and National Exchange and Trading System (“NET”) companies to transfer their equities. The PEEQ was called

¹³⁸ The NEEQ is administered by a special-purpose company that was registered in 2012 and has been operating since 16 January 2013.

¹³⁹ State Council, *The Decision of the State Council on Issues Relating to the National Equities Exchange and Quotations*, [guowuyuan guanyu quanguo zhongxiaowei qiye gufen zhuanrang xitong youguan wenti de jue ding] Guofa [2013] No. 49.

¹⁴⁰ See Appendix 1, text accompanying notes 223-225.

¹⁴¹ *Id.*

the “third” board because it was the third stock exchange when it was developed in 2001, after the Main Boards (the SSE and the SZSE) and the SME Board.¹⁴² It was named the “New Third Board” in 2006 as part of a trial OTC programme involving only a few high-tech enterprises in Beijing’s Zhongguancun Science Park. In 2012, the pilot programme was expanded to include the high-tech zones in Shanghai, Zhangjiang, Wuhan Donghu and Tianjin Binhai. In 2013, the pilot program was again expanded to cover all qualified companies nationwide and the NEEQ was officially launched.¹⁴³ A year later, the market maker mechanism¹⁴⁴ was introduced by the Regulations of the National Equities Exchange and Quotations on the Administration of Market Makers' Market-Making Business on 5 June 2014.

Arguably, the launch of the NEEQ moved China’s stock market a step closer to the market-oriented model. It has greatly facilitated financing for VC-backed companies (see Figure 4).

First, unlike the Main Boards, the SME Board and ChiNext, all of which employ the merits-based regulatory system (also known as the approval-based system) for IPOs (see Part III above), the NEEQ uses the filing system, in which board listings are not subject to CSRC approvals. Instead, it is for the NEEQ itself to approve the listings based on the application materials prepared and submitted by sponsors of the applicant companies.

Second, the relatively low listing requirements and shorter listing timeline have greatly expedited financing for small, high-growth Internet enterprises, especially companies that were hitherto unable to meet the listing standards of the Main Boards, the SME Board, or ChiNext.

As shown in Appendix 1, amongst all the stock markets in China, the NEEQ has the least stringent listing requirements. Listing on the NEEQ requires a company to have

¹⁴² National Equities Exchange and Quotations, “Investor Guide” (2013), online: NEEQ <<http://www.neeq.com.cn/detail?id=BB42DD8D58Z234CE60&type=2615638C58Z234CE60>>.

¹⁴³ State Council, *The Decision of the State Council on Issues Relating to the National Equities Exchange and Quotations*, (guowuyuan guanyu quanguo zhongxiao qiye gufen zhuanrang xitong youguan wenti de jue ding) Guofa [2013] No. 49.

¹⁴⁴ See infra text accompanying notes 151-153.

a valid existence for only two years, whereas the other three boards (the Main Boards, the SME Board, and ChiNext) require three years.¹⁴⁵ Meanwhile, unlike the other three boards that have minimum pre-IPO profit requirements, the NEEQ only requires a company to have “sustainable profitability” and does not prescribe detailed requirements.¹⁴⁶ Further, while the other boards have a minimum requirement of 200 shareholders, companies listed on the NEEQ may have less than 200. There is also no listing requirement pertaining to cash flow, net assets, or total share capital.¹⁴⁷ Finally, unlike listings on the Main Boards which usually take one year,¹⁴⁸ listings on the NEEQ only require an average of 6 months.¹⁴⁹

Third, companies listed on the NEEQ can seek financing through various means, including private placement of ordinary shares, private issuance of preference shares,¹⁵⁰ issuance of convertible debts, and privately-raised company bonds. These investment tools meet the particular needs of the various high-growth enterprises that constantly need urgent funding, and also prevent the problem of share dilution after IPO.

Fourth, unlike the Main Board, the SME Board and ChiNext, which mainly use the order-driven mechanism (*jingjia jiaoyi*), in which trades occur between buyers and sellers by bidding, the NEEQ runs on the market maker mechanism introduced in 2014. Companies listed on the NEEQ would appoint securities firms to act as market makers to “quote” buy or sell share prices,¹⁵¹ and so transactions are not concluded directly between buyers and sellers.¹⁵² The market maker has to meet certain trading requirements and bear various obligations in order to “make the market”. These include responding to quote requests within a set time limit and providing continuous

¹⁴⁵ See Appendix 1.

¹⁴⁶ *Ibid.*

¹⁴⁷ See CSRC, *Interim Measures for the Administration of National Equities Exchange and Quotations Co. Ltd* (*quanguo zhongxiao qiye gufen zhuanrang xitong youxianzerengongsi guanli zhanxing banfa*) (2013).

¹⁴⁸ *Supra* note 114.

¹⁴⁹ WANG Mingming, “Listing on the New Third Board Needs only 6 months” (7 September 2015), Chongqing Business.

¹⁵⁰ Preference shares are only permitted in a few eligible companies in China. See CSRC, *Administrative Measures on the Pilot Scheme for Preference Shares [youxiangu shidian guanli banfa]* Zhengjianhuiing No.97 (2014), which indicated the formal launch of the Chinese preference shares scheme for specific companies.

¹⁵¹ That is why companies listed on the NEEQ is also termed as “quoted companies” (*guapai gongsi*).

¹⁵² Market makers are employed by many leading stock markets such as the NASDAQ and the London Stock Exchange.

stock quotes within certain trading hours. Because of these features, the market maker has been empirically proven as an important intermediary that increases liquidity, price efficiency and price stability in stock markets.¹⁵³

With a series of positive laws and policies being promulgated to facilitate the development of the NEEQ, this Board has emerged as an attractive and important financing channel for small and medium-sized companies. It has also become a major exit channel for VC-backed companies.

The total funds raised on the NEEQ reached RMB 850 billion as of May 2015, an increase of 621% from slightly less than RMB 137 billion in the entirety of 2013.¹⁵⁴ In 2014 alone, trading volume on the NEEQ grew to 1.21 billion shares with a turnover value of RMB 6.67 billion.¹⁵⁵ As of 31 December 2015, 5129 companies have listed on the NEEQ, with trade volume reaching a new high at 102.363 billion shares. Also, total market capitalisation reached 2458.4 billion, setting new milestones both in terms of trading volume and turnover value (see Figures 5 and 6).¹⁵⁶

Figure 4: The Popularity of the NEEQ in 2015¹⁵⁷

¹⁵³ Michael GOLDSTEIN and Edward NELLING, “Market Making and Trading in Nasdaq Stocks” (1999) *The Financial Review* 34 at 27-44.

¹⁵⁴ Zero2IPO Research Centre, “Latest Data on New Third Board 2015” (15 June 2015), online: Pedaily <<http://research.pedaily.cn/201506/20150615384172.shtml>>.

