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Abstract

The U.S. venture capital market is the world's most developed and most successful venture capital market. Replicating the American experience in the creation of a venture capital market brings up the "simultaneity problem" as coined by Prof. Ronald Gilson – three central inputs must be simultaneously available: (1) capital with the appetite for high-risk high-return investments, (2) specialized investment vehicle which properly incentivize all participants in the venture capital market, and (3) entrepreneurs.

China is now the second largest country in venture capital investment, ranking only after the U.S. China offers a fascinating case study of engineering a national venture capital market. This article contributes to the existing literature by exploring the role of law and the government in building up the Chinese venture capital market, and shows that the Chinese government has played a major role in shaping the underpinning legal and regulatory infrastructure of the venture capital market. Based on empirical and comparative evidence, this article finds that the three-factor simultaneity problem has gradually been solved through legislative efforts in providing and encouraging venture capital funding, introducing new business vehicles, as well as encouraging entrepreneurship. The paper also examines the peculiar Chinese problems within each factor and suggests legal solutions to those problems. Several other determinants that have been important to China's venture capital experience are also discussed in this paper. Ultimately, this paper concludes that the Chinese government has made significant progress in engineering a venture capital market. This can be largely attributed to the evolution of the central government's role vis-à-vis the fund – from being a direct participant in the capital allocation process, to a facilitator that merely provides seed funding. Nonetheless, in order to realize the industry's full potential, there is still room for improvement in various social, legal, and economic areas.

Keywords: Venture Capital, Venture Capital Market, Development, China

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I. Introduction

Venture capital, which is the provision of financial capital to early-stage, high-potential and high-growth entrepreneurial enterprises and technology companies, has been widely recognized as a powerful engine for a nation's innovation, job creation, knowledge economy, and macroeconomic growth.[1] There is a sizable body of research literature emphasizing the significant role of the venture capital market in commercializing cutting-edge science and linking finance and innovation.[2]

The U.S. venture capital market is the world's most developed and most successful venture capital market. According to Ronald Gilson, a leading scholar in venture capital research, the U.S. experience tells us that the creation of a thriving venture capital market requires the "simultaneous availability" of three major factors, with the provision of any one being contingent on the availability of the other two: (1) entrepreneurs, (2) investors with the funds and the appetite for high-risk, high-return investments, and (3) a right vehicle which incentivizes all participants in the venture capital market, especially the venture capitalist and the entrepreneur.[3] In addition, there are various significant economic, institutional, fiscal and legal factors that help a national venture capital market to flourish,[4] such as economic growth, liberal bankruptcy laws,[5] tax incentives that accommodate the establishment of venture capital funds,[6] an investor-friendly environment,[7] and a culture of entrepreneurship[8]. In particular, theory and empirical evidence also finds a strong link between the size and liquidity of a nation's stock market and the development of its venture capital market.[9] Black and Gilson argue that the vibrancy of the

[1] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience* 55 STAN. L. REV. 1067, 1068 (2003). See generally on the importance of venture capital, Da Rin, Marco and Hege, Ulrich and Llobet, Gerard and Walz, Uwe, The Law and Finance of Venture Capital Financing in Europe: Findings from the RICAFE Research Project. European Business Organization Law Review (EBOR), Vol. 7, 2006; Brigitte Haar, European Business Organization Law Review/2004 - Volume 5/Issue 1, 1 March/Articles/Impressions of the First RICAFE Conference: Risk Capital and the Financing of European Innovative Firms - European Business Organization Law Review (2004) 5: 201-205.
[2] *Id.* at 1068.
[3] *Id.* at 1093.
[4] Armour, John and Cumming, Douglas J., The Legislative Road to Silicon Valley. Oxford Economic Papers, Vol. 58, pp. 596-635, 2006. Available at SSRN: http://ssrn.com/abstract=473593 at 598-599.
[5] *Id* (arguing that a more liberal personal bankruptcy law stimulate demand for venture capital finance) However, there is no personal bankruptcy law in China, so this article will not address this issue in the context of China.
[6] Christian.Keuschnigg, "Start-ups, Venture Capitalists, and the Capital Gains Tax", (jointly with Soren Bo Nielsen), Journal of Public Economics 88, 2004, 1011-1042; Christian.Keuschnigg "Tax Policy, Venture Capital, and Entrepreneurship", (jointly with Soren Bo Nielsen), Journal of Public Economics 87, 2003, 175-203.
[7] EVCA (European Venture Capital Association) (2006) Benchmarking European Tax and Legal Environments, EVCA, Zaventum; Cited in Armour, *supra* note 4, at 600.
[8] Marc-Oliver Fiedler and Thomas Hellmann, "Against All Odds: The Late but Rapid Development of the German Venture Capital Industry". The Journal of Private Equity (2001), at 37(noting the importance of culture in general venture capital market).
[9] Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, 11 JOURNAL OF APPLIED CORPORATE FINANCE 36 (1999); Edward B. Rock, *Greenhorns, Yankees and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and US Markets*, 2 THEORETICAL INQUIRIES IN LAW 711 (2001); Gompers, P.A. and

venture capital market is dependent on the presence of an active stock market through which the venture capitalist can exit from a successful portfolio company via an initial public offering ("IPO").[10]

Duplicating American success in creating a strong venture capital market is a significant challenge for China, being a developing economy with an underdeveloped equity market. However, this is not an unreachable dream. After nearly three decades of development, China is now the country receiving the second greatest amount of venture capital investment in the world, ranking only after the U.S.[11] As Ernst & Young notes, China had the highest rate of growth in median deal value and also recorded the highest median value across all markets in 2014.[12] Additionally, China had the second most number of mega investments (more than USD 50 million) globally after the U.S.[13] In 2014 alone, 258 new venture capital funds were set up in China to raise USD 19 billion worth of fresh capital for investment, surging 174.9% from the previous year, according to consultancy Zero2IPO Group.[14] Further, 444 venture capital exits were achieved in 2014,[15] with exits via IPO raising USD 7.1 billion and exits via mergers & acquisitions ("M&A") raising USD 6.5 billion.[16] Billions have been injected into various vital and emerging industries, in particular the Technology, Media and Telecommunications ("TMT") segment.[17] These figures underline the significance of the Chinese venture capital market and its influence on the economy. In general, China's rapid economic and technological development, deepening financial reforms, and improving regulatory environment have largely been attributed to the venture capital boom.

Lerner, J. (2001) The venture capital revolution, Journal of Economic Perspectives, 15, 145-68. Mayer, C., Schoors, K., and Yafeh, Y (2005) Sources of funds and investment activities of venture capital funds: evidence from Germany, Israel, Japan and the UK, Journal of Corporate Finance, 11, 586-608; Armour and Cumming, *supra* note 4.

[10] Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, 11 JOURNAL OF APPLIED CORPORATE FINANCE 36 (1999).

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

[12] Ernst & Young, *2014 Venture Capital Review* (2015) at 2, a*vailable at* http://www.ey.com/Publication/vwLUAssets/ey-2014-venture-capital-review/$FILE/EY-2014-venture-capital-review-1.pdf.

[13] *Id.,* at 3.

[14] Zero2IPO Research Center, *Venture Capital Annual Report 2012*, Zero2IPO Publisher (2015). Compared to the U.S., which has over 50 years of experience in venture capital investment since the 1960s, China has a much shorter history in this sector. The beginning of venture capital in China can be traced back to 1985.

[15] Zero2IPO Research Center, *Zhongguo Guquan Touzi Shichang 2014 Nian Quannian Huigu* [*China Private Equity Market 2014 Annual Review*], (2015) at 24.

[16] *See* Ernst & Young, *upra* /note 12, at 2.

[17] Steve Blank, *Zhongguancun in Beijing – China's Silicon Valley (Part 4 of 5)* (Apr 13, 2013), http:/steveblank.com/2013/04/13/zhongguancun-in-beijing-chinas-silicon-valley-part-4-of-5/.

There already exists extensive literature discussing the impact of government intervention in the development of entrepreneurial and venture capital activity,[18] as well as the legal infrastructure and contractual designs that are used to address the agency problem within the venture capital cycle.[19] However, the role of law and governmental efforts in creating the venture capital market in China, the characteristics of the Chinese venture capital market, and the peculiar legal problems within the venture capital cycle In China remain largely unexplored. This paper seeks to fill the literature gap by examining how China has created a venture capital market, particularly the legislative efforts made in providing capital, creating specialized investment vehicles and promoting entrepreneurship, as well as developing an active stock market. This paper hopes to contribute to a deeper understanding of the legal and institutional determinants of a viable venture capital industry from comparative and empirical perspectives. Findings of this article would provide guidance in constructing a rough template for government efforts in engineering a venture capital market and will be of interest to policymakers, as a number of jurisdictions such as Israel, Taiwan and Singapore have explicitly sought to develop a national venture capital market and some have recently implemented initiatives in line with this goal.

The primarily comparative approach this article adopts will involve juxtaposing the two largest venture capital markets in the world – that of the U.S. and China. The reasons for choosing the U.S. are twofold. Firstly, the U.S. is the origin of venture capital and the most successful venture capital market in the world. Secondly, the U.S. has extensive legislative and judicial experience with the limited partnership, which has been a common business vehicle in the U.S. venture capital market since the 1970s[20], and has also been the source of inspiration for the introduction of Chinese limited partnership model. As such, reference will be made to the U.S. in discussing the laws and practices regarding venture capital in China.[21]

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[18] Josh Lerner, *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed--and What to Do About It* (Princeton University Press, 2009).

[19] *See generally* Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete*, 74 N. Y. U. L. REV. 575 (1999); Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 H. L. REV. 874 (2003); Ronald J. Gilson, *Engineering Venture Capital Markets: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003); Ronald J. Gilson & Bernard S. Black, *Does Venture Capital Require an Active Stock Market?* 11 JOURNAL OF APPLIED CORPORATE FINANCE 37 (1999); Ronald J. Gilson & Bernard S. Black, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 JOURNAL OF FINANCIAL ECONOMICS 243 (1998); James A. Brander, Qianqian Du & Thomas Hellmann, *The Effects of Government-Sponsored Venture Capital: International Evidence*, REVIEW OF FINANCE (2014), *available at* http://strategy.sauder.ubc.ca/hellmann/pdfs/BranderDuHellmannRoF2014.pdf.

[20] Paul Gompers and Josh Lerner, *The Venture Capital Cycle*, 10 (MIT Press, 2004).

[21] The empirical study consists of three parts. Part A is a study on a sample of fifty venture capital limited partnership agreements. Each agreement in the dataset will be read and analyzed according to the research questions. These agreements are obtained from leading Chinese law firms specialized in venture capital investment, i.e. Beijing Fangda Law Firm, Beijing Global Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm and Shenzhen Huashang Law Firm. Part B is the author's personal interviews with persons who participate in the Chinese venture capital market. This consists primarily of venture capitalists, counsel, and investors from twenty venture capital funds. The interviewees come from the six cities that are the major places

The remaining parts of the paper are as follows: Part II will give an overview of China's venture capital market. It will discuss the development of the venture capital industry in China, the evolving role of the government in this process, as well as China's legislative framework governing venture capital. Governmental efforts in nurturing entrepreneurship and fostering a culture of innovation will also be discussed. Part III will examine specifically the Chinese experience by focusing on three areas: first, legislative efforts in providing venture capital funding; second, the introduction of the limited partnership as a specialized investment vehicle; and third, the creation of a stock market. It will also point out salient issues and suggest improvements that can inspire further growth and progress of venture capital in China. Part IV returns to the theoretical basis of the paper and explores other economic, institutional and legal determinants of a viable venture capital market in an emerging economy like China. Part V will conclude that the Chinese government's progress in engineering a venture capital market has been relatively positive. This can be largely attributed to the evolution of the government's role from being a direct participant in the capital allocation process to that of a facilitator by through the provision of seed funding. However, in order to fully realize its potential, there still several key areas that can be improved on.

II. The Chinese Venture Capital Market

A. The Need of Venture Capital in China

The importance of innovation to economic growth, and the role that young firms, particularly those backed by venture capital, play in stimulating innovation is widely accepted by governments around the world.[22] Innovation is clearly on the agenda of the Chinese central government, which has increasingly come to appreciate the importance of developing knowledge-based economies as a prerequisite to competitiveness and sustainable growth. Apart from this, there are several other factors that demonstrate the importance of venture capital to China's economic development.

1. Addressing unemployment, reducing inequality and re-charting China's development

Firstly, it is widely recognized that technological innovation is a catalyst for economic growth and by extension, venture capital, which is crucial stimulating innovation, is extremely important for economic development.[23] Venture capitalists and firms

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which attract private equity investment in China, i.e. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, and Guangzhou. Part C comprises the study of data and reports published by a leading service provider and investment institution in China's venture capital industry, *zero2ipo*, as well as the *China Venture Capital Yearbooks* published by China Venture Capital Research Institution.

[22] See Lerner, *supra* note 18 at 63-64.

[23] *Id.,* at 9.

have developed tools that are well suited to the challenging task of nurturing promising new ideas that are high-risk but at the same time potentially high-reward.[24] Developing the venture capital industry is a way to shift traditional growth patterns characterized by high input and low output, to innovation-driven development. China has traditionally been economically dependent on the manufacturing and real estate sectors. However, these industries are weakening. China's Gross Domestic Product (GDP) has fallen from 10.4% in 2010 to 7.4% in 2014.[25] It is thus imperative for the central government to foster the development of high-technology industries and knowledge intensive sectors to rejuvenate China's economy.

Secondly, fostering entrepreneurship and innovation at national level would help to promote employment, productivity and sustainable growth of the nation. With a population of 1.3 billion and a labor force of 900 million, China is facing pressure to address an increasingly significant unemployment issue.[26] Millions of college graduates are facing employment pressure,[27] along with many rural migrant workers formed during the transfer of surplus rural labor force from rural places to urban places, low-skilled urban residents who have difficulty finding jobs, and decommissioned military personnel.[28] A promising method to utilize this valuable human capital is to foster entrepreneurship and provide the entrepreneurs with access to venture capital financing.

Thirdly, although China's GDP grew consistently over the past decades, the Gini Index has reflected a sharp increase in income inequality over the last two decades, ranging between 0.47 and 0.49 over the last decade, higher than the warning line of increased risk of social unrest.[29] This increasing income inequality has put further pressure on the central government to reduce inequality and maintain social stability. Indeed, in order to promote income redistribution, the central government is actively promoting entrepreneurship-driven employment, addressing unemployment in a targeted manner, as well as strengthening fair employment, entrepreneurship services and vocational training.

2. Satisfying Demand for Capital

On the demand side, high-tech startup firms are major sources of innovation and knowledge economy of a nation. However, for a long period of time, the growth of

[24] *Id.*
[25] World Bank, GDP Growth Rate(%), http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG
[26] State Council, *Guowuyuan guanyu dali tuijin dazhong chuangye chuangxin. Ruogan zhengce cuoshi de yijian* (Jun 16, 2015) http://www.gov.cn/zhengce/content/2015-06/16/content_9855.htm
[27] Report on the Work of the Government (2015) [Guowuyuan Zhengfu Gongzuo Baogao].
[28] State Council, *supra* note 26. For instance, the number of college graduates will reach 7.49 million, a record high in 2015.
[29] Statista, *Gini index: inequality of income distribution in China from 2004 to 2014* (2015) http://www.statista.com/statistics/250400/inequality-of-income-distribution-in-china-based-on-the-gini-index/

these start-ups was constrained because of capital restrictions. Due to China's planned economy and public ownership structure, its capital markets have long been unable to serve as a viable channel for equity financing for companies, especially small ones. China's corporate sector was thus largely dependent on debt financing from banks. While large state-owned companies are able to receive low-interest loans from Chinese state-owned banks in part due to administrative influence from the central or local governments,[30] small and private companies receive no such help and thus face enormous difficulties in securing bank loans due to insufficient collateral. This problem of securing debt financing is exacerbated in the case of startups, which generally do not have any assets that can be used as collateral. This inadvertently contributed to a high demand for venture capital, as the only viable financing alternative for high-tech and high-growth start-ups. This demand is nicely complemented by the venture capitalists' taste in high-risk high-return investments and their ability to provide access to industrial connections and managerial skills. Consequently, venture capital has played an instrumental role in funding the rapid expansion plans of these companies, most of which require extraordinary large up-front investments.[31] Empirical findings also confirm that equity financing in the form of venture capital, instead of debt financing, is predominant in high-tech industries.[32]

Further, in recent times, Chinese innovation and IT infrastructure have greatly improved, resulting in a rapid growth of internet and high-tech companies. This is largely due to the launch of various state programs promoting science and technology, such as the 985 Program[33] and the Torch Program in 1980s (which aims to "improve China's competitiveness in science and technology in the 21st century").[34] These developments appear to have produced tangible results. In Beijing's Zhongguancun district, the so-called "Chinese Silicon Valley", 49 start-ups were birthed daily in 2014.[35] As of March 2015, the tech startup industry in China had more than 1,600 technology incubators supporting more than 80,000 startups,

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[30] Lan Yuping, Fengxian Touzi ke Youxiao Jiejue Zhongxiao Qiye Rongzi Nan [*Venture Capital can Effectively Solve the Problem of Capital Financing of Small and Medium Enterprises*] (Sep 17, 2010), http://finance.sina.com.cn/leadership/mroll/20100917/00108671397.shtml.

[31] Marc-Oliver Fiedler and Thomas Hellmann, "Against All Odds: The Late but Rapid Development of the German Venture Capital Industry". The Journal of Private Equity (2001), at 37(noting the importance of culture in general venture capital market).

[32] Freear, J., and Wetzel, W. E. "Who Bankrolls High-Tech Entrepreneurs?, Journal of Business Venturing, 5, 77-89; Carpenter,R., and Petersen,B. (2002), Capital Market Imperfections, high-tech investment, and new equity financing, Economic Journal, 112, F54-72; Cited in Armour, John and Cumming, Douglas J., *supra* note 4, at 598.

[33] The Project 985 is a project aiming to promote the development and reputation of the Chinese higher education system by founding world-class universities in the 21st century.

[34] The Torch Program was launched in 1988 aiming to promote the high-technology industry.

[35] Edmond Lococo & Yuling Yang, *China's Silicon Valley Sparking 49 Technology Startups a Day*, BLOOMBERG BUSINESS, Mar. 11, 2015, *available at* http://www.bloomberg.com/news/articles/2015-03-11/china-s-silicon-valley-sparking-49-technology-startups-a-day, quoting Wan Gang, China's Minister of Science and Technology 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*], http://www.china.com.cn/zhibo/zhuanti/2015lianghui/2015-03/11/content_34996059.htm (last visited May 30, 2015) [hereinafter *Wan Gang*].

115 university technological centres, creating more than 1.7 million jobs.[36] China now has 1,000 organizations investing in start-ups with capital exceeding 350 billion RMB (USD 56 billion).[37] New ventures have enabled a surge in technological innovation in China. In 2014, China saw 660,000 effective invention patents, 12% more than the previous year.[38] Indeed, the importance of venture capital in China is further exemplified by the fact that many of today's Chinese internet giants that assume macroeconomic significance in China's economy, such as Sina,[39] Sohu[40] and Alibaba[41] had received venture capital backing in their early days. This has substantally increased the demand for venture capital in the high-tech industry.

Lastly, the number of businesses and registered companies have been increasing, particularly after the process of starting a business was streamlined in 2014 after the enactment of the revised PRC Companies Act. In the first quarter of 2015, 844,000 new companies were registered, a 38.4% rise from the same period last year.[42] This healthy economic environment and expanding domestic market is translating into stronger consumerism, thereby facilitating the development of small businesses and in turn increasing the need of venture capital.

3. Meeting the Supply of Investors and Entrepreneurs

On the supply side, the number of high-net-worth individuals and families is increasing, generating large amounts of available capital in China. China currently has the second-highest number of high-net-worth individuals in Asia at about 1.3 million, holding a combined wealth of USD 4.3 trillion.[43] The increased economic prosperity and the recent venture capital boom have helped to attract investors into the high-growth segment. Moreover, the government has taken a more liberal approach and broadened the scope of eligible investors in the domestic venture capital market. More foreign investors are now permitted to make equity investments in China in view of the various foreign investment programs being launched.[44] At the same time, institutional investors have been gradually allowed to make equity investments in recent years as well.[45] In view of these developments,

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[36] As noted by Wan Gang, China's Minister of Science and Technology at a briefing for the National People's Congress in Beijing. *See* Wan Gang*, id.*
[37] *Id*.
[38] *Id*.
[39] Sina is a Chinese online media company for Chinese communities.
[40] Sohu is a Chinese Internet company.
[41] Alibaba is a Chinese e-commerce company that provides consumer-to-consumer, business-to-consumer and business-to-business sales services via web portals.
[42] Xinhua News, *New policies encourage entrepreneurship, boost employment* (Apr 22, 2015), http://www.chinadaily.com.cn/china/2015-04/22/content_20510974.htm.
[43] Capgemini & RBC Wealth Management, *16th Annual World Wealth Report 2012* (2012), *available at* https://www.capgemini.com/resource-file-access/resource/pdf/The_16th_Annual_World_Wealth_Report_2012.pdf.
[44] *See* infra text accompanying note 165 to 166.
[45] *Id.*

there is a large supply of capital ready to be harnessed for the venture capital industry.

Additionally, a new generation of entrepreneurs – the "post-90s" generation of entrepreneurs (those born in the 1990s), has emerged in China. As "bold digital natives" brought up in the founding era of domestic Internet giants such as Tencent and Alibaba,[46] they tend to be young and unafraid of failure. It is reported that 2.3% of university graduates of 2013 have chosen to start businesses. This figure was higher among graduates from high schools and polytechnics, with 3.3% choosing to be entrepreneurs.[47] Such an interest in venture capital among young entrepreneurs is being further encouraged by the State Council's guidelines on "Mass Entrepreneurship and Innovation" (*dazhong chuangye, wanzhong chuangxin*).[48] This has resulted in a ready supply of potential entrepreneurs.

The Chinese venture capital market has also benefited greatly from the large number of overseas returnees ("*haigui*") who contribute with their technologies, expertise, valuable overseas resources and personal connections. As of 2014, the number of overseas returnees has reached 1.8 million, accounting for 51.4% of China's total overseas graduates.[49] The number of overseas returnees has also increased consistently in recent years – the number of returnees in 2014 is 3.2% more than the number in 2013, and almost 10% more than in 2012.[50] In an interview conducted with 913 overseas returnees, 78.4% of whom had returned after 2010,[51] more than half of them expressed that their decision to return to China was largely based on the attractive entrepreneurial environment and the great potential of domestic markets,[52] reflecting the positive effect of government policies in encouraging entrepreneurship and innovation.

In short, China's need for sustainable economic development has resulted in a greater emphasis on innovation and IT infrastructure, a huge increase in investors with excess capital who are eager to invest, and a new generation of entrepreneurs. This mix of factors reflect a strong demand for high-risk high return investments, an increasing supply of entrepreneurs, resulting in an increased number of small businesses. All these exemplify the need for venture capital, making it evident that the creation of a viable and vibrant platform for the venture capital industry is crucial to the future development of China.

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46 China Daily, *China's Post-90s Entrepreneurs*, http://www.chinadaily.com.cn/china/entrepreneursinchina/.
47 Chen Zhengfei, *Post-90s Entrepreneurs*, http://www.juece.net.cn/content-7-1009-1.html.
48 The "Opinions of the State Council on Several Policies and Measures for Vigorously Advancing the Popular Entrepreneurship and Innovation" was released by the State Council on March 11, 2015. http://english.gov.cn/policies/latest_releases/2015/03/11/content_281475069667730.htm
49 Center for China & Globalization, China Overseas Returnees Entrepreneurship Report 2015 (Zhongguo Haigui Chuangye Diaocha Baogao 2015).
50 *Id.*
51 *Id.*
52 *Id.*

B. The Concept of "Venture Capital" in the Chinese Context

Prior to these developments and before the launch of the open-door policy and economic reform (*gaige kaifang*) in 1978, the legacy of the planned economy was such that all decisions regarding production and investment were embodied in a plan formulated by the government, and hence, there were no private enterprises, startups, venture capital funds or entrepreneurship in China.

The concept of venture capital was first mooted in China in 1985, in the central government's "Decision to Reform the Science and Technology System".[53] The term "venture capital" was initially translated as "risk capital (*fengxian touzi)*" in the official documents to reflect the "high-risk" nature of this financing method. In order to encourage entrepreneurship and innovation, several government agencies, including such as the National Development and Reform Commission ("NDRC") and the Ministry of Science and Technology started to use the term of "entrepreneurial capital (*chuangye touzi*)" in the regulations.[54]

Today the Chinese understanding of the "venture capital" among specialist industry expertise is consistent with international practice in that it is generally defined as an investment in high growth, high risk, often high technology firms that need capital to finance product development of growth in the form of equity instead of debt.[55] Also, the general understanding among professionals is that venture capital is a subset of private equity. Although venture capital and private equity share similar legal structures, incentive schemes and investors, venture capital generally focuses on early stage, high-risk, high-technology companies, while private equity invest in literally every industry and especially later-stage companies. Also, venture capital does not include restructuring, leveraged buyout financing where the private equity firm acquires majority control of an existing or mature firm from its current owners.[56]

Nonetheless, due to the short history of Chinese venture capital market, the understanding of venture capital among ordinary investors and inexperienced fund managers is limited and it is always confused with "private equity".[57] According to a practitioner in Chinese venture capital market, the number of venture capital firms who strictly invest in venture capital sector but not private equity sector is much

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[53] CPC Central Committee, *he Decision to Reform the Science and Technology Systems* (Mar 13, 1985), http://cpc.people.com.cn/BIG5/64162/134902/8092254.html.

[54] http://data.book.hexun.com/chapter-962-9-2.shtml

[55] My interviews with lawyers in the Chinese venture capital markets indicate that their understanding on venture capital is consistent with the international definition of venture capital. See also the definition of private equity in Zou Jing, *Placement and Operation of Private Equity-Legal Practice and Cases*, 11 (Law Press China, 2014).

[56] *See* Gilson, *supra* note 1; *see also* Brander, Du & Hellmann, *supra* note 19.

[57] My interviews with participants in the Chinese venture capital markets.

smaller than reported.[58] Many existing Chinese venture capital firms arose with the boom of the capital market and have limited experience in venture capital industry.[59] Many mangers were investment bankers prior to entering the venture capital market. They inclined to make short-term investment in later stage portfolio companies in traditional industries with quicker return.[60] Chinese investors also focus more on the business models, firm size and cash follow, instead of the potential of the portfolio companies. They generally do not willing to commit too much capital in high-risk early stage startups.[61] Moreover, unlike a typical venture capital cycle in the US which usually last for seven to ten years, an 2012 survey among Chinese venture capital and private equity firms show that the average cycle is 32 months, which is much shorter than its US counterparts.[62]

In recent times, the boundary between venture capital and private equity is increasingly blurred in recent times. On the one hand, from the perspective of venture capital firms, having left to grapple with difficulties in fund-raising after the 2008 global financial crisis and cope with investors' expectations of higher returns have led to many of such firms, which used to invest in early stage startups, to became more inclined to invest in later-stage and lower-risk enterprises as well as pre-IPO companies, so as to gain quick returns.[63] On the other hand, from the perspective of private equity firms, the launch of two new boards – ChiNext and the New Third Board which offer alternative financing for startups, and the rapid development of the mobile internet industry, have led to traditional private equity firms shifting their investment preferences from later-stage and pre-IPO companies to early-stage companies.[64] Indeed, this is evident as the phrase that is used to reflect the industry trend in China was modified from "*quanmin PE*" (which translates to "everyone invests in the private equity industry") in 2010 to "*quanmin VC*" (which translates to "everyone is keen on venture capital investment") today.[65]

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[58] Interview with Mr. A (anonymity requested), Vice President, Shanghai [X] Venture Capital Management Co. (January, 2015).
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] Source: ChinaVenture 2012, http://www.xcf.cn/zjth/xwbd/201206/t20120619_319661.htm. The survey was conducted as of 14 June 2012. Statistics show that two venture capital firms' investment cycle is less than 20 months; only 5 firms' investment cycle is above 40 months; and 17 firms' investment cycle is beween 20-40 months.
[63] *See* Zhou Ming, PE yu VC Touzi Shuangshuang Houyi [*PE and VC investments after both shift*] (Mar 17, 2008), http://tech.qq.com/a/20080317/000116.htm.
[64] *See* Zhongguo zhengquan bao [China Securities News], Xin sanban chixu huobao de PE / VC daju jinru juejin (Jan 17, 2015) http://finance.qq.com/a/20150117/008407.htm.
[65] Touzi jie, Yu Tian Er, Changjiang guohong touzi hehuo ren lichunyi: Quanmin PE dao quanmin VC shi shidai chanwu (Dec 3, 2014), http://www.grandyangtze.com/article/article?parent_id=3&id=39.