¹⁵⁵ *Ibid.*

¹⁵⁶ National Equities Exchange and Quotations Market Information, online: Homepage of the New Third Board <<http://www.neeq.com.cn/index>> [hereinafter NEEQ market data].

¹⁵⁷ Zero2IPO Research Centre, “China’s Equity Investment Markets in 2015: A Full Year Recap and Outlook” (2016), online: Pedaily <<http://www.pedata.cn/free/1440998436829778.html>>. Note that the NEEQ listings should be distinguished from the traditional IPOs in that companies listed on the NEEQ may only offer shares via private placement and may not raise funds from the general public (see explanation above).

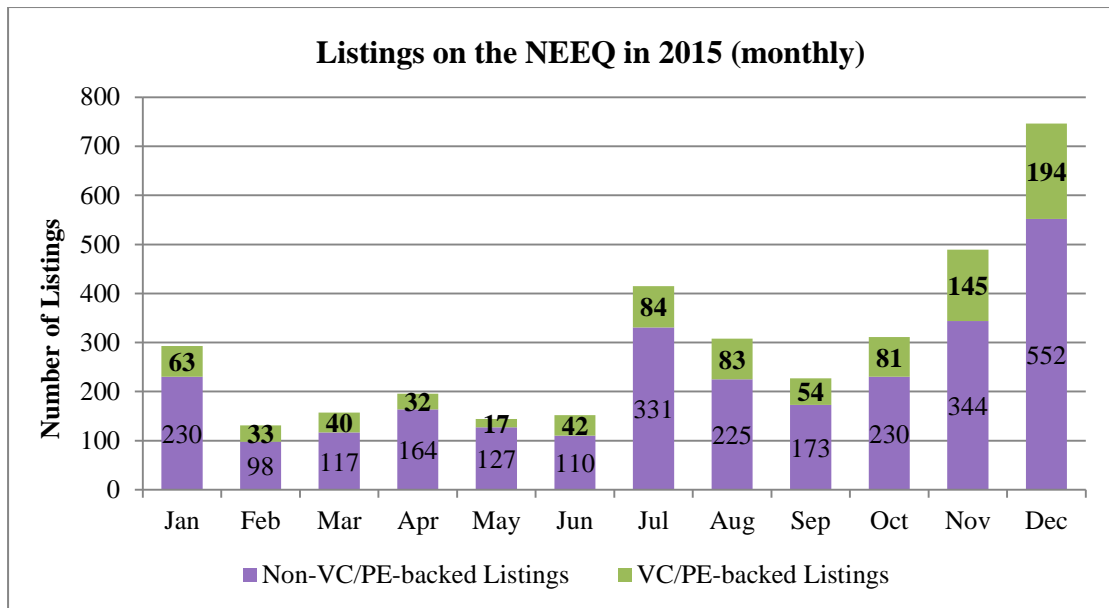


Figure 5: Comparative Growth in China’s Multi-Layered Capital Markets¹⁵⁸

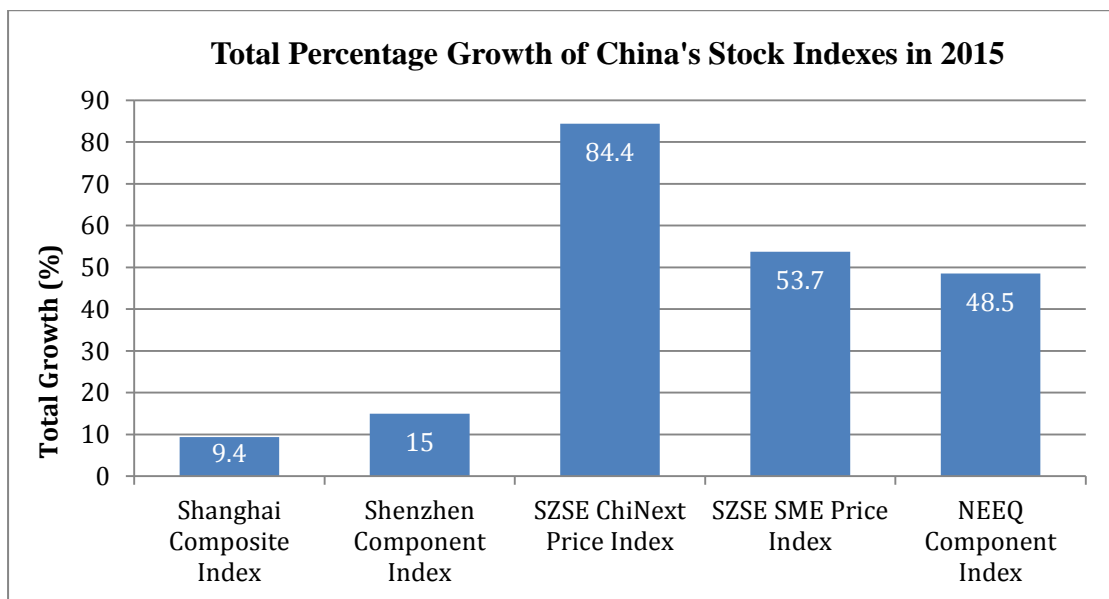
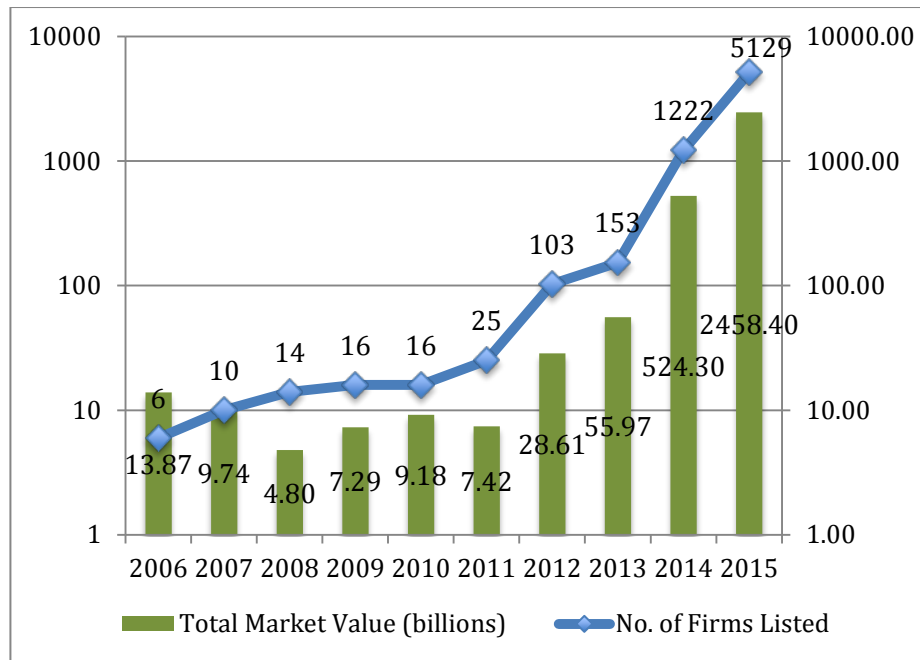


Figure 6: The Development of the NEEQ on a Logarithmic Scale 2012-2015¹⁵⁹

¹⁵⁸ *Ibid.*

¹⁵⁹ Zero2IPO Research Centre, “Statistical Analysis of the New Third Board in 2015” (2015), online: Pedaily <<http://en.pedaily.cn/Item.aspx?id=220359>>; and NEEQ market data, *supra* note 156.