C. The Evolution of China's Venture Capital Market and the Evolving Role of the Government

As observed by Josh Lerner, "the venture capital industry in many nations has been profoundly shaped by government interventions."[66] These countries include Israel, Chile, Taiwan and Singapore.[67] Even in the US, the public intervention played a crucial role in accelerating the early growth in the Silicon Valley and the venture capital industry.[68] In particular, public subsidies during two world wars shaped the critical features of the Silicon Valley.[69] In relation to venture capital programs, the Chinese government has sought to duplicate American success in developing an effective venture capital market.[70]

This section aims to highlight the most important governmental efforts that have been made in the creation of venture capital market in China.

1. Emerging Phase (1985-1990)

Unlike the US, which has over 70 years of experience in venture capital since the 1940s,[71] China has had a much shorter history in venture capital. The industry really only started to emerge in 1985 when the first venture capital firm, the *China New Technology Venture Capital Co*mpany (*zhongguo xinjishu chuangye touzi gongsi*) was set up as a government-initiated project.[72] To foster entrepreneurship and facilitate technology innovation, the Ministry of Science and Technology launched the influential Torch Program in 1988, which kick-started the national-wide high-tech development and innovation. Thereafter, a number of local governments and ministries established companies to provide financing to technology companies. Consequently, most of the venture capital firms and funds at that time were government-backed. However, the unfamiliarity with the concept of venture capital, as well as the lack of a capital market placed substantial obstacles in the development of the venture capital during this period.[73]

2. Experimentation Phase (1991-2000)

Since 1990, innovation has been gaining prominence on agendas of Chinese central

[66] Lerner, *supra* note 18 at 42.
[67] *See* Gilson, *supra* note 1, at 1068; *see also* Brander, Du & Hellmann, *supra* note 19; Christopher John Gulinello, *Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience*, 37(4) GEORGE. WASH. INT. LAW. REV 845 (2005).
[68] Lerner, *supra* note 18 at 33 - 42.
[69] *Id.,* at 33 - 42.
[70] After the open door and economic reform, Chinese policy makers have made consistent efforts to study the experience of Silicon Valley in developing the venture capital industry. In 1980s, a large number of scholars were sent to the US to pursue higher degrees. Some of them, including the "Godfather" of venture capital in China – Mr. Cheng Siwei, have brought back the idea of venture capital and started to promote this concept when they returned to China. *See* Xinhuawang, *A Historical and Modern Look at the Chinese Venture Capital Market* (May 13, 2008), http://news.xinhuanet.com/theory/2008-05/13/content_8156697.htm.
[71] *See* Gompers & Lerner, *supra* note 20, at 8.
[72] *See* Zhu Shaoping & Ge Yi, *he Amendment of the Partnership Enterprise Law of People's Republic of China*, (Beijing: Citic Publishing House, 2004) at 4. *See also* Lu Haitian, Tan Yi & Chen Gongmeng, *Venture Capital and the Law in China* 37 HKLJ 229 (2007).
[73] Cheng Siwei, *Cheng Siwei on Venture Capital* (Renmin University Press, 2008), at *Preface.*

governments who increasingly appreciate the need to develop knowledge-based economies as a prerequisite to competitiveness and growth. A turning point came in 1998 when Mr. Cheng Siwei,[74] the then vice chairman of the National People’s Congress Standing Committee presented a groundbreaking proposal to the first meeting of the 9th Chinese People's Political Consultative Conference in 1998 urging on the development of venture capital in China, the so-called “No.1 Proposal”.[75]

After the No.1 Proposal, a series of government policies was issued by both central and local governments to facilitate the development of venture capital, including the Strategy of Invigorating China through Science and Education (*ke jiao xing guo*) and the Law on Promoting the Transformation of Scientific and Technological Achievements.[76] A number of government funds were set up to provide capital to high tech startups, including the Technical Innovation Fund for Small and Medium Sized Enterprises 1999.[77] China’s capital market emerged upon the establishment of the Shanghai and Shenzhen Stock Exchanges in 1990, which offered a new exit channel for venture capital investment.

However, due to the less developed regulatory infrastructure, such as the very limited choices of business vehicles available for venture capital practitioners and an under-developed secondary market, venture capital developed slowly during this period. Although foreign venture capital firms like IDG Capital Partners and Walden International started to enter into the Chinese venture capital market, and domestic private venture capital firms were set up, government-backed venture capital firms still dominated the industry.[78]

3. Depression and Growing Phase (2001-2005)

Venture capital investment declined substantially in China after the burst of the “dot-com bubble” in 2001 and the global economic slowdown in 2002. Thereafter, in order to provide a business-friendly regulatory environment and a feasible legal

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[74] Mr. Cheng Siwei is known as the “Godfather” of venture capital in China. He began to promote the concept of venture capital went he returned from the University of California, Los Angeles for a MBA degree, in 1984.

[75] http://news.xinhuanet.com/theory/2008-05/13/content_8156697.htm

[76] In 1999, the Ministry of Science and Technology, the State Development Planning Commission, the State Economic and Trade Commission, the People’s Bank of China, the Ministry of Finance, the State Administration of Taxation and the China Securities Regulatory Commission jointly issued “Opinions on Establishing a Venture Investment Mechanism”. *The Circular of the State Council Concerning the Approval of the National Development Zones for New and High Technology Industries and Relevant Policies and Provisions (1991), the Decisions Concerning Technology Innovations, Development of High-Technology and Realization of Industrialization (1999) and the Several Opinions on the Establishment of the Venture Capital Mechanism (1999);* Law of the PRC on Promoting the Transformation of Scientific and Technological Achievements 1996. The Interim Measures of Shenzhen Venture Capital High Technology Industry which was the first local regulation on venture capital firm.

[77] Qingke Guancha, *Qingke Guancha: Simu Guquan Touziye Shinian Huali Feiyue, 2014 Nian Kaiqi Zhongguo Guquan Touzi Shidai* (Apr. 24, 2015), http://www.pedata.cn/main_do/news_detail/214294.

[78] Beijing Zhongguancun Technology Venture Capital Company was the first private venture capital firm. In 1992, the first foreign VC *(Capital)* entered into China. In 1995, *Sheli jingwai zhongguo chanye touzi jijin guanli banfa*, was promulgated. The 1st Sino Foreign Joint Venture in venture capital sector – Kezhao High Tech Co. Foreign PE invest in Sohu, Sina, 163, etc and made them listed on NASDAQ. See Steve Blank, *The Rise of Chinese Venture Capital (Part 3 of 5)* (Apr 12, 2013), http://steveblank.com/2013/04/12/the-rise-of-chinese-venture-capital/.

framework to venture capital practitioners, clear guidance and regulations were issued on the establishment, approval, management, supervision taxation and foreign investment[79] relating to venture capital.[80] The Small and Medium-sized Enterprise Board ("SME Board")[81] was also launched to provide a new exit channel for startups in 2004. As a result of these policy incentives, the proportion of foreign venture capital invested increased from 5% in 2003 to 43.7% in 2006.[82]

4. Deepening Structural Reform Phase (2006- 2013)

The rapidly changing landscape of the capital markets contributed significantly to a more mature equity investment environment in China and provided more exit channels for venture capital-backed companies. As showed in Figure 1, there is a significant increase of capital raised in the venture capital market in the year of 2011, where both the number of newly established venture funds and the amount raised increased two-fold. The changes to the stock market include the split share structure reform, which was designed to float shares of non-tradable legal persons on the Mainboard; ChiNext (a NASDAQ-like exchange for growth enterprises)[83] in 2012; and the launch of the New Third Board in 2013, which serves as a national share transfer system for Small and Medium-sized Enterprises ("SME") to transfer shares and raise funds.[84]

In addition, the revision of the PRC Partnership Enterprise Law ("PEL") in 2006[85] was a significant milestone as it allowed a new business vehicle – limited partnership. Such measure further stimulated venture capital financing, as it allowed both domestic and foreigners to set up partnership-type funds,[86] and broadened scope of eligible domestic and foreign investors in the venture capital market through updated foreign investment catalogues and foreign exchange policies.[87]

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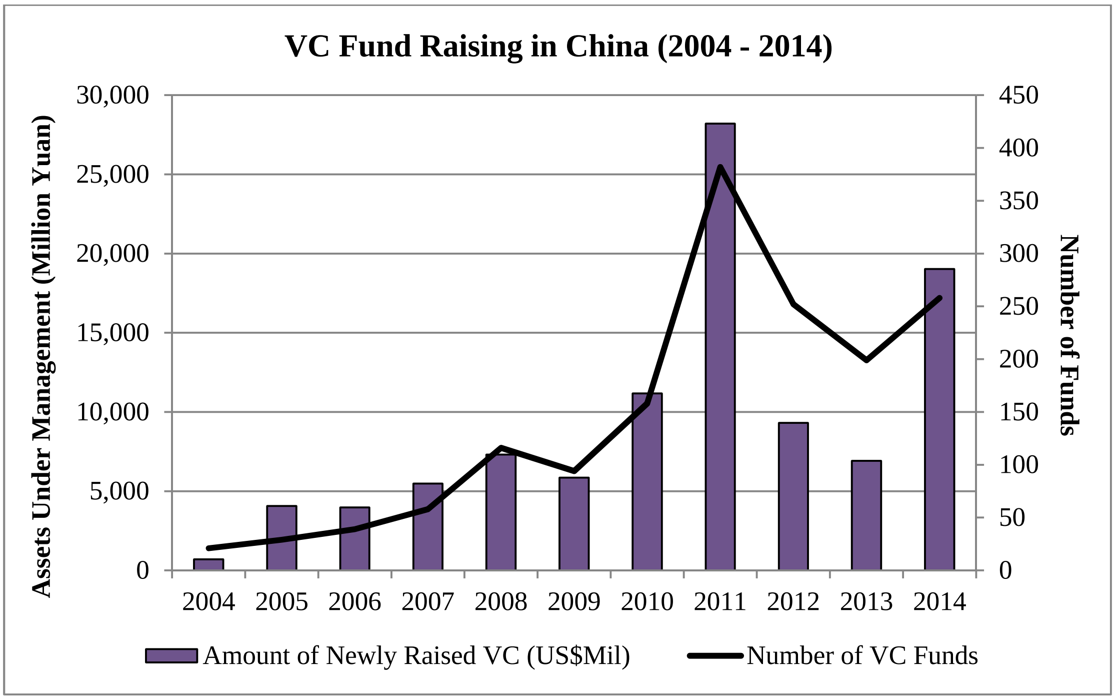
[79] *The Regulations on the Administration of Foreign Invested Venture Capital Enterprises* (the "2003 FIVCIE Regulations") foreigners to invest in Chinese VC market through setting up an FIVCIE can take the form of an incorporated entity or a non-legal person entity.
[80] The Interim Measures for Administration of Startup Investment Enterprises 2005.
[81] In 2004, the Small and Medium-sized Enterprise Board was launched at Shenzhen, China.
[82] China Venture Capital Yearbook 2007, *id*. at 247.
[83] However, unlike NASDAQ which is a mainboard, ChiNEXT is a secondary board.
[84] Since the government put a moratorium on IPOs in 2011, Chinese venture capital firms have faced huge difficulty in fund raising and exit. However, that freeze was lifted early 2014, and since then venture capital investment has dramatically increased.
[85] *See* Zou, *supra* note 55.
[86] Administrative Measures relating to the Establishment of Partnerships in China by Foreign Enterprises or Individuals (promulgated by the State Council, Nov. 25, 2009, effective Mar 1, 2010), Order No. 567 of the State Council.
[87] In 2001, Beijing government issued the Measures on Limited Partnership (youxianhehuo guanlibanfa); in the same year, the Interim Measure on the Establishment of Foreign-Invested Venture Capital Enterprises (guanyu sheli waishang touzi chuangye qiye de zhanxing guiding) was issued. In 2002, Foreign Investment Industry Guidance Catalogue was issued to attract more foreign investment. In 2005, the State Administration of Foreign Exchange issued the Circular 75, which greatly improved the foreign equity investment environment in China.

Figure 1. Venture Capital Fund Raising in China (2004-2014) (US Million)

Source: zero2ipo



5. Toward a Market-Oriented System (2014-present)

Since May 2013, the central government has issued at least 22 documents to encourage "Mass Entrepreneurship and Innovation", including a guideline[88] issued by the State Council in March 2015 followed by an opinion laying down specific measures in June 2015. Specific measures have also been laid out to reduce institutional obstacles and innovate its institutional mechanisms to facilitate mass entrepreneurship and innovation. It aims at creating a better environment for fair competition, deepening business system reforms, strengthening intellectual property protection and establishing a mechanism for the training and hiring of talented professionals.[89] Related government bodies are optimizing their financial policies to support mass entrepreneurship and innovation. Strengthened financial support policies, inclusive funding measures.[90] Utilize financial markets to facilitate funding and investment. Optimizing the capital market, the government encourages corporations to raise funds through the bond market, and will study practical ways to enable start-up Internet and high-tech companies to enter specialized stock exchanges under the growth enterprise market ("GEM") category. Banks are encouraged to cooperate with other financial institutions to offer special support to start-up firms. The government will support the development of Internet finance

[88] *Supra* note 48.
[89] *Id.*
[90] *Id.*

companies and crowd-funded projects.[91]

Since 2014, the Chinese government has gradually departed from a government-directed approach in engineering the venture capital market and is moving towards the "Government Led + Market Operation" model.[92] Rather than setting up government-backed venture capital firms, the government will instead support the venture capital industry by providing seed funding through Government Guided Funds, but will not participate in the capital allocation process.

The State Council announced in 2015 that China will be setting up the 40 billion RMB (USD 6.5 billion) State Venture Capital Investment Guidance Fund ("SVCIG", *guojia xinxingchanye chuangyetouzi yindao jijin*) to support start-ups in emerging industries, to foster innovation and to upgrade industry.[93] The planned fund would be funded by the government's existing capital designated for the expansion of emerging industries, as well as by state corporations and private investors, who will be invited to participate. Thereafter, public tenders will be invited from professional asset management firms, with priority for returns given to private investors.[94]

At the same time, the Chinese State Council has promised to provide a better environment for popular entrepreneurship and mass innovation by lowering barriers, strengthening public services, and encouraging college students, scientists and engineers to start new businesses.[95] It has also issued guidance on the development of the Group Innovation Space ("GIS", *zongchuangkongjian*) and offered new platforms for innovation and business startups.[96]

6. Summary

As indicated in the above discussion, the Chinese government, both at the central and local levels, together with key government agencies (such as the NDRC, Ministry of Science and Technology, Ministry of Commerce and CSRC) play a significant role in the creation of a venture capital market. This is especially so when it comes to shaping the underlying legal, regulatory and entrepreneurial infrastructure, as well as building up a capital-centered system to allow venture capitalists to exit.

[91] *Id.*
[92] Zero2IPO Research Center, *2015 Nian Zhongguo Zhengfu Yindao Jijin Fazhan Baogao Jianban [eport of the China Government Guidance Fund 2015]* ((Feb. 28, 2015), http://research.pedaily.cn/report/free/960.shtml.
[93] *Id.*
[94] *Id.*
[95] Xinhua News, *China Issues Opinions to Encourage Mass Entrepreneurship, Innovation* (Mar. 11, 2015), http://news.xinhuanet.com/english/2015-03/11/c_134059020.htm.
[96] Guowuyuan bangongting [State Council] *Guowuyuan bangongting guanyu fazhan zhongchuang kongjian tuijin dazhong chuangxin chuangye de zhidao yijian* [*State Council on the development of a public space to promote innovation and entrepreneurship guidance*] (2 March 2015), http://www.gov.cn/zhengce/content/2015-03/11/content_9519.htm.

The wide range of support that the Chinese government provides for the venture capital market includes: providing public funding for entrepreneurs and startups via the establishment of government-backed venture capital companies and government guided funds; providing legal structures that accommodate the establishment of venture capital funds; encouraging entrepreneurship through providing tax incentives, preferential regulation, subsidies for firms in targeted industries and technologies; and developing national incubators and high-tech laboratories.[97]

Meanwhile, the Chinese venture capital industry has also grown with the changing mindset of the governments towards this emerging market. The central government's role has gradually evolved from that of being both a capital provider and financial intermediary in the 1980s – 2000s, to being a mere facilitator ever since 2014, merely providing seed funding through government guidance funds and policy incentives, while leaving specific capital allocation decisions largely to private ordering.

D. Legislative Framework and Regulatory Regime Governing Venture Capital

China's legal framework governing venture capital is still evolving. The venture capital model encompasses a number of different types of transactions and stages in the venture capital cycle, including fund raising, operation, investment, and exit, all of which have long been regulated by different areas of legislation.

Given the hierarchy of legislation in China, venture capital-related laws can be generally divided into three types: (1) national laws promulgated by the National People's Congress and its Standing Committee, such as the Securities Law, the PRC Company Law 2005, PRC Partnership Enterprise Law 2006, Trust Law, and the Revised Securities Investment Funds Law 2013 ("New Fund Law"), [98] (2) administrative regulations promulgated by the State Council and the ministries under the State Council, such as the Interim Measures for Administration of Startup Investment Enterprises 2005 ("Startup Measures"), [99] and (3) local regulations promulgated by the local legislature. Before the Startup Measures were issued, local

[97] *Zongli han ni lai chuangye*, http://news.pedaily.cn/zt/20150522383087.shtml#m005 (last visited May 30, 2015).

[98] On 28 October 2003, the PRC Securities Investment Funds Law 2004 PRC Fund Law) was promulgated, effective as of 1 June 2004. However, the 2004 PRC Fund Law regulated only publicly offered funds, leaving private funds in regulatory limbo. Nine years later, on 8 December 2012, new amendments were finally adopted to the 2004 PRC Fund Law (Amended Fund Law, effective as of 1 June 2013), and this time private funds were brought into the regulatory regime thereunder. Unfortunately, the Amended Fund Law was designed in such a way that private equity funds and venture capital funds were excluded from its scope of application, perhaps for the reason described below.

[99] Chuangye touzi qiye guanli zhanxing banfa (promulgated by the National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People's Bank of China, State Administration of Taxation, State Administration for Industry and Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission, and State Administration for Foreign Exchange, Sep. 7, 2005, effective Mar. 1, 2006), Order No. 39.

governments such as Beijing, Shanghai and Shenzhen promulgated various kinds of local regulations to facilitate venture capital investment in their regions. In addition, there are also voluntary guidelines made by the two major associations in China: China Securities Investment Fund Association (*zhongguo zhengquan touzi jijin xiehui*) and China Equity Investment Fund Association (*zhongguo guquan touzi jijin xiehui*).[100]

With regards to the regulatory regime of venture capital, a key aspect of the Chinese regime that is different from that of the US[101] is that the Chinese regulatory framework has long been based on the type of financial institutions and their products. For example, funds organized as trust companies are regulated by the China Banking Regulatory Commission ("CBRC"), while securities companies and fund management companies, and their financial products, are regulated by the China Securities Regulatory Commission ("CSRC"). In addition, the NDRC and CSRC have been competing to take charge of supervision of the private equity and venture capital industry in China.[102] This fragmented regulatory regime has hampered the development of venture capital industry and allowed regulatory arbitrage by market participants.

In order to clarify the regulatory responsibilities of different government agencies and create a widely recognized venture capital regime in China, Chinese regulators are in the process of amending relevant laws and regulations to govern venture capital funds.[103] A notable improvement is the new regulatory framework for private equity and venture capital funds in China through the promulgation of the Registration of Private Investment Fund Managers and Filing of Private Investment Funds (for Trial Implementation) 2014 by the Asset Management Association of China ("AMAC")[104] and the Interim Measures for Supervision and Administration of Private Investment Funds (CSRC Interim Measures) 2014.[105] Under this new regulatory framework, CSRC the regulatory power over the private equity and venture capital industry has been transferred from NDRC to the CSRC, which then delegated such power to a self-regulatory organization – AMAC.[106]

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[100] As a civil law jurisdiction, case law has no legal effect in China.

[101] In the U.S., various legislations played a positive role in the development of VC, including the 1933 Securities Act, 1940 Investment Company Act, 1958 Small Enterprise Act, Uniformed Limited Partnership Act all played some role in the U.S. VC market.

[102] See further in Dean Collins, Qingjian Wang and Hailin Cui, "A New Era for Private Funds in China?" http://sites.edechert.com/10/3730/landing-pages/a-new-era-for-private-funds-in-china.asp

[103] *See* Circular on Further Regulating the Development and the Administration on Filings of Equity Investment Enterprises in Pilot Regions ("Circular No.253") (2011); *see also* Circular on Promoting Regulation and Development of Equity Investment Enterprises ("Circular No.2864") (2011).

[104] Taking effect on 7 February 2014.

[105] It sets forth the regulatory regime for private funds under five key topics: (i) registration and filing; (ii) qualified investors; (iii) fund raising; (iv) fund operation; and (v) special rules for venture capital funds.

[106] Since 2013, the NDRC has been empowered to compile policies for the development of the private equity and venture capital industry.

In view of these legal developments, CSRC is currently the key regulator of venture capital funds, in charge of the supervision and administration of funds.[107] The current stance of CSRC on the regulation of the venture capital industry is similar to the U.S., in the sense that the market should not be imposed with substantial mandatory regulations, but should instead largely rely on voluntary guidelines and self-regulatory measures set by the industry itself. Further, the regulations issued by CSRC should focus on the regulation of fund managers instead of the funds. As a result, the CSRC Interim Measures are designed to enhance registration of fund managers and filing of the funds with AMAC, as well as the establishment of the qualified investor regime.

III. The Engineering Problems in China: A Comparative Analysis

As highlighted in Part I, according to Ronald Gilson, the creation of a venture capital market requires the "three-factor simultaneity model".[108] Accordingly, if a country's legal and market institutions lacks any of these factors, the country cannot develop a viable venture capital market. As it is beyond the scope of this article to explore every determinant in engineering the Chinese venture capital market, and the part on entrepreneurship has been addressed in Part II,[109]this part will focus on three issues in Chinese context, i.e. venture capital funding, investment vehicles and the stock market.

A. Sources of Funding

1. Government Funding

Government funding has been recognized as one of the most important sources of funding for fueling entrepreneurship, after bank credit.[110] Over the years, many countries have provided various kinds of government programs to support entrepreneurial and start-up businesses, such as government-sponsored venture capital funds to make investments in young enterprises. Notable examples include Israel's Yozma Programme[111], Chile's Corporation for the Incentive of Production ("CORFU"),[112] Germany's Deutsche Wagnisfinanzierungsgesellschaft ("WFG"),[113] the New Zeland Venture Investment Fund ("NZVIF")[114] and the Singapore Early Stage

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[107] In June 2013, the Central Government issued the Notice on the Division of Responsibilities of Private Equity Fund Management (guanyu simu guquan jijin guanli zhizhe fengong de tongzhi) (Zhongyang Bianbanfa No. [2013] 22), specifying that CSRC will be responsible for the supervision and administration of private equity funds.
[108] Gilson emphasis three elements in the Engineering article
[109] Text accompanying note 46-48.
[110] *See* Ernst & Young, *he EY G20 Entrepreneurship Barometer 2013*i (2013). *See also* Ernst & Young, *supra* note 11, at 14.
[111] Gilson, *supra* note 1, at 1097-1098.
[112] Gilson, *supra* note 1, at 1098-1099.
[113] *See* Gilson, *supra* note 1.
[114] For a detailed analysis of the program, see LERNER, J., Moore D., Shepherd, S. (2005). A study of New Zealands venture capital and private equity market and implications for public policy. LECG Limited. Wellington.

Venture Fund ("ESVF") scheme[115]. While there has been substantive government funding in support of the venture capital market in all these examples, the effects of these programs vary significantly from jurisdiction to jurisdiction.[116] As such, it is pertinent to examine the lessons in the various countries, as well as the pitfalls that should be avoided (see Appendix 1 for detailed comparison).[117]

There are many factors that affect the effectiveness of the government programs: the length of the programmes,[118] its size,[119] flexibility,[120] incentives for the financial intermediary to monitor portfolio companies,[121] and implementation.[122] The common thread amongst the factors is the involvement of market forces in engineering a venture capital market.[123] Accordingly, this is illustrated in Chile and Israel's venture capital engineering programs, which emphasize the need for market forces as opposed to Germany's heavy governmental involvement in capital allocation during venture capital investments.[124]

Empirical evidence indicates that a well-designed government-sponsored fund that is effectively governed would increase the overall level of venture capital investment and fundraising; in contrast, where there are government-sponsored funds that do not sufficiently incentivize fund managers and employ appropriate monitoring mechanisms to ensure maximum return of the fund, private investments would be crowded out, thereby reducing the overall effectiveness in venture capital investment and fundraising[125]. For example, while the German WFG program ultimately proved to be a failure due to the limited incentives provided, the Chilean CORFU program was much more effective due to the greater incentives provided as well as the presence of suitable means of monitoring through private ordering (See Appendix 1).

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115 Terence Lee, *Singapore government to pump $48 million into six venture capital funds*, TECHINASIA (Apr 22, 2014), https://www.techinasia.com/singapore-government-invests-8-million-venture-capital-firms/.

116 *See* Gilson, *supra* note **Error! Bookmark not defined.** According to Professor Gilson, while some government programs, such as Israel's Yozma Programme and Chile's *CORFU*" have been successful, there have been unsuccessful programmes such as Germany's Deutsche Wagnisfinanzierungsgesellschaft ("WFG").

117 Professor Gilson analyzed three different government programs and concluded that one remarkably unsuccessful early effort in Germany; one more recent, more successful program in Israel; and a newly launched program in Chile. *See* Gilson, *supra* note 1, at 1071.

118 Lerner, *supra* note 18 at 112-116. (arguing that an entrepreneurship requires a long-run commitment on the part of public officials, thus they should not have a short0term perspective or require quick return of the government program.)

119 *Id.*, at 117-123 (arguabing that either too small or too large an government initiative can pose profound difficulties).

120 *Id*., at 124-127 (suggesting that government officials must appreciate the need for the flexibility in iventure capital investment and relying more on market force in selection of the sector, location, and portfolio companies)

121 *See* Gilson, *supra* note 1.

122 Lerner, *supra* note 18.

123 *See* Gilson, *supra* note 1, at 1094-1096.

124 *See* Gilson, *supra* note 1, at 1094-1099.

125 Armour, John and Cumming, Douglas J., *supra* note 4 at 601; Cumming, D.J., and J. MacIntosh, 2006. Crowding Out Private Equity: Canadian Evidence Journal of Business Venturing 21, 569-609.