2. Existing Problems and Possible Solutions

Nevertheless, as a new market, the NEEQ is not without its problems. One pervasive issue is the low liquidity of the market – 2816 out of 5074 listed companies on the NEEQ have not seen any share transactions via the Board as of December 29, 2015.¹⁶⁰ The NEEQ’s average daily turnover was only RMB 1457.461 million as of December 31, 2015,¹⁶¹ much less than that of the SZSE.¹⁶²

Arguably, the high investor threshold of the NEEQ has partially contributed to the low liquidity of the market. For institutional investors, only institutions with legal personality and a registered capital of more than RMB 5 million, or partnership enterprises with paid-up capital of more than RMB 5 million can trade on the market.¹⁶³ For individual investors, the admission standard also requires RMB 5 million in the securities account.¹⁶⁴ While a high investor threshold is ostensibly necessary given that the majority of companies listed on the NEEQ are high-risk

¹⁶⁰ NEEQ Market Data, *supra* note 156.

¹⁶¹ *Ibid.*

¹⁶² RMB 253.6547606 billion as of 31 December 2015. See Shanghai Stock Exchange Market Data, online: SSE <<http://www.sse.com.cn/market/index.shtml>>.

¹⁶³ See Appendix 1, text accompanying notes 234-236.

¹⁶⁴ *Ibid.*

companies,¹⁶⁵ such strict requirements are not found in the NASDAQ, which similarly hosts a number of high-risk VC-backed firms. Nevertheless, lowering the threshold may not be an effective solution to the problem of low liquidity. As the NEEQ was designed to facilitate financing for high-tech, high-growth SMEs and micro-sized startup firms, having a large portion of retail individual investors with little clue on how to properly invest in high-risk companies is likely to increase market volatility and market speculation. Therefore, instead of lowering the listing requirements, a better solution to address the issues of thin trading volumes and low market liquidity would be to encourage institutional investors, such as mutual funds, to participate more actively in the market.

The new stratification reform (*fenceng gaige*)¹⁶⁶ which was implemented in June 2016, is likely to improve market efficiency and liquidity of the NEEQ. The reform divides the NEEQ listed companies into two tiers - the Basic Tier (*Jichuceng*) and the Innovation Tier (*Chuangxinceng*). It also offers three different sets of listing and trading requirements to meet the varying needs of different companies.¹⁶⁷ Companies in the Innovation Tier have priority in using pilot schemes, such as new trading methods and financing methods. However, they are also subject to stricter supervision and disclosure requirements.¹⁶⁸ The two-tier system will likely help investors identify potential companies based on the different listing requirements of different tiers, and reduce investors' reliance on market makers for making investment decisions. It will also increase competition among the listed companies on the NEEQ and incentivise them to grow so as to be able to trade on the higher Innovation Tier, permitting them access to more sophisticated investors.

¹⁶⁵ Sina Finance, “[*Xinsanban buneng bizuo zhongguoban nasidake*] New Third Board Cannot be Taken as China’s NASDAQ” (28 July 2015), online: [*zhongguo jingji zhoukan*] China Economics Weekly <<http://finance.sina.com.cn/stock/xsbpl/20150728/003822804007.shtml>>.

¹⁶⁶ A consultation paper on multi-tier reform of the NEEQ was issued on 20 November 2015. The consultation paper is available at NEEQ homepage: <<http://www.neeq.com.cn/detail?id=147280F4E24ZE9B680&type=EE2A7CB24ZE9B680>>.

¹⁶⁷ The consultation paper is available at: <http://www.neeq.com.cn/neeq_rules/detail?id=13CCF504E07Z442A90&type=6F924CB11Z6B1E50>.

¹⁶⁸ *Ibid.*

Second, as the CSRC administers and controls the licensing of market makers, there are only 83 qualified market makers as of July 2015.¹⁶⁹ The market has come to be “monopolised” by a few market makers which in turn control the pricing of shares in NEEQ-listed companies.¹⁷⁰ Meanwhile, as the market maker is a new trading mechanism in China, there is still a lack of sophistication and experience with this new mechanism among qualified market makers.¹⁷¹

It is suggested that the CSRC should strengthen its supervision of market makers so as to prevent market manipulation, insider trading, and other economic crimes. One possible solution is to require market makers to disclose trading information in a timely manner. Moreover, more qualified market makers should be permitted to trade in the NEEQ. Arguably, the emerging unified national credit reporting system run by the People’s Bank of China should be integrated with the stock exchanges so as to encompass more enterprises and individuals within the market. Further, overseas markets such as the NASDAQ and London Stock Exchange operate mixed trading mechanisms which utilise both the market maker and order-driven models. It is suggested that the NEEQ may also consider introducing the order-driven mechanism to broaden the choice of trading mechanisms and prevent a monopoly by the existing market makers from taking hold.

Third, although the NEEQ is targeted at high-growth, high-technology companies, the lower listing requirements of the NEEQ have attracted a wide range of companies from various industries, with great differences in asset volume, profitability, and scale,¹⁷² including many low-quality companies which were unable to list on the Main Boards.¹⁷³ Overvaluation among these companies is also a problem faced by investors on the NEEQ.¹⁷⁴

¹⁶⁹ See Eastmoney, “[Xinsanban lidongxing chixu ‘shixue’, ‘zhuoshishang’ lianhe huyu gaige] New Third Board Liquidity Continues to ‘Bleed’, ‘Market Makers’ Jointly Call for Reform” (30 July 2015), online: Eastmoney Wealth Net <<http://stock.eastmoney.com/news>>.

¹⁷⁰ *Ibid.*

¹⁷¹ Interview with Ms. K, Global Law Firm, 29 October 2015 (on file with author).

¹⁷² National Equities Exchange and Quotations, “Information of Listed Companies” (2012), online: NEEQ <<http://www.neeq.com.cn/listingNew>>.

¹⁷³ JIA Hongyu, “Is the New Third Board a Blue Ocean or Refuse Dump?” (28 July 2015), online: [*Zhongguo guangbowang*] China National Report <<http://finance.china.com.cn/stock/xsb/sc/20150728/3256287.shtml>>.

¹⁷⁴ “The Listing Cost of Shell Companies on NEEQ is 2 million RMB while the Sale Price is 20 million RMB” (7 March, 2016), online: Changjiang times, <<http://www.changjiangtimes.com/2016/03/527845.html>>.