In China, venture capital funding has been provided to tech startups through various government-backed programs, including the Innovation Fund for Technology Based Firms ("IFTBF", *kejixing zhongxiaoqiye jishu chuangxin jijin*),[126] the Industrial Investment Fund ("IIF", *chanye yindao jijin*)[127] and the Government Guidance Funds ("GGF", *zhengfu yindao jijin*).[128] In order to facilitate the transfer of technology into entrepreneurial ventures, the National Fund for Technology Transfer and Commercialization ("NFTTC", *guojia keji chengguo zhuanhua yindao jijin*) was launched in 2011. In fact, data from 2008 demonstrates that 80% of the venture capital funding was government backed.[129]

The rest of this discussion will focus on the GGF.

a) Government Guidance Funds

The first form of the GGF was established in 2002 when the Zhongguancun Management Committee set up the first government funded Venture Capital Guided Fund.[130] However, the role and definition of GGF had been vague until the promulgation of several departmental regulations,[131] particularly the Venture Capital Fund Specifications and Operational Guide 2008 ("2008 GGF Guide"). This guide clarified that the GGF was to be a government established fund mainly for guiding social capital into the venture capital industry and supporting venture capital companies.[132]

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[126] *Keji Xing Zhongxiao Qiye Chuangxin Jijin Guanli Zhongxin*, http://www.innofund.gov.cn/ (last visited May 30, 2015). The IFTBF was set up by the State Council to promote the government's goals of encouraging innovation and fostering research by making funds available to entrepreneurs. As a government non-profit program, the IFTBF is intended to contribute to China's development by helping to increase GDP and create jobs.

[127] Zou Jing, supra note 55 at 104-106. The IIF was a special type of government-backed fund with its capital raised from "specific institutional investors", including the National Social Security Fund, SOEs, commercial banks, insurance companies, securities companies and other financial institutions, and other institutional investors specified by the NDRC. The establishment must be approved by NDRC. The 1st Industrial Investment Fund, the Bohai Industrial Investment Fund Management Co, was set up in 2006 in Tianjin with shareholders from the Bank of China, National Social Securities Fund, CDB Capital, etc, and typically invests with a minimum of 300 million RMB ($46.48 million) per portfolio company.

[128] Industrial Investment Fund s a special type of government-backed fund, whereby capital is raised*Z* from "specific institutional investors", including the Social Security Fund, SOEs, commercial banks, insurance companies, securities companies, financial institutions and other institutional investors specified by the NDRC. The establishment must be approved by NDRC. The first IIF, the Bohai Industrial Investment Fund Management Co, was set up in 2006 in Tianjin with shareholders from the Bank of China, National Social Securities Fund, CDB Capital, etc. It is an investment firm specializing in equity investments. It typically invests with minimum of 300 million RMB ($46.48 million) per portfolio company.

[129] Xinhuawang, *supra* note 70.

[130] Qingke Yanjiu Zhongxin (清科研究中心), *Qingke Yanjiu Zhongxin: 2015 Niankainian 400 Yi Zhengfu Yindao Jijin Jiama VC ni Kandong le ma (清科研究中心：2015 开年 400 亿政府引导基金加码 VC 你看懂了吗)* (Apr. 29, 2015), http://www.wfjkjt.com/news_show.aspx?id=900.

[131] The "Interim Measures for the Administration of Startup Investment Enterprises" 2005 specified that central and local governments could set up venture capital guided funds to lead funding into the venture capital industry; as did the "Interim Measure for the Technology Oriented SME Venture Capital Investment Guided Fund" 2007.

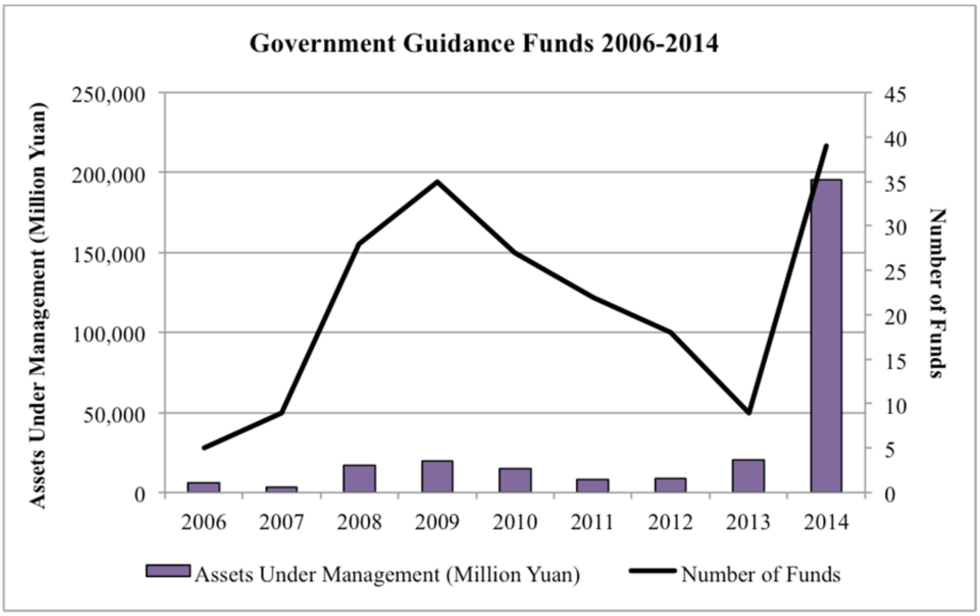
[132] *See* Touzi Zhongguo, *Touozhong guandian: 2013 Nian Zhengfu Yindao Jijin Zhuanti Baogao (投中观点：2013 年政府引导基金专题报告)* (Feb. 11, 2014), http://research.chinaventure.com.cn/report_830.html. The measure was jointly issued by the National Development and Reform Commission ("NDRC"), the Ministry of Finance ("MoF") and the Ministry of Commerce ("MOFCOM"). In the following year, 20 venture capital funds were set up by NDRC, Ministry and Finance and seven local governments. In 2011, the MoF and the NDRC

The key feature of the GGF, pursuant to the 2008 GGF Guide, is that it is market oriented, and hence the government is not directly involved in the venture capital business or selection of portfolio companies.[133] The GGF is designed to increase the amount of venture capital funding and seeks to channel more venture capital funds from growth and mature companies towards seed funding and initial stage funding. The roles of the GGF include,[134] *inter alia*, supporting the establishment of new venture capital firms, following up with investment in the established venture capital firms, and providing venture capital institutions (that early-stage and technology SMEs) with guidance and grants, with a second round of grants as insurance.[135] GGFs are kick started by government, but after that, other participating investors typically include local governments, institutional investors and social capital funds.

As can be seen from Figure 2 below, in the year 2014 alone, 39 GGFs were raised with a combined investment amount of 195.6 billion RMB – this is 3.5 times the number of funds and 9.4 times the investment amount raised in 2013.[136] However, despite the positive progress and swift development, GGFs have not been without its problems.

Figure 2: Government Guidance Funds in China 2006-2014

Source: Zero2ipo



issued the "Interim Measure for the Administration of Funds for Equity Investment in Emerging Industries Scheme". It specified an investment focus in emerging industries such as environmental, information, biomedicine, new energy, new material, aerospace and aviation, maritime, manufacture of advanced facilities, new energy car, high-tech and high-value-added services, among other fields.

133 Art 3 of Venture Capital Fund Specifications and Operational Guide 2008.

134 MBA LIB, http://wiki.mbalib.com/wiki/政府引导基金, (last updated Sep. 15, 2014).

135 *See* Zou, *upra s*note 55, at 84.

136 *See* Qingke Yanjiu Zhongxin, *supra* note 130.

b) Problems with GGFs

Agency problems exist widely within GGFs. Local governments typically take a top-down approach, whereby bureaucrats mandate which sectors, companies or locations are to be funded. This is all done with their self-interests for political promotion under a GDP-centered appraisal system looming like a spectre in the background. Governments also directly intervene with the fund operation and investment processes, by for instance setting artificial limitations on investment locations, instead of relying on market forces in the selection of portfolio projects.[137]

The problem of excessive governmental intervention is further exacerbated by certain restrictions imposed by local governments onto venture capitalists receiving GGF support. Although the GGF Guidance 2008 mandates that the GGF shall not participate in the day-to-day operation of the invested companies by serving as the General Partner ("GP") in limited partnership-type venture capital firms, the reality is that the directions and policies taken by the funds are dictated by the local governments to a large extent, since local governments do finance the local GGFs. For example, the local government may dictate that the venture capital firms must invest in the enterprises in their regions, instead of enterprises elsewhere that may have a higher growth potential. This would lead to conflicts between the GGF and the venture capital firm, resulting in fewer venture capital firms being willing to receive GGF assistance.[138]

There are also conflicts between governments and the venture capital firms with regard to the compensation of venture capital firms. Typically, under a venture capital limited partnership, the conventional 2/20 compensation rule would apply, under which a management fee of 2% of the fund's capital is paid to the GP (venture capitalist), and a carried interest of 20% of the fund's profits will be distributed to the Limited Partners ("LP") (investors).[139] This is however not always the case in China, where the profit sharing mechanism under GGFs vary significantly. In many cases, local governments are overly protective of their investment principal and their interests while negotiating the risk and profit allocation, resulting in the venture capitalist being less incentivized. A typical example is that the GGF would enjoy preference in the distribution of profits and a guaranteed return of its investment principal in the event the venture capital fund is liquidated.[140]

Yet another problem relates to poor internal governance of the GGFs, arising from a lack of expertise, experience and professionalism of the government authorities and

[137] For the discussion of administrative intervention of government guided fund, see Li Hongrun, Research on the Equity Agreemnt of Venture Capital Investment Guided Fund (Chinese University of Politics and Law Publisher, 2013).
[138] *Id.*
[139] A default of management fees of 2% fund's capital, and carried interest of 20% fund's profits
[140] *See* Qingke Yanjiu Zhongxin, *supra* note 130.

officials managing the GGFs. This problem is present both at the central and local levels of government guidance, and is especially apparent in the areas of investment strategies, post investment management, and exit strategies.[141]

Lastly, as observed by Lerner, an inappropriate sizing of the government program is a common mistake made in venture capital financing. A public program that is too small would hardly have any impact on a large and diverse economy, while a program that is too large might crowd out or discourage private funding.[142] In the Chinese context, the size of the GGF program is insignificant relative to the whole venture capital industry. As of the year 2014, there was a total of USD 885.0 billion worth of investable equity assets in the industry, out of which a mere USD 17.5 million worth of investable assets were attributed to GGFs, which accounts for just 2.0% of the total investment amount.[143] This problem is more pronounced in rural areas, where GGFs are so small to the extent that they cannot play an effective role in guiding capital flow to startups.[144]

c) New Directions for GGFs

Cognizant of the problems afflicting the operation of the GGF over the past decade as discussed above, the Chinese government has decided to adjust its strategy in the provision of public funding. This new direction involves attracting more private investors into the venture capital market, as well as reducing government intervention and moving towards a market-oriented approach.[145]

This shift in strategy is complemented by a new wave of GGF creation and injection of funds.[146] The most significant development is the State Council's announcement of the creation of the 40 billion RMB (approx. USD 6.5 billion) State Venture Capital Investment Guidance Fund (SVCIGF) (*guojia xingxin chanye touzi jijin*) to support start-ups in emerging industries, foster innovation and develop industries.[147] The objectives of the SVCIGF are to support entrepreneurship and encourage innovation, but more importantly, to redirect funding towards venture capital and revolutionize the employment of financial resources to facilitate effective funding of scientific and technological start-ups.[148]After the SVCIGF was set up at the central level, a number

[141] Qingke Yanjiu Zhongxin, *Qingke Guancha: <2015 Nian Zhengfu Yindao Jijin Baogao> Fabu, Yindao Jijin Yinghou "62 Haowen" Xinshidai* (Mar. 4, 2015), http://research.pedaily.cn/201503/20150304379207.shtml.
[142] Lerner, *supra* note 18 at 117-119.
[143] *Id.*
[144] *Id.*
[145] *See* Qingke Yanjiu Zhongxin, *supra* note 141.
[146] Local governments began introducing new policies and setting up specialized funds, such as the Shandong Provincial Equity Capital Fund. On a national level, several GGFs were also set up, such as the National investment fund for integrated circuit industry of 120 billion RMB, the National Fund for Technology Transfer and Commercialization, and the Shanghai Angel Investment Guidance Fund.
[147] *See* Qingke Yanjiu Zhongxin, *supra* note 141.
[148] Zhongguo Zhengfu Wang, *Likeqiang: Guojia Chuangtou Jijin Sheli hou yao yong Shichang hua Banfa Caozuo* (Jan. 14, 2015), http://www.gov.cn/xinwen/2015-01/14/content_2804213.htm.

of venture capital investment guidance funds were set up at local levels, including in Guangdong, Shanghai, Beijing and Jiangsu.

Small firms typically face great difficulties raising capital, due to the information asymmetry between the entrepreneurs and investors, resulting in reduced investor confidence.[149] As such, government expenditure seeking to catalyze venture funds could have an "add-on effect". [150] Investors would be more willing to invest in such funds once the government investors have taken the lead.

Indeed, the first crucial feature of the SVCIGF is that it is able to leverage on government funding to attract private investors to participate in the SVCIGF.[151] Over time, it is likely that more private and overseas capital will be drawn into the domestic venture capital industry by the presence of government credit.[152] It is hoped that the lowered risk would also attract institutional investors such as pension funds and endowments, thereby altering the composition of investors in the Chinese venture capital market. This leverage should also be effective in increasing the size of the venture capital funding, shifting funds from mature companies to companies in the growth and early stages.

Second, overseas experience in government programs such as Taiwan and New Zealand has suggested that, by requiring matching funds be raised from the private sector, the dangers of uninformed decisions and political interference can be greatly reduced.[153] As illustrated in Appendix 1, the SVCIGF, to be set up by the Chinese government, will comprise of 40 billion RMB of capital funding, with 10-15 billion RMB coming from the government, matching the remainder coming from other investors such as private enterprises and large institutional investors.[154] Arguably, by allowing more than half the funding be from the private sector, the SVCIGF is likely to reduce government interference and rely the market for guidance. Also it would enable the fund managers to make more informed decisions in capital allocation.