In order to protect investors' interests, to ensure the quality of the listed companies, and to match international best practices from exchanges such as the New York Stock Exchange and London Stock Exchange, a delisting mechanism should be introduced to force a poorly performing company to delist itself from the NEEQ if it fails to meet the listing requirements and corporate governance standards mandated by the NEEQ. The newly implemented stratification reform would also help to optimise the NEEQ and inform investors of the potential of the different listed companies.

In addition, unlike the Main Boards which impose a price limit of $\pm 5\%$ daily on poorly performing firms assigned the special treatment ("ST") status,¹⁷⁵ stocks listed on the NEEQ do not have daily price limits. As a result, some stocks may swing 300% to 400% in a day.¹⁷⁶ While regulatory price limits arguably work against free market efficiencies, introducing daily price limits may relieve the concerns that investors, especially long-term institutional investors, have about the volatility of the NEEQ.

B. Streamlining the IPO Process

1. The IPO Reforms

China's IPO regime has long been subject to tight administrative controls which are commonly blamed for distorting the capital market and encouraging official corruption.¹⁷⁷ Because of China's unique political and institutional infrastructure, its two stock exchanges (SSE and SZSE) are not state-independent and lack significant autonomous regulatory authorities.¹⁷⁸

¹⁷⁵ E.g. *Shenzhen Stock Exchange Trading Rules*, Rule 3.3.15; *Shanghai Stock Exchange Trading Rules*, Chapter 2 Rule 14.

¹⁷⁶ WANG Yinping, "[Xinsanban, Dangdai Zhongguo Ziben Shichang de Baofu Jihui] New Third Board-A New Opportunity for China's Capital Market" (23 June 2015), [*Huaxia Licai*] Huaxia Business.

¹⁷⁷ Benjamin L. LIEBMAN and Curtis MILHAUPT, "Reputational Sanctions in China's Securities Markets" (2008) 108 *Columbia Law Review* 929 at 931 and 939. (That Chinese main boards have long been blamed as underdeveloped and less functional because of weak investor protection, weak enforcement, inefficient pricing, accounting fraud, market manipulation, and poor disclosure.)

¹⁷⁸ *Ibid.* at 931-935. Since the two stock exchanges were established in 1990, the Chinese stock market has developed alongside economic reform and served specific political missions, such as the privatisation of state-owned enterprises ("SOE") and the stimulation of investment sentiment amongst the public.

Under the current merits-based regulatory system, many aspects of securities offering are heavily regulated, such as the pace of listing, the price of shares and the permitted industries, thereby significantly hampering the efficiency of the capital market as well as the operation of market forces. As mentioned above, due to difficulties with listing on China's stock market, many Chinese companies, especially high-growth and Internet companies, have chosen to turn to overseas capital markets for listing.

To address these issues, China's IPO system has undergone a series of reforms since the 1990s.¹⁷⁹ The first system implemented in China was a strictly-planned "Quota Management" system (*e du guanli*)¹⁸⁰ from 1993 to 1995, under which the issuer must first obtain share issue quotas from local governments or central ministries.¹⁸¹ The CSRC would review the approved stock issuance application and decide the volume, issuing price and other details of the shares to be issued.¹⁸²

From 1996 to 2000,¹⁸³ the IPO system transitioned into the "IPO Number Management" (*zhibiao guanli*) system. The CSRC would set a quota for the number of IPOs for relevant local authorities to adhere to.¹⁸⁴ These local bodies would then recommend pre-selected enterprises for listing, subject to review and approval by the CSRC and State Council Securities Committee ("SCSC").¹⁸⁵

¹⁷⁹ For more information on the evolution of IPO in China, see Huang Hui, *supra* note 110.

¹⁸⁰ On 25 Apr 1993, the State Council of the People's Republic of China issued *Provisional Regulations on the Administration of Share Issuance and Trading*, signaling the official establishment of the administrative approval system.

¹⁸¹ People's Governments of the province, autonomous regions, municipality directly under the Central Government or municipality listed separately under the State plan (collectively referred to as the "local governments").

¹⁸² China Securities and Regulatory Commission, "The Evolution of the Approval System of Securities Issuance in China" (3 July 2013), online: CSRC News Release <http://www.csrc.gov.cn/pub/newsite/ztl/xgftzgg/xgfbjcl/201307/t20130703_230251.html> [CSRC, *Evolution of Approval System*].

¹⁸³ In 1996, the State Council Securities Committee ("SCSC") published the *Opinions on Work Arrangement for the National Securities & Futures Market in 1996* (*guanyu 1996 nian quanguo zhengquan qihuo gongzuo anpai yijian*).

¹⁸⁴ CSRC, *Evolution of Approval System*, *supra* note 182.

¹⁸⁵ In 1999, the CSRC issued the *Circular on the Improvement of the Share Issuance Work* (*guanyu jinyibu wanshan gupiao faxing fangshi de tongzhi*), zhengjianfaxingzi [1999] No. 94, which implemented an additional administrative procedure that sought to examine the pre-selection materials for enterprises applying for an IPO. The CSRC would take over the role in pre-selecting enterprises recommended by the local governments or the departments in charge of central enterprises. This procedure in turn changed the simple old practice of local recommendations under the two-level administrative review system, and ushered in an examination mechanism prior to any formal selection.

In 2001, the “Channel System” (*tongdao zhi*) was established.¹⁸⁶ Each securities firm could only recommend a certain number of companies to apply for IPOs, with the quota to be obtained from the CSRC.¹⁸² Only when a recommended issuer was approved could the next recommendation be made. Therefore, under this system, the number of IPOs was still controlled. However, compared to the previous systems in which the issuers were administratively selected, underwriters were granted the right to recommend issuers and accordingly would bear the risks of an IPO’s success or failure to some extent.

From 2004 till now, the Sponsorship System has been used (*baojian zhi*),¹⁸⁷ under which certified sponsors may recommend companies for stock issuance and listing. Sponsors are required to instruct, assist, and guide companies on information disclosure, and to guarantee that all financial information provided in the IPO prospectus is true.¹⁸⁸ The Sponsorship System reinforces the responsibility and accountability of the sponsors,¹⁸⁹ though the rights of approval for IPO applications are still vested with the CSRC.

2015 saw a significant move in orienting China’s stock market towards market demands and deepening the IPO regulatory reform. On April 20, 2015, the draft bill of the *Securities Law of the People’s Republic of China* was published, which specified the new registration system for stock issuing and listing. On December 27, 2015, the Standing Committee of the National People’s Congress approved a proposal to revamp the IPO system (“the Proposal”), authorising the State Council to implement changes to the system in March 2016.¹⁹⁰

¹⁸⁶ On 17 March 2001, the CSRC announced the abolition of the administrative approval system for stock issuance and the official implementation of the channel system, which was characteristic of the qualification approval system for stock issuances. On 29 March 2001, the Securities Association of China offered detailed explanations for the “Channel System”.