The third key feature of the SVCIGF is that the government does not participate in fund management (unlike the previous GGFs), relying on incentivized financial intermediaries instead, for instance allocating capital and selecting portfolio companies.[155] Investment-wise, it will invite public tenders from private asset management institutions, with priority for returns given to private investors, free

[149] Lerner, *supra* note 18 at 69.
[150] *Id.,* at 70.
[151] *See* Qingke Yanjiu Zhongxin, *supra* note 141.
[152] *Id.*
[153] Lerner, *supra* note 18 at 128-133.
[154] Sina Finance, *400 yi guojia chuangtou jijin dingceng fangan sheji yi jiben wancheng* (Mar 30, 2015) http://finance.sina.com.cn/china/20150330/155021844627.shtml.
[155] *Id.*

from government intervention. By providing public funding through the SVCIGF, the government attracts knowledgeable financial intermediaries to manage the venture capital funds' business, mitigating the problem of having to attract proficient fund management institutions. Arguably, the ceding of control to the market forces mechanism also mitigates operational inefficiency arising from incompetence and unprofessional government authorities and tackles agency problems caused by divergence of interests between governments and fund managers.

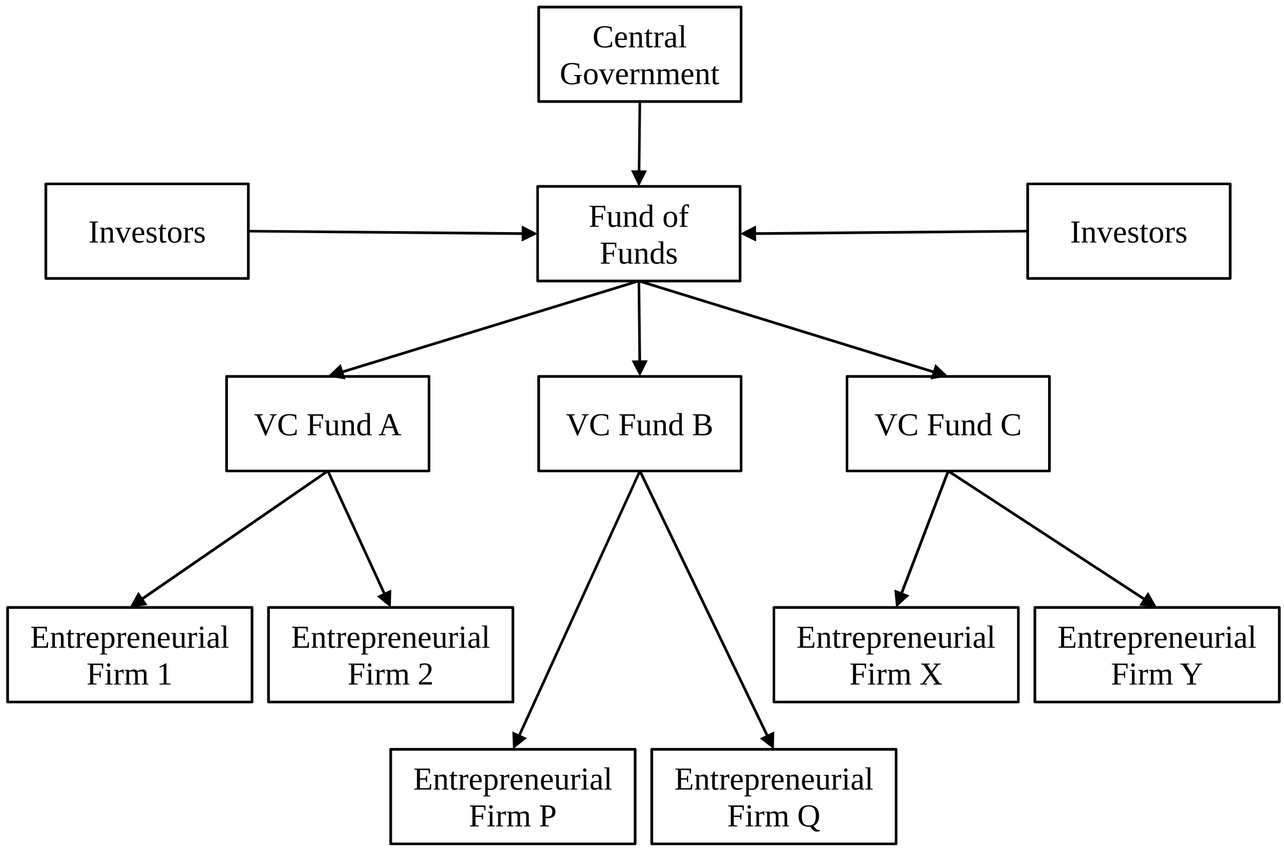
Fourth, the SVCIGF will take a "fund of funds" approach whereby the fund will make investments in a number of venture capital funds. Being a consolidated fund, the SVCIGF is not restricted to one particular project (as might the case with GGFs in the past), hence incentivizing fund managers to take a more hands on approach with the fund's investments which are no longer artificially limited. The SVCIGF is hence better able to reduce the likelihood of a mismatch between demand and supply, in contrast to the previous scheme whereby individual or local specialized funds were committed to only one project.[156] Meanwhile, with a target of 40 billion RMB, together with a number of forthcoming local venture capital investment guidance funds, it tackles the problem of the GGF being too small to make a difference in guiding capital flow to startups.

As seen from the above discussion, in the context of public funding, there has been rapid development to facilitate the growth of the Chinese venture capital industry. This is marked by various milestones, and most significantly, the establishment of the SVCIGF and subsequent various local venture capital investment guidance funds, which attempt to mitigate the various problems faced by GGFs so far. Arguably, with the government acting only to provide seed capital to the venture capital market without participating in the capital allocation exercise, this would allow venture capitalists and subsequently the entrepreneurs should be able to work more effectively and achieve positive results in a venture capital cycle driven by market forces.

Nonetheless, a more pivotal question is the perfection of the design of the fund and implementation at local level. In order to make the SVCIGF work effectively and efficiently, it is suggested that the fund should avoid wide-ranging mandates on generating quick financial returns and excessive reporting requirement. Meanwhile, with increasing number of venture funds setting by Chinese local governments, how to evaluate the success of these government efforts and reduce the chance of overfund is a crucial issue. Arguably, establishing a well-design appraisal system for governments and bureaucrats in these government programs is likely to be a pertinent solution.

[156] *Id.*

Diagram 1 Schematic drawing of the Chinese State Venture Capital Investment Guidance Fund (SVCIGF)



2. Predominance of Wealthy Individuals And Families

Given the business nature of institutional investors such as pension funds, endowments and insurance companies, they are more inclined to long-term venture capital investment. These institutions are the major investors ("LPs") in the US venture capital market.[157] However, as shown from Table 1 & Table 3, the current composition of LPs differ starkly for U.S. and China in the sense that large institutional investors contribute conspicuously much less to Chinese venture capital funding.

As seen from Table 2 below, in terms of the number of Chinese LPs, 54.5% are wealthy individuals and families, 14.9% are private enterprises and 8.5% are investment companies. The rest were venture capital/private equity institutions, listed companies, government institutions, government guided funds, asset

[157] These institutional investors constitute, on average, 75% of VC fundraising in the US from 1993 to 2002 (The Venture Capital Cycle, supra note 20).

management companies and funds of funds.[158] In particular, there is a growing number of wealthy companies with their own venture funds, primarily focusing on consumer-and internet-related enterprises.[159]

In terms of the amount of investments, in the year of 2014, listed companies formed the biggest class of investors in the Chinese venture capital sector, accounting for 25% of total assets invested with investable assets of 221.66 billion USD, followed by public pension funds and sovereign wealth funds which accounted for 19.2% and 17.5% of total assets invested respectively.[160]

The predominance of wealthy individuals and enterprises in the Chinese venture capital fund raising scene, as opposed to pension funds and insurance companies, can be boiled down to two main reasons. Firstly, as mentioned earlier in Part II(A), there are a large number of high-net-worth individuals with large amounts of available capital to invest in the equity market. Secondly, institutional investors such as the NSSF and insurance companies were prohibited from making equity investment due to past policy constraints.[161]

Nonetheless, as will be further discussed below,[162] the domination of individual investors has created some problems in venture capital limited partnerships. Crucially, individual investors generally have less financial literacy and are less risk-tolerant than institutional investors. A number of individual investors belong to the first wealth generation (*fuyidai*), which gained wealth after the open-door and economic reform of 1978. Therefore, they are reluctant to fully entrust their money to third parties for investment and tend to want to control the fate of their capital by choosing portfolio companies themselves. Also, as the limited partnership is a new business vehicle in China, individual investors have not yet fully appreciated the structure of the limited partnership and the value of professional venture capitalists to their capital contribution to the fund. As such, much like shareholders in corporations, individual investors still tend to be active in the management of the limited partnership funds. Investors are also able to control the selection of portfolio companies by participating in the internal investment committees through veto

[158] Qingke Yanjiu Zhongxin, ingke Shuju: 2014 Nianni*T*an Zhongguo Shichang Huoyue LP Chixu Zengzhang, LP Jigouhua Chengxin Changtai (Jan. 19, 2015), http://research.pedaily.cn/201501/20150119377187.shtml.
[159] *See* Ernst & Young, *supra* note 11, at 20.
[160] Gui Jieying, Zero2IPO Research Center, *2014 Active LP was Increased in Chinese Market (2014 Nian Zhongguo Shichang Huoyue LP Chixu Zengchang, LP Jigouhua chen gxinchangtai)* (Jan. 20, 2015), http://www.p5w.net/fund/gqjj/201501/t20150120_920701.htm.
[161] For example, insurance companies were explicitly prevented from investing in venture capital until 2014 when the Chinese Insurance Regulatory Commission issued the Notice Of Venture Capital Investments by Insurance Capital (Baojianfa [2014] 101) to allow insurance capital to be invested in venture capital funds (guanyu baoxian zijin touzi chuangye touzi jijin youguan shixiang de tongzhi).
[162] See infra text accompanying note 222 - 225.

rights.[163] Domestic investors are also less patient than sophisticated institutional investors who are experienced in long-term equity investments. These domestic investors would prefer to invest in later-stage portfolio companies so as to gain quick returns, while professional venture capitalists would identify potential portfolio companies at early stage.

3. Broadening the Investor Base for Institutional Investors

Knowing the importance of institutional investors as a major and suitable source of investable funds in long-term and high-risk investments, as well as recent success stories, such as Israel and Singapore which had the growth of their venture capital industries driven by global investors,[164] China's regulators have made substantial efforts in changing the composition of the investor base in the venture capital market, thus allowing more qualified institutional investors to engage in venture capital investments.

Foreign investors were progressively permitted to make equity investments in China through the Qualified Foreign Limited Partner ("QFLP")[165] scheme, the Renminbi Qualified Foreign Institutional Investor ("RQFII") programme[166], as well as the Renminbi Qualified Foreign Limited Partner ("RQFLP") programme.[167]

Regulators, notably CSRC, China Insurance Regulatory Commission ("CIRC") and CBRC have also removed previous restrictions on NSSF, insurance companies,

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163 Lin Lin, *The Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners*, 13(1) JOURNAL OF CORPORATE LAW STUDIES 185 (2013).
164 Lerner, *supra* note 18 at 101.
165 Under the QFLP, foreign-invested private equity funds and fund management companies are permitted to convert their foreign currency capital into RMB in order to invest into RMB funds, i.e. funds that are raised in RMB. Factors for foreign funds to be qualified participants under the program included whether (i) the fund identified investors and obtained firm commitments from such investors; (ii) the management team has sufficient PRC investment experience; (iii) the fund had certain favoured investors such as government guidance funds or SOEs; (iv) the fund established a governance structure, investment plans, and capital contribution, distribution and allocation mechanism. See Bryan Pereboom, *Renminbi Qualified Foreign Limited Partner: an Incremental Step Toward RMB Internationalization in the Private Equity Industry*, THE NATIONAL LAW REVIEW (May 21, 2013), http://www.natlawreview.com/article/renminbi-qualified-foreign-limited-partner-incremental-step-toward-rmb-international.
166 Under the RQFII, Hong Kong subsidiaries of approved PRC securities firms were permitted to raise RMB funds in Hong Kong to invest in the PRC securities markets. Each firm was limited to a quota determined by the State Administration of Foreign Exchange ("SAFE"). RQFII investments are limited to stocks, bonds and warrants traded on stock exchanges, fixed-income products traded on inter-bank bond markets, securities investment funds, stock index futures and other financial instruments permitted by the CSRC.
167 Renminbi Qualified Foreign Limited Partner Program ("RQFLP") 2012 permits offshore-raised RMB to be invested in PRC companies by PRC private equity funds and managers. RQFLP is an extension of the QFLP, and also follows in the wake of the RQFII. The RQFLP avoids the necessity of obtaining foreign currency exchange approval. Like the RQFII, RQFLP funds raise and deploy offshore RMB. However, unlike RQFII, the foreign invested fund may invest in convertible instruments, private companies, and private placements in listed companies. Qualified RQFLP participant funds will include Hong Kong subsidiaries of PRC investment firms and foreign fund managers with an established record and offshore-RMB fundraising capacity. In the PRC, the RQFLP fund can set up a foreign invested fund manager ("FIE Manager") with registered capital of USD 2 million or a foreign-invested fund ("FIE Fund") with registered capital of US 15 million to act as a general partner onshore. Each foreign investor in the FIE Fund must own assets of US 500 million or have US 1 billion under management. Limitations for investors in Fund Managers have not been specified.

commercial banks and trust companies[168] in equity investments. For example, CIRC has issued a set of investment guidelines to allow insurance companies to engage in venture capital investments. They have built up substantial assets in venture capital industry at a fast pace, reaching 10 billion RMB at end of 2014. Up to 20% of these assets amounting to 203 billion RMB can be allocated to equity investments, according to the Report on Insurance Statistics 2014.[169]

Although policy relaxation has positively opened more investment channels for institutional investors, investment restrictions are placed for the purpose of investor protection in this high-risk industry. For instance, total assets invested into venture capital funds must not exceed 2% of an insurance company's total assets and exposure to a single fund is capped at 20%, according a CIRC notice issued in 2014.[170] As for National Social Security Funds, up to only 10 % of its total assets can be used for venture capital and private equity investments.[171] Also, local pension funds have not been allowed to make equity investments in China, though proposals have been made to enable pension funds inject funding to China's venture capital funds.