¹⁸⁷ *Ibid.*

¹⁸⁸ *Ibid.*

¹⁸⁹ *Ibid.*

¹⁹⁰ CSRC, *Evolution of Approval System*, *supra* note 182. Further, in the *Opinions on Further Promoting the IPO System Reform*, (*zhengjianhui guanyu jinyibu tuijin xingu faxing tizhigaige de yijian*) *Zhengjianhui gonggai 2013 No. 42*, the CSRC announced that, under the registration-based IPO system, it would focus on the compliance review of the new listing candidates without assessing the profitability of the IPO companies. The timing of new share issuances and the question of how to issue shares will be determined by the market, in the hope that the valuations of new share offerings will better reflect market demand and supply.

The major feature and key objective of the new registration system is the shift away from an administrative regime, towards a market-driven one in allocating resources. Presently, IPO applications are subject to the CSRC's approval. Under the new system, however, financial intermediaries, instead of the CSRC, will be primarily responsible for the substantive verification of such applications.¹⁹¹

Under the registration system, the main role of the stock exchanges is to assess the “completeness, consistency, and intelligibility” (*qibeixing, yizhixing, kelijiexing*) of application materials submitted by issuers. The completeness requirement mainly refers to whether the contents, scope, and degree of the materials have satisfied the disclosure rules and provided necessary and sufficient information for investors to make informed decisions.¹⁹² The consistency requirement concerns the reasonableness of the operating conditions of the enterprise as disclosed, the logicity of financial statements articulated, and the level of corroboration by financial and non-financial data.¹⁹³ Finally, the intelligibility requirement requires that the language and expression of submitted materials be succinct and understandable.¹⁹⁴ Upon completing the review of the application materials, if the stock exchange deems the application acceptable, it will issue a favourable opinion and submit this, together with the application materials, to the CSRC for registration.¹⁹⁵ The CSRC will then validate the registration within a prescribed timeframe from the date of application, unless a dissenting opinion is issued by the stock exchange.¹⁹⁶

However, the proposed IPO registration system has not been implemented. It has not even been mentioned in the government work report of 2016.¹⁹⁷ As such, it is unclear when the new system will be implemented. Crucially, it is still an open question whether the new registration system can fundamentally rid itself of administrative interference in the capital market, given that the degree of administrative intervention

¹⁹¹ DU Qingqing, “[*zhucezhi hexinneirong shoudu gongkai: xizezhidingyijibenchengxing, quxiaofashenwei*] The Framework of the Registration System is Confirmed” (29 June 2015), First Financial Daily.

¹⁹² *Ibid.*

¹⁹³ *Ibid.*

¹⁹⁴ *Ibid.*

¹⁹⁵ *Ibid.*

¹⁹⁶ *Ibid.*

¹⁹⁷ The State Council of the People's Republic of China, Press Release, “China to push IPO registration reform gradually: CSRC” (12 March 2016), online: Xinhuanet <http://english.gov.cn/news/top_news/2016/03/12/content_281475306104406.htm>.

in China's capital market has always been prominent.

2. Suggestions to VC Backed-IPOs

First, it is submitted that the proposed IPO reform should be carried out to improve the regulatory environment of VC-backed IPOs. The shift from an administrative merits-based regulatory system to a registration-based one would greatly simplify the IPO process and substantially reduce transaction costs for VC backed-IPOs. Under the new system, entrepreneurial firms would not need to wait for months or years before they can raise capital. Neither would they need to worry about suspensions of the IPO process during periods when the market is weak. Thus, the shift would fundamentally eliminate the negative impacts caused by IPO suspensions. Reducing the CSRC's control over the IPO process would also solve the corruption and price distortion problems under the current merits-based system.

The shift would also likely impact Chinese venture capital firms' choice of portfolio companies and investment timings. Under the current system, the regulator rather than the market decides the price of an issuer's shares. Since the CSRC controls the IPO process, investors are likely to presume that a successfully listed company is financially strong and has high potential, having survived the tedious and burdensome approval process by the CSRC. This has partially contributed to the extremely high P/E ratios of companies on China's stock market.¹⁹⁸ Therefore, in the past few years, a number of venture capital firms which traditionally invested in early-stage startups changed their investment strategy to invest in pre-IPO, later-stage projects so as to get fast and high returns.¹⁹⁹ After the impending IPO system reform, the market will presumably play a more decisive role in capital allocation and price setting. The preference of venture capital funds for investing in pre-IPO projects is likely to diminish. Venture capital funds may shift back to investing in early-stage portfolio companies, as they traditionally did, thus providing more funding for nascent companies that are in greater need of financing to fuel their growth.

Second, existing listing rules and requirements must be revisited and revised. As discussed above, profitability is a major listing requirement of the Main Boards, the

¹⁹⁸ See text accompanying *supra* notes 62-64.

¹⁹⁹ ZHOU Ming, "The Investment Stage for Private Equity and Venture Capital was Extended" (17 March 2008), *China Securities Journal*.

SME Board and ChiNext. However, many entrepreneurial firms are young firms which lack the cash flow and profits that would enable them to meet the profitability requirement for listing. Also, it is not an international practice for secondary boards targeted at high-growth companies to have requirements pertaining to profitability or track record.

Since ChiNext was initially launched to encourage innovation and entrepreneurship by facilitating capital financing for high-tech and high-growth entrepreneurial firms, ChiNext should remove or reduce the profitability requirement in the listing rules and focus on the “growth” and “innovation” ability of the issuers instead. For example, ChiNext may consider following the approach adopted by the Hong Kong Growth Enterprise Board (“GEM”) which requires a listing applicant to “have a trading record of at least 2 full financial years with substantially the same management throughout the 2 years, and a continuity of ownership and control throughout the full financial year immediately preceding the issue of the listing document”.²⁰⁰ Moreover, the issuer is required to disclose in detail its past business track records and future business plans and innovation models, and make them the key components of the listing documents. The issuer is also required to publish quarterly accounts and make half-yearly comparisons of its business progress and innovation models with the business plan and models of the first 2 financial years.

Third, the role played by investment intermediaries in an IPO exit has been empirically documented.²⁰¹ The more reputable the investment banker, the less extreme the short-term underpricing of the issue.²⁰² Similarly, “the better the reputation of the firm’s accountants, the less extreme the underpricing.”²⁰³ In the context of China, it has been found that for non-state-owned enterprise issuers, the underwriter’s reputation is positively correlated with the issuer’s post-IPO performance, indicating that prestigious underwriters can incrementally improve the issuer’s post-IPO performance.²⁰⁴ Under the new registration-based IPO system, the

²⁰⁰ Hong Kong Stock Exchange, “Basic Listing Requirements for Equities” (8 Jan 2016), online: HKEX <https://www.hkex.com.hk/eng/listing/listreq_pro/listreq/equities.htm>.

²⁰¹ Cumming and MacIntosh, *supra* note 19 at 115.

²⁰² *Ibid.*

²⁰³ *Ibid.*

²⁰⁴ Chao CHEN, Haina SHI and Haoping XU, “Underwriter Reputation, Issuer Ownership, and Pre-IPO Earnings Management: Evidence from China” (2013) 42(3) *Financial Management* 647.

accountability and role of underwriters, lawyers and accounting firms will be increased, as the CSRC will not scrutinise the substantive aspects of the listing documents. Therefore, increasing the sophistication of financial intermediaries is crucial to the implementation of the IPO reform. Arguably, this can be achieved by (1) imposing criminal liability for any fraud or improper information disclosure during a listing, (2) appointing internal control experts to improve the internal control within underwriters, and (3) introducing a comprehensive credit rating system for the underwriters.

Fourth, an effective implementation of the new IPO system would also rely on the greater sophistication of investors in the Chinese stock market. One major feature of the Chinese stock market is the large proportion of retail investors.²⁰⁵ A survey conducted by the SZSE showed that in 2015, the average trading assets of the securities accounts of 84.4% investors were below RMB 50,000.²⁰⁶ As of September 2014, individual investors accounted for 64.4% of the total share capital of ChiNext, in contrast to the 35.6% held by institutional investors.²⁰⁷ The IPO initial return study found a positive correlation between heightened investor sentiments and the phenomenon of overvaluation.²⁰⁸ Many of these retail investors are more likely to speculate and be influenced by investor sentiments. Arguably, without greater participation from institutional investors and sophisticated investors, the Chinese stock market will continue to be very susceptible to shocks caused by retail investors who are less risk tolerant and who are more inclined to invest based on fear or greed rather than an analysis of a firm's actual worth.²⁰⁹

²⁰⁵ Shenzhen Stock Exchange Report, "2015 Report of Individual Investors" (18 March 2016), online: SZSE Main <<http://www.szse.cn/main/aboutus/bsyw/39759023.shtml>>.

²⁰⁶ *Ibid.*

²⁰⁷ Shenzhen Stock Exchange, "Five Year Anniversary of ChiNext- Composition of Investors and Investment Behavior Report 2014", cited in Liu Wei, "Shanghai Securities News" (30 October 2014), online: Peoplenet <<http://finance.people.com.cn/stock/n/2014/1030/c67815-25936954.html>>.

²⁰⁸ Shunlin SONG, Jinsong TAN and Yang YI, "IPO Initial returns in China: Underpricing or Overvaluation?" (2014) *China Journal of Accounting Research* 31 at 47.

²⁰⁹ Esther TEO, "China's Stock Market Casino and the Real Economy" (13 Jan 2016), online: The Straits Times <<http://www.straitstimes.com/opinion/chinas-stock-market-casino-and-the-real-economy>> (Last visited on April 17, 2016). Also see Nicolas C. HOWSON and Vikramaditya S. HANNA, "The Development of Modern Corporate Governance in China and India" in Muthucumaraswamy SORNARAJAH and Jiangyu WANG, *China, India and the International Economic Order*, ed., (Cambridge: Cambridge University Press, 2010) at 543 (noting that China's stock market has been unfavourably compared to a "casino").

Under the current system, as the supply of IPOs is artificially constrained by the CSRC, retail investors with little clue on how to properly invest will always be seeking the “next best thing” that is listed on the stock exchanges, driving up the share prices of newly listed companies. However, the proposed IPO registration system will be more objective and market-driven in terms of approval and pricing. Accordingly, with market forces playing a greater role, investors will increasingly need to make investment judgments themselves. Therefore, improving the sophistication of investors on the stock exchange is of crucial importance for the future IPO reform. This can be achieved by continuous investor education and relaxing the restrictions on institutional investors making equity investments.²¹⁰

Fifth, many auxiliary legal reforms and institutional improvements are needed to facilitate the implementation of the registration system, so as to effectively re-orient China’s stock market onto a market-driven track. As alluded to above, these include building and attracting more sophisticated investors, promulgating a well-designed delisting mechanism, and establishing a competent regulatory body with effective public enforcement. Additionally, given the large number of reported cases on corruption by CSRC officials in relation to IPOs,²¹¹ party and regulatory discipline should be enhanced.²¹²

VII. CONCLUSION

China provides an important and instructive case study to test the theory that stock markets and venture capital markets are closely linked. China’s experience offers

²¹⁰ Institutional investors such as the NSSF and insurance companies were prohibited from making equity investments due to past policy constraints. While relaxations have been made in recent years to allow institutional investors to made equity investments, many institutional investors are subject to restrictions on the investment ratio. For example, public pension funds are allowed to make investment in stocks, equity funds, and bond funds up to 30% of their investible assets only under Article 37(3) of the 2015 *State Council Guideline on Investment for the Pension Fund (guowuyuan guanyu yinfa jiben yanglao baoxian jijin touzi guanli banfa de tongzhi) guofa [2015] No. 48*. (promulgated on 17 August 2015).

²¹¹ Wang Shu, “How Does CSRC Reform to Solve the Problem of IPO Corruption” (26 April 2016) The Beijing News, online: <<http://www.bjnews.com.cn/news/2016/04/26/401393.html>>.

²¹² The Chinese Communist Party’s Central Commission for Discipline Inspection has been conducting investigation on CSRC officials for violations of discipline. Three officials from CSRC who was in charge of the approval of IPOs were investigated since 2015, including the Vice Chairman Yao Gang. See *ibid*.

interesting evidence of how legislative efforts in building a stock market can facilitate the mutual development of the venture capital market.²¹³

Preliminary empirical results presented above confirm the correlation between the stock market and venture capital market in China. This article also significantly extends the existing literature by finding that the regulatory environment driven by an efficient stock market has a significant impact on the venture capital market in China, particularly when it comes to venture capital availability. For example, favourable investment policies have typically been accompanied by observable increases in venture capital availability, while the IPO window closures heralded the exact opposite.

The article also shows that despite China's progress towards cultivating a favourable regulatory environment for VC-backed exits, there remain various institutional impediments within the stock market that hinder the development of the venture capital industry. Most importantly, it is difficult to foresee when and how the proposed IPO registration system will be implemented and, in light of the party-state system in China, whether this new system will successfully orient the stock market towards market forces rather than administrative control. It is likely that the unclear and grey areas of the IPO regulatory regime would be capitalised on by the CSRC to retain control (albeit in an indirect manner) on the issuance and pricing of shares in the IPO market. Ultimately, much has to be done before China's stock market can fully fulfil its role in allocating capital in the venture capital market and to strike a proper balance between government control and market autonomy. Given the IPO strategy's significant popularity as an exit channel, it is suggested that governments prioritise reform efforts towards creating a strong and sustained policy to improve the institutional structure and regulatory environment of the stock market, in order to facilitate VC-backed IPO exits and grow the venture capital industry.