Table 1: Percentage Of Capital Raised By Limited Partners in China's Venture Capital and Private Equity Market
(By Investor Type)[172]
Sources: Zero2IPO

China	2011(%)	2012(%)	2013(%)	2014(%)
Wealthy families and individuals	2.1	2.5	2.6	2.7
Corporations and enterprises	32.2	29.7	29.9	29.5
Investment funds and companies	33.1	35.0	34.7	34.2

[168] Since 2008, National Social Security Fund has been permitted to make equity investment in certain industrial funds. Since 2010, insurance companies were allowed to make equity investments under the Interim Measure of the Equity Investment by Insurance Capital (*baoxian jijin guquan zhanxing banfa*). In 2014, Insurance companies were permitted to make investment in venture capital market under the Notice of the China Insurance Regulatory Commission on Matters concerning the Investment of Insurance Funds in Venture Capital Funds. In 2013, asset management companies were permitted to make equity investments in public securities investment fund (zichan guanli jigou kaichan gongmu zhengquan touzi jijin guanli yewu zhanxing guiding).

[169] Touzijie, *2015 nian yi jidu huoyue LP zengzhi 14337 jia, xianzi, yindao jijin qianzai guimo pangda* (Apr 29, 2015), http://www.zgctrz.com.cn/shownews-29840.html.

[170] Notice of the China Insurance Regulatory Commission on Matters concerning the Investment of Insurance Funds in Venture Capital Funds 2014.

[171] This ratio at the end of August 2014 was only 2.26%, with ample room to be growth. *See* Geshangli Research Centre, *Quanguo shebao jijin, baoxian zijin touzi PE "liangda buxiao"* (Aug 7, 2014), http://m.licai.com/zixun/content?id=60577.

[172] "Wealthy individuals and families" comprise family offices and wealthy individuals; "Investment funds and companies" comprise funds of funds, GP and sovereign wealth funds; "Pension funds" comprise public, corporate and union pension funds.

Pension funds	24.7	24.8	24.3	22.9
Endowments	0.8	0.7	0.7	0.7
Insurance companies	1.1	1.0	1.1	1.1
Banks/ financial services	3.8	3.0	2.9	2.8
Government related agencies	2.2	3.0	3.1	5.4
Others	0.0	0.3	0.7	0.7
Total	100.0.0	100.0	100.0	100.0

Table 2: Percentage Of Types of Limited Partners in China (By Number)[173]
Sources: Zero2IPO

China	2011(%)	2012(%)	2013(%)	2014(%)
Wealthy families and individuals	46.1	50.2	50.8	54.4
Corporations and enterprises	19.5	17.2	16.6	14.9
Investment companies	4.7	5.9	6.1	8.5
Others	29.7	26.7	26.5	22.2
Total	100.0.0	100.0	100.0	100.0

Table 3: Percentage Of Capital Raised in the U.S. Venture Capital Market (By Investor Type)
Sources: National Venture Capital Association

US.	2013(%)	2014(%)
Wealthy families and individuals	17	16
Corporations and enterprises	2	3
Investment funds and companies	26	21
Pension funds	33	27
Endowments	10	17
Insurance companies	6	7
Banks/ financial services	3	4
Others	3	5
Total	100	100

173 "Wealthy individuals and families" comprise family offices and wealthy individuals; "Investment funds and companies" comprise funds of funds, GP and sovereign wealth funds; "Pension funds" comprise public, corporate and union pension funds.

B. Investment Vehicles

Over time, a considerable number of jurisdictions have introduced various kinds of investment vehicles in order to increase a venture capital market's attractiveness and the investment vehicles used by venture capitalists and investors vary from jurisdiction to jurisdiction. The limited partnership has been the predominant vehicle for venture capital fund raising in the US since the 1970s,[174] while the company is the predominant vehicle in Taiwan's venture capital market.[175] In recent years, a number of jurisdictions such as Singapore,[176] New Zealand,[177] Taiwan,[178] Japan[179] and Switzerland[180] have introduced the limited partnership into their business menus so as to attract equity investment in their regions. Some jurisdictions, such as the UK[181] and Australia[182] have recently adjusted their limited partnership regimes in order to encourage the growth of venture capital investment.

Chinese policymakers have strong incentives to create efficient legal rules and organizational form to meet the needs of the emerging venture capital market. It has also taken positive steps in inducing the development of the necessary specialized financial intermediaries that help to create a venture capital market, especially in introducing new business vehicles that can solve contracting problems in the venture capital cycle.

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174 *See* Gompers & Lerner, *supra* note 20, at 10.

175 Christopher John Gulinello, *supra* note 67.

176 Singapore has passed the Limited Partnership Bill on 18 November 2008. The Singapore Limited Partnership Act 2008 came into operation on 4 May 2009.

177 The Limited Partnerships Act 2008 came into force on 2 May 2008 in New Zealand. See New Zealand Companies Office, *News Release*, and "*Introducing Limited Partnerships*" (3 December 2008), http://www.companies.govt.nz/cms/other-registered-entities/limited-partnerships/introducing-limited-partnerships/.

178 Taiwan Executive Yuan passed the Limited Partnership Law on 27 June 2007. See Taiwan Council for Economic Planning and Development, News Release, "Council Passed the Limited Partnership Bill" (10 August 2007), online: Taiwan Council for Economic Planning and Development, < http://www.cepd.gov.tw/m1.aspx?sNo=0008466> (in Chinese).

179 In 1999, the National Diet of Japan passed the Limited Partnership for Investment Act (投資事業有限責任組合契約に関する法律) to enable the formation of "the Limited Partnership for investment". Text available online: < http://www.meti.go.jp/topic/data/e40430aj.html> (in Japanese).

180 A special form of limited partnership which was designed for collective investments in the alternative investment area was introduced into Swiss law in 2007. See Remy Bärlocher, "the Swiss Limited Partnership - an attractive structuring alternative for Private Equity in Europe" (2007 December/2008 January) European Lawyer 77.

181 The British Government announced in 2006 that it would reform the Limited Partnership Act 1907 so as to clarify and modernise the law relating to limited partnerships. Certain changes based on these recommendations were brought forward in a Legislative Reform Order (LRO) laid before Parliament in June 2009. For further information on the reform of the Limited Partnership Act 1907, see Department for Business Innovation and Skills, "Partnership Law", online: Department for Business Innovation and Skills < http://www.berr.gov.uk/whatwedo/businesslaw/partnership/page25911.html>. In July 2015, the British government published a proposal on using legislative reform order to change partnership legislation for private equity investments. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/447458/Proposal_on_using_LRO_for_LimPart_condoc.pdf

182 In 2007, a Tax Laws Amendment (2007 Measures No. 2) Bill was introduced to Australia in order to relax the eligibility requirements for foreign residents investing in venture capital LPs and Australian venture capital funds. See Minister for Revenue and the Assistant Treasurer, Media Release, "Government to Make Further Improvements to the Tax System" (29 March 2007), online: the Treasury Portfolio Ministers Portal <http://assistant.treasurer.gov.au/pcd/content/pressreleases/2007/028.asp>.

Depending on the organizational forms of the funds, Chinese venture capital funds can be categorized into three major types: (1) company-type funds, (2) trust-type funds[183], and (3) limited partnership-type funds.[184] A recent survey shows that, among the newly raised venture capital funds in 2008, 51.19% were limited partnerships, 39.29% were company-type funds, and 4.76% were trust-type funds.[185]

The trust-type funds have emerged in China since 2007.[186] In a typical trust-type fund, a trust company acts as a trustee of the fund and is responsible for fund raising and investments. The capital is pooled from investors through the trust plan. A trust company would employ a professional investment company (normally private equity firms or investment banks) as the investment consultant of the fund, or conduct investment on its own. It is also common for trust company to set up an investment committee to choose portfolio companies and make investments. Investors participate in the management of the trust plan through beneficiary meetings and share profits according to the trust plan. There is no taxation on trust profits, but income tax or enterprise tax on the beneficiary level.

However, due to the complex structure, insufficient protection to investors and beneficiaries[187], as well as the lack of registration regime,[188] the trust-type funds

[183] The trust-type private equity funds have emerged in China since 2008. The trust type of fund is regulated by the PRC Operational Guidelines for Private Equity Investment Trust Business of Trust Companies 2008 (The China Banking Regulatory Commission, Yinjianfa 2008 No 45).

[184] *See* Lin, *supra* note 163, at 190.

[185] *China Venture Capital Yearbook 2009*, (Democracy and Construction Press, 2009) at 252.

[186] This type of fund is regulated by the PRC Trust Law, the *Operational Guidelines for the private equity Investment Trust Business of Trust Companies 2008 (*PRC) (The China Banking Regulatory Commission, Yinjianfa 2008 No. 45). Before that, trust companies were not allowed to invest in the private equity sector directly. Under the *Trial Implementation Measures for the Customer Asset Management Business of Securities Companies 2003 ('Measures for Asset Management'), Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds 2007 ('Measures for Trust Plans of Assembled Funds'),* securities companies, trust companies or individuals in China can establish "the non-limitative aggregate asset management plan" or "the trust plan of assembled funds" to engage in the private equity investments. Under such trust plans, securities companies or trust companies enter into investment management contracts with individual investors. The investors' assets are transferred to the securities companies and pooled together for the purposes of investment. The securities companies or trust companies act as trustees of these assets.

[187] Under the Guideline Of The Trust Company Collective Funds Trust Scheme Management, the investment committee in the trust-type fund is the highest decision making authority, and decides on the important investment issues. The investment committees are not strictly required by law, their composite may vary, although it is typically chaired and made up of members from the investment consultants and supplemented by members from the trustee company. After portfolio companies have been shortlisted by investment consultants and undergone processes such as due diligence and negotiations, it is for the investment committee to decide on the selection of investment projects and investment strategies. The beneficiary meeting does not have powers to be involved in or interfere with project selection and investment decision making. Although investment consultants are restricted to the provision of advisory services, and are not permitted to have powers to make nor implement investment decisions by law, in practice, investment consultants play ta similar role of GPs in a limited partnership-type fund. The involvement of investment consultants in the investment making process creates a problem of inadequate protection for the beneficiaries or investors. Since the investment consultants are not the agent of the beneficiaries or investors but are appointed by the trust company, they do not owe duties or accountability to the beneficiaries or investors, nor bear unlimited liability as the GPs do in a limited partnership-type fund. Arguably, the investment consultants would serve in the best interests of the beneficiaries or investors in making advice to the fund. Also, in contrast with GPs, trustee companies do not bear unlimited liability. It only bears limited liability in specific

have not been a popular business form for fund raising in China. Therefore, this section discusses the major types of investment vehicles that are used in the Chinese venture capital market, as well as the major legal problems that they face.

1. Limited Partnership

a) A Venture Capital Oriented Business Vehicle

The limited partnership is a new business vehicle in China, and was adopted by the revised Partnership Enterprise Law of the People's Republic of China ("PEL") on 1 June 2007[189].

The adoption of the limited partnership is a part of the government's strategy to develop scientific innovation as articulated in its 11th Five-Year Plan (2006-2010).[190] Enacted in 2005, this Five-Year Plan identified promoting venture capital investment as a critical element for achieving "independent innovation" and sustainable economic progress of China.[191] The Chinese legislature, knowing that the limited partnership had already been proven to be a popular business form for venture capital funds in the US and had been introduced by a number of jurisdictions to encourageing investment, such as Singapore and New Zeland[192], decided to introduce the limited partnership in China so as to attract venture capital to high-

situations, such as illegal activities or breach of the trust agreement, while bearing no liability for any failures under ordinary operating situations. As such, the accountability of the trustee company towards the fund is limited.

188 Article 27 of the Trustee Company Management Guideline provides that the "trustee company has the duty towards the trustor and beneficiaries to keep all other trust matters and documentation confidential, except when it is otherwise agreed upon." As such, this often means that the trustee company, as part of keeping the identity of the beneficiaries confidential, does not need to engage in the registration of the trust. For a legal viewpoint, the lack of registration means that trust assets and properties cannot be fully ascertained, thus there is implication on the transfer and determination of assets, and this has adverse effects on safeguarding the rights of transacting parties. More importantly, as the trust regime lacks a compulsory public registry, the identity of the beneficiaries cannot be determine and this becomes an obstacle when the portfolio company of the trust-type VC fund wants to conduct an IPO. According to the Securities and Futures Commission (SFC) of Hong Kong requirements, a business must reveal the actual shareholders, to prevent problems such as cross shareholding. As the trustee company merely manages the trust assets on trust, the identity of the beneficiaries cannot be ascertained. As the SFC does not recognize the trustee company as a legitimate shareholder in an IPO, it means that a trust-type VC fund is likely to face problems with its exit strategy when it was to conduct an IPO. For example, China Pacific Insurance Group was unable to get listed until the shares are no longer held indirectly by trustee companies. This led to a pre-listing sale by the beneficiaries of the trust or a direct purchase by the trustee companies themselves, leading to a huge cut in the profits of the venture capital business, relative to its subscription price.

189 The law was promulgated in 2006 and came into effect in 2007. Prior to the revision of this particular statute, the general partnership (GP) was the only partnership vehicle allowed under PRC law.

190 See "中共中央关于制定国民经济和社会发展第十一个五年规划的建议"（2005 年 10 月 11 日中国共产党第十六届中央委员会第五次全体会议通过）[Central Committee of the China Communist Party, "The Eleventh Five Year Plan", online: Government of PRC <http://www.gov.cn/ztzl/2005-10/19/content_79342.htm >].