On top of a robust stock market, an effective venture capital market also requires a wide range of complex institutions, including comprehensive contractual designs in addressing agency problems that arise in venture-capital contracting, a robust M&A

²¹³ See also Appendix 2 for a detailed list and explanation of key legal developments.

market, sophisticated financial intermediaries and reputable market intermediaries, strong investor protection and effective court enforcement. Further research must be done to analyse how a vibrant M&A market that facilitates VC-backed M&A exits may be developed.

Appendix 1: A Comparison of the Listing Requirements under
China's various Stock Markets

	NEEQ	ChiNext	Mainboard / SME Board
Listing requirements			
General requirements	The issuer must be a joint stock company that is not already listed and must either have (1) cumulatively more than 200 shareholders or (2) stock that can be publicly transferable. ²¹⁴	The issuer must be a joint stock company lawfully established and must have been in continuous operation for the last 3 years. ²¹⁵	The issuer must be a joint stock company established in compliance with the Companies Law of the PRC and other conditions prescribed by the securities regulatory authority. Documents such as the company's articles of association, the promoters' agreement, and the prospectus must be submitted to the securities regulatory authority. ²¹⁶

²¹⁴ Art 2, *Measures for the Supervision and Administration of Unlisted Public Companies (feishangshi gongsi jianli guanli banfa)* (2013 Revised).

²¹⁵ Art 11(1), *Administrative Measures for Initial Public Offering and Listing on ChiNext (shouci gongkai faxing gupiao bing zai chuangyeban shangshi guanli banfa)* (2009).

²¹⁶ Art 12, *Securities Law of the People's Republic of China [zhengquanfa]* (first promulgated on 29 December 1998, amended in 2005 and 2013).

Number of shareholders	The number of shareholders is not allowed to exceed 200. If it exceeds 200, the listing requires CSRC approval. ²¹⁷	Not less than 200 persons. ²¹⁸	Not less than 200 persons. ²¹⁹
Minimum duration of continuous business operations of the issuer	2 years. ²²⁰	3 years, unless approval is otherwise granted by the CSRC. ²²¹	3 years, unless approval is otherwise granted by the CSRC. ²²²
Profitability requirements	Sustainable profitability. ²²³	Either: (1) positive net profits for the last 2 consecutive fiscal years, with cumulative net profits not less than RMB 10 million, or (2) positive net profit for the last fiscal year, with annual revenue	Positive net profits for the last 3 consecutive fiscal years, with cumulative net profits for those 3 years not less than RMB 30 million. ²²⁵

²¹⁷ Decision III, *Decision of the State Council on Issues concerning the National Equities Exchange and Quotations* (guowuyuan guayu quanguo zhongxiaoqiye gufenzhuanrangxitong youguan wenti de jueding) (2013).

²¹⁸ Rule 5.1.1, *Rules Governing the Listing of Stocks on ChiNext* (2014 Revision).

²¹⁹ Art 10, *Securities Law of the PRC* states: “Issuing securities to more than 200 specific persons in aggregate or to unspecified objects will be deemed to be a public offering”.

²²⁰ Art 2.1, *National Equities Exchange and Quotations Share Transfer Business Rules* (quanguo zhongxiao qiye gufen zhuanrang xitong yewu guize) (2013 Revision) [NEEQ Share Transfer Business Rules]

²²¹ Art 11(1), *Administrative Measures for Initial Public Offering and Listing on ChiNext* (chuangye ban shouci gongkai faxing gupiao bing shangshi guanli banfa) (2009) [2009 Administrative Measures].

²²² Art 9, *Administrative Measures for Initial Public Offering and Listing of Shares* (shouci gongkai faxing gupiao bing shangshi guanli banfa) (2006) [2006 Administrative Measures].

²²³ NEEQ Share Transfer Business Rules, *supra* note 220.

		not less than RMB 50 million. ²²⁴	
Cash flow requirements	Nil.	Nil.	In the last 3 fiscal years, either: (1) cumulative net cash flow is not less than RMB 50 million, or (2) accumulated revenues are not less than RMB 300 million. ²²⁶
Net asset requirements	Nil.	At the end of the latest fiscal period, net assets must be greater than RMB 20 million and there must be no unrecovered losses. ²²⁷	At the end of the latest fiscal period, the proportion of intangible assets must not exceed 20% of net assets and there must be no unrecovered losses. ²²⁸
Minimum share capitalisation requirements	Nil.	RMB 30 million. ²²⁹	RMB 50 million. ²³⁰
Supervision of brokers	Continuous supervision. ²³¹	For IPOs and new listings, the period of	For IPOs and new listings, the period of

²²⁵ 2009 Administrative Measures, *supra* note 221, Art 33(1).

²²⁴ 2006 Administrative Measures, *supra* note 222, Art 11(2).

²²⁶ *Ibid.* Art 33(2).

²²⁷ 2009 Administrative Measures, *supra* note 221, Art 11(3).

²²⁸ 2006 Administrative Measures, *supra* note 222, Art 33(4)-(5).

²²⁹ 2009 Administrative Measures, *supra* note 221, Art 11(4).

²³⁰ Art 30, *Interim Provisions on the Management of the Issuing and Trading of Stocks (gupiaofaxing yu jiaoyi guanli zhanxing tiaoli)* (Issued by the State Council on April 22, 1993) No. 112.

²³¹ NEEQ Share Transfer Business Rules, *supra* note 220, Art 2.1.

	<p>supervision is the remainder of the current year and the following 3 full fiscal years.</p> <p>For an already listed company that issues new stocks or convertible corporate bonds, the period of supervision is the remainder of the current year and the following 2 full fiscal years.²³²</p>	<p>supervision is the remainder of the current year and the following 2 full fiscal years.</p> <p>For an already listed company that issues new stocks or convertible bonds, the period of supervision is the remainder of the current year as well as the following full fiscal year.²³³</p>
Investor requirements		
<p>Qualified investors, including: Institutional investors that are (1) corporate entities with a registered capital of RMB 5 million or more, or (2) partnership enterprises that have paid-in capital contributions of RMB 5 million or more;²³⁴ and</p> <p>Natural persons who (1) own securities that have a combined market value of more than RMB 5 million²³⁵, or (2) have more than 2</p>	<p>Legal persons, funds, individuals.²³⁷</p>	<p>Legal persons, funds, individuals.²³⁸</p>

²³² Art 36, *Administrative Measures for the Recommendation Business of the Issuance and Listing of Securities (zhengquan faxing shangshi baojian yewu guanli banfa)* (2009 Revision).

²³³ *Ibid.*

²³⁴ Art 3, *Detailed Rules of the National Equities Exchange and Quotations System on Management of Investor Fitness (quanguo zhongxiao qiye gufen zhuanrang xitong touzizhe shidangxing guanli xize)* (for Trial Implementation) (2013 Revision) [NEEQ 2013 Detailed Rules].

²³⁵ The 3 million requirement was increased to 5 million.

years of experience in securities investment, accounting, finance or other related professional backgrounds. ²³⁶		
Major Trading mechanisms		
Transfer by Agreement (<i>xieyizhuanrang</i>); Dealer/Market maker trading (<i>zuoshishang</i>).	Auction trading.	Auction trading.

²³⁷ Art 10, *Administrative Measures for Initial Public Offering and Listing on ChiNext (shoucigongkaifaxing gupiao bing zai chuangyeban shangshi guanli banfa)* (first promulgated on 1 May 2009, amended in 2014) (the latest version was issued on 14 May 2014 by the CSRC [2014] No. 99) read with *Implementation Measures for Assessing Investor Suitability for ChiNext on the Shenzhen Stock Exchange (Shenzhen zhengquan jiaoyisuo chuangyeban shichang touzizhe shidangxing guanli shishi banfa)* (promulgated on 1 July 2009) Shenzhengfa [2009] No. 17.

²³⁸ There are no express qualifications regarding setting up a securities trading account, but investors will not be considered professional investors unless they satisfy certain requirements specified in Art 10 of the *Guidelines for Securities Investors* (2013). For instance, investors who are natural persons will not be considered professional investors unless their financial assets exceed RMB 5 million and they have more than 2 years of relevant investment experience, with not less than 40 stock market transactions in the last 12 months.

²³⁶ NEEQ 2013 Detailed Rules, *supra* note 234, Art 5.

Appendix 2: Legal Developments in China's Stock Markets and their Implications for
the Venture Capital Market
1990-2015²³⁹

Dates	Law/policy	Implications for the VC market
December 1, 1990	Shanghai stock exchange was established.	First stock exchange in China.
December 19, 1990	Shenzhen stock exchange was established.	Second stock exchange in China.
December 28, 2003	<i>Interim Measures for the Stock Issuance and Listing Sponsorship System</i> was published, marking an official shift from a system under which IPO applications were recommended by a lead underwriter to a sponsorship system.	Established the sponsorship and sponsor accountability mechanism.
April 29, 2005	China Securities Regulatory Commission announced split share structure reform of the SOEs.	Increased market liquidity
May, 2005	The Small and Medium-sized ("SME") Board was launched in 2005.	Provided a new exit channel for SMEs
2006	Publication of related regulations such as the <i>Administrative Measures for the Issuance of</i>	New merits-based IPO system came into effect.

²³⁹ This table is not intended to be an exhaustive survey of all the legislations or policies issued since the launch of the Shanghai Stock Exchange and Shenzhen Stock Exchange in 1990. It only seeks to highlight the most important legal developments in relation to the development of the stock market and its implication for the venture capital market in China.

Dates	Law/policy	Implications for the VC market
	<i>Securities by Listed Companies</i> , ²⁴⁰ <i>Measures for the Administration of Initial Public Offering and Listing of Stocks</i> , ²⁴¹ and <i>Measures for the Administration of Securities Issuance and Underwriting</i> ²⁴² .	
December 31, 2006	<i>Equity Incentive Measures for the Administration of Listed Companies (Trial Implementation)</i> ²⁴³ was published.	Introduced the stock option system and provided that restricted shares and stock options were to be the main equity incentives used by listed companies.
September 8, 2006	<i>Provisions on the Merger or Acquisition of Domestic Enterprises by Foreign Investors</i> ²⁴⁴ was implemented.	Facilitated the exit of venture capitalists via M&A.
October 30, 2009	Launch of the Growth Enterprise Market (ChiNext) in Shenzhen.	Provided a new exit channel for venture capitalists.
March 2011	State Council issued the <i>Twelfth Five-Year Plan for National Economic and Social Development of the People's</i>	Decided to expand the pilot programme of the NEEQ and to accelerate the development of OTC market.

²⁴⁰ (*shangshigongsi zhengquan faxing guanli banfa*) Order of China Securities Regulatory Commission (No. 30) (first promulgated in 2006)

²⁴¹ (*shouci gongkai faxing bing shangshi guanli banfa*) Order of China Securities Regulatory Commission (No. 32) (first promulgated in 2006 and amended in 2016)

²⁴² (*zhengquan faxing yu chengxiao guanli banfa*) Order No.37 of China Securities Regulatory Commission (first promulgated in 2006 and amended in 2010)

²⁴³ (*shangshigongsi guquan jili guanli banfa*), China Securities Regulatory Commission, zhengjiangongsizi [2005] No. 151 (issued on 31 December 2005)

²⁴⁴ (*shangwubu guanyu waiguo touzizhe bingou jingnei qiye de guiding*) Order No. 6 [2009] of the Ministry of Commerce (issued on 22 June 2009)

Dates	Law/policy	Implications for the VC market
	<i>Republic China.</i>	
November 30, 2013	The State Council of China issued the <i>Guiding Opinions on the Pilot Launch of Preference Shares</i> ²⁴⁵ .	Allowed the use of preference shares in certain listed companies.
December 14, 2013	State Council issued the <i>Decision on Relative Issues of the National Equities Exchange and Quotations (The NEEQ)</i> .	Decided to expand the NEEQ nationwide.
December 27, 2013	CSRC issued the <i>Measures for the Supervision and Administration of Unlisted Public Companies</i> ²⁴⁶ .	Officially expanded the NEEQ to nationwide.
April 20, 2015	Draft Bill of the <i>Securities Law of People's Republic of China</i> was issued.	Specified the registration-based IPO system.
June 5, 2014	<i>Regulations of the National Equities Exchange and Quotations on the Administration of Market Makers' Market-Making Business</i> ²⁴⁷ was promulgated.	Market maker mechanism introduced on NEEQ.

²⁴⁵ (guowuyuan guanyu kaizhan youxiangu shidian de zhidao yijian) guofa [2013] No. 46.

²⁴⁶ (feishangshi gongzhong jiandu guanli banfa), zhengjianhuiling [2013] No. 85.

²⁴⁷ (quanguo zhongxiao qiye gufen zhuanrang xitong zuoshishang zuoshi yewu guanli guiding (shixing) Guzhuanxitonggonggao [2014] No.48.

Dates	Law/policy	Implications for the VC market
July 3, 2014	The NEEQ issued <i>Guidelines of the National Equities Exchange and Quotations Co. Ltd. for the Confirmation and Modification of Stock Transfer Method</i> ²⁴⁸ .	Application of market maker system in the NEEQ.
December 27, 2015	Announcement of the Implementation of the Registration system of IPO in 2016.	Fundamental change of the IPO system from merits-based to registration-based.
June 27, 2016	The NEEQ implemented the stratification reform and divided the NEEQ listed companies into two tiers - the Basic Tier (<i>Jichuceng</i>) and the Innovation Tier (<i>Chuangxinceng</i>).	Sought to improve market efficiency and liquidity of the NEEQ.

²⁴⁸ (*quanguo zhongxiao qiye gufen zhuanrang xitong gupiao zhuanrang fangshi queding ji biangeng zhiyin*), guzhuangxitonggonggao [2014] No. 62.