191 See NPC news release in May 2006, "Reasons for revising Partnership Enterprise Law", copy available in Chinese at http://www.npc.gov.cn/npc/bmzz/caizheng/2006-05/08/content_1383740.htm (viewed 1 October 2008). Before the introduction of LPs, the only major legal structures generally available for venture capital firms in PRC are the Limited Liability Company, Joint Stock Company and General Partnership but all of them are unattractive because of their inherent features.

192 For the legislative background of the Singapore LP and the New Zealand LP, see Law Reform and Revision Division ("LRRD") of Singapore, *Singapore Report of the Study Team on Limited Partnerships*, online: MOF <http://www.mof.gov.sg/consultation_archives/public_con_lp_bill_2006.html> [Singapore LP Report]. New Zealand Companies Office, News Release, and "Introducing Limited Partnerships" (3 December 2008), online: N Zealand Companies Office <http://www.companies.govt.nz/cms/other-registered-entities/limited-partnerships/introducing-limited-partnerships/>.

tech growth enterprises and encourage the development of venture capital market in China.[193] Nonetheless, as indicated in the drafting materials of the PEL,[194] Chinese limited partnership is not intended to model a specific or single foreign limited partnership regime, but has taken different legal institutions and provisions from the existing limited partnership regimes around the world.[195]

Right after the enactment of the revised PEL on 1 June 2007, the very first Chinese Limited Partnership (*Nanhai Chengzhang Venture Investment Limited Partnership*)[196] was set up on 27 June 2007. Till the end of 2008, hundreds of private equity funds were registered as limited partnerships in China,[197] reflecting an overwhelmingly positive attitude in the business community towards this new business vehicle. More than half of new venture capital funds raised in 2008 were organized as limited partnerships.[198] Today, the limited partnership has become the most common business vehicle in the Chinese venture capital market.[199]

The popularity of the limited partnership in China is contributed by a variety of factors. Firstly, the adoption of the limited partnership increases the business menu available for venture capitalists in China. Before the limited partnership was introduced, the major business forms for venture capitalists were the Limited Liability Company ("LLC"), the Joint Stock Company ("JSC") and the general partnership. However, these business vehicles have their own limits such as the double tax treatment and the substantial formation costs and disclosure requirement on financial information.[200] As for the general partnership, the unlimited liability of all the partners and the harsh tax burden[201] were major drawbacks.

Secondly, similar to the nature of partnerships in most parts of the world, Chinese partnership is governed by the partnership agreement and partners are able to enter

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[193] Yan Yixun, *Reasons of Revising the Partnership Enterprise Law*, National People's Congress, News Release (8 May 2006), http://www.npc.gov.cn/npc/bmzz/caizheng/2006-05/08/content_1383740.htm.

[194] See generally in 朱少平&葛毅,《中华人民共和国合伙企业法的修订:立法进程资料汇编》(中信出版社: 2004) [Zhu Shaoping & Ge Yi eds, *The Review of "the Partnership Enterprise Law of People's Republic of China"* (Beijing: Citic Publishing House, 2004)]. [Zhu & Ge, *The Amendment of the Partnership Enterprise Law*].

[195] *Id.*

[196] Shanghai Securities News, *The First Venture Capital Limited Partnership was Established* (29 June 2007).

[197] See 许慧颖, "有限合伙投资企业上市受限制 业内呼吁政策松绑" 《第一财经日报》 (15 October 2008) [Xu Huiying, "LP Investee Companies face IPO Problems" *First Securities Daily* (15 October 2008), online: Sina News <http://finance.sina.com.cn/stock/y/20081015/02105390391.shtml>].

[198] *China Venture Capital Yearbook 2009, supra* note 185, at 252.

[199] *See* China Venture Capital Yearbook 2009*, supra* note 185 at 252. A 2008 survey shows that the LP has become the most popular business vehicle for venture capital fund raising in China. More than half of new venture capital funds raised in 2008 were organized as LPs.

[200] Before the revision of the *PRC Company Law 2005*, it was not easy to incorporate a company in China as the minimum capital required for the Limited Liability Company and the Joint Stock Company was 500,000 RMB and 10 million RMB (USD 73000 and USD1450000) respectively.

[201] Before 2000, the PRC partnership enterprise was subject to taxation both at the enterprise level and upon distribution. Since 2000, the partnership enterprise has been considered tax transparent.

into covenants that align the interests of both parties and incentives the venture capitalists, particularly in terms of compensation and internal governance. Moreover, as compared to companies, it is evident that partnerships enjoy a larger degree of confidentiality in their financial information which is an advantage for investors who do not wish to disclose the investment in the funds. Partnerships also enjoy considerable lower formality costs as compared to companies. Further, the combination of limited liability and personal liability meets the needs of the key practitioners in the venture capital market, especially the investors who prefer to entrust the capital to the experienced venture capitalists and who do not want to bear the unlimited liability for the debts of the partnership.[202]

Additionally, partnerships enjoy the tax transparent treatment on entity level. There are also a number of preferential tax policies on LPs and GPs at local level. For example, in Tianjin, a considerably low 20% individual income tax rate is applicable GPs and LPs who are natural persons, and a 100% subsidy is granted to the part beyond the 20% individual income tax of natural person partners as retained by development zones. In Shenzhen, a 5%-35% five-level progressive tax rate in excess of a specific amount has been implemented for natural person GPs and a 20% individual income tax rate is applicable for LPs.

b) Basic Features of the Chinese Limited Partnership

The Chinese Limited Partnership[203] model possesses basic features of a modern limited partnership regime. It is deemed to be valid from the date of issue of the partnership enterprise business license.[204] It has the right to hold assets,[205] to sue and be sued[206] and the partnership does not dissolved upon dissociation of partners.[207] There are two types of partners: GPs who are jointly and severally liable for the debts and liabilities of the firm, and LPs who are only liable to the extent of their capital contributions.[208] In addition, there must be at least one expressly identified general partner who would bear unlimited liability for the debts of the firm,[209] and

[202] *Id.*
[203] As indicated in the drafting materials of the PEL, the Chinese Limited Partnership was not intended to model after a specific or single foreign limited partnership regime, but has adopted different legal institutions and provisions from the existing limited partnership regimes around the world. *See generally* Zhu & Ge, *supra* note 72.
[204] *See id.* Art 11.
[205] *Partnership Enterprise Law 2006* (PRC) Art. 20, 21 and 22.
[206] See *Civil Procedural Law 2007* (PRC) Art. 49.
[207] *Partnership Enterprise Law 2006* (PRC) Art. 48 provides that where any partner is under any of the following circumstances, the said partner shall be deemed to have withdrawn naturally from the partnership:
(1) a natural person partner is deceased or declared deceased according to law;
(2) it (he) is insolvent;
(3)a partner as a legal person or any other organization whose business license is revoked, or who is ordered to close up for revocation, or who is declared bankrupt;
(4) a partner loses the relevant qualifications as required by law or as stipulated in the partnership agreement; or
(5) a partner's entire property share in the partnership business has been executed by the people's court.
[208] *See* Art 2 of Partnership Enterprise Law (promulgated by the Standing Comm. Nat'l People's Cong., Feb. 23, 1997, effective Aug. 1, 1997, revised Aug. 27, 2006) [hereinafter *PRC PEL*].
[209] *Partnership Enterprise Law 2006* (PRC) Art. 61.

partners can be individuals and legal persons.[210]

The Chinese Limited Partnership model also provides the fundamental default rule on the management of the firm within a modern limited partnership regime – a limited partner shall not "carry out partnership affairs", while GPs have the right to exercise day-to-day management of the firm.[211] However, the PEL does not provide that a limited partner shall be personally liable for the obligations of the firm should he carry out partnership affairs. The PEL merely offers guidelines by providing a "safe-harbor" list of activities that are not considered as taking part in partnership management. Meanwhile, alternative rules such as common law estoppel dictates that, if a limited partner carries out partnership business without authority and causes loss to the partnership and other partners, the limited partner is liable for the loss caused. Furthermore, if a third party reasonably believed that the contracting party was a general partner and conducted transactions with that partner, the limited partner would bear the same liability as a general partner in the partnership. However, to establish liability under this rule, the third party bears the burden of proving that he reasonably believed that a limited partner was a general partner, and that he accordingly proceeded to conclude a transaction with the limited partner.[212]

In the context of the Chinese venture capital market, a typical venture capital fund is a fixed-life fund organized as a limited partnership, raised and managed by a professional venture capital firm comprising investment professionals. These funds are usually termed as venture capital limited partnerships, where the rights and obligations of GPs and LPs, as well as the fund's governance are set out in the limited partnership agreement.. The venture capital firm generally serves as the general partner in the limited partnership, making and monitoring the fund's investment and carrying out the day-to-day operations of the fund's business, such as raising new funds, selecting and approving portfolio companies, and managing and monitoring the fund's investments. For the investors, they act as LPs who are passive in the management of the fund and merely provides capital to the fund.

c) Chinese Limited Partnership in the Venture Capital Context

While there is a rapid growth of venture capital funds in China, a handful of problems have arisen alongside. This part highlights two pervasive problems within Chinese venture capital limited partnerships and the differences between US and Chinese practice on the two matters.

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[210] Art 2, Partnership Enterprise Law of PRC.
[211] *See id.,* Arts 2, 67 and 68.

(1) Control

Unlike LPs in US venture capital funds, who are generally passive and do not participate in the control of the fund,[213] a pervasive problem in the Chinese venture capital industry is that LPs are more active and eager to take part in the management of the fund, especially in the selection of portfolio companies.[214]

Beyond such instances of active participation by Chinese LPs, there are also internal governance mechanisms that cede powers to them. As compared to a typical U.S. venture capital fund where only GPs make decisions on the daily operation of the fund, many Chinese LPs are able to participate in the management of the fund through various kinds of internal committees.[215] These internal committees are typically referred to as "investment strategy committees" (*touzi juece weiyuanhui*), and would generally comprise both limited and GPs, and external advisers, and which is formed to review and approve investment proposals.[216] This was the case for Richlink Capital Fund, where the investment strategy committee of seven consisted of two GPs, three representatives from the LPs, and two external experts, and the LPs have veto power over all investment proposals.[217]

The LPs are generally able to overcome the risk of being considered as GPs if they actively participate in the management of the funds because of the legislative gap within the PEL. That is, Article 68 of the PEL simply provides that "a limited partner shall neither carry out partnership affairs nor represent the limited partnership when dealing with other parties." However, in contrast to jurisdictions such as US-Delaware,[218] New Zealand[219] and Singapore[220] which specifically make an LP personally liable for the obligations of the firm if he does takes part in the control of the partnership's affairs, the PEL is silent on whether a LP is personally liable for the obligations of the firm if he does takes part in the management of the partnership's affairs. Also, the meaning of "management" has not been authoritatively determined in China. The PEL merely provides a list of the activities which limited partners will not be deemed as "carrying out the partnership affairs" (also known as the "safe-harbour" list) [221]

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[213] *See* Zou, *supra* note 55, at 79.
[214] *See* Lin, *supra* note 163.
[215] *See* Chen Wei, *The Opportunity and Evolution of PE after the Financial Crisis*, China Venture Capital Research Institute (ed), China Venture Capital Yearbook 2010 (Democracy and Construction Press, 2010) at 61.
[216] Zero2IPO Research, *Report for China Venture Capital and Private Equity Management Mechanism and Compensation Scheme 2011* (2012) at 13.
[217] Yang Yongxiang and Xu Xiaocheng, *Limited Partners in China* (2008) 8 *TopCapital 1*.
[218] Delaware Revised Uniform Limited Partnership Act, § 17-303
[219] Limited Partnership Act 2008 (New Zealand), s 30.
[220] Limited Partnership Act 2008 (Singapore), s 6.
[221] Art 68, Partnership Enterprise Law of PRC 2006. These activities include: "(1) participation in a collective decision to admit or remove a general partner;(2) making a proposal relating to the business management of the limited partnership firm; (3) participation in the selection of an accounting firm to audit the limited partnership firm; (4) receiving an audited financial report of the limited partnership firm; (5) inspection of accounting books and other financial information of the limited partnership business which involve self-interest; (6) commencement

Additionally, there are two alternative rules under PEL that might make a limited partner personally liable for the obligations of the firm if he does exercise control of the partnership's affairs. For example, under Article 98 of the PEL, if a partner carries out partnership business without authority to do so and causes loss to the partnership and other partners, the limited partner is liable for the loss caused. Nevertheless, this article does not applicable if LPs have concluded into the partnership agreement that they have the authority to make decision or advice to the investment projects. Also, according to Art 76 of PEL, if a third party reasonably believed that the contracting party was a GP and conducted transactions with that partner, the partner would bear the same liability as a general partner in the partnership. However, to establish liability under this rule, the third party bears the burden of proving that he reasonably believed that a partner was a GP; and he accordingly proceeded to conclude a transaction with the LP. For third parties of the venture capital funds who do not have information about the decision making process of the funds, it is difficult to prove that they are aware that LPs have exercised control in the management of the fund.

Nonetheless, while limited partners' activism used to be prominent in China, the situation might well just be temporary. Firstly, China's limited partnership is a relatively new business vehicle and the market is young and do not have the rich entrepreneurial experience that U.S.' venture capitalists possess. Many Chinese venture capitalists come from investment banking background without venture capital industry experience[222] and there is a shortage of experienced venture capitalists with good track record. Therefore, Chinese limited partners' activism is likely to be merely a manifestation of their unfamiliarity with the business vehicle and the unsatisfactory of the inexperienced venture capitalists. Secondly, as shown in Table 1 & 2, institutional investors are increasingly becoming the major composition of venture capital investors in China. Unlike the individual investors, they are less likely or willing to participate in the management of the fund.

In practice, there have been changes in recent times, as the Chinese investors are becoming increasingly passive and generally do not interfere with the GPs' investment decisions. One such evolution is doing away with the need for unanimous approval on the investment proposal, coupled with the presence of a general partner majority on committees. For instance, the investment strategy committee of New Margin Ventures Fund (*yongxuan jijin*) is made up of three GPs

of legal proceedings against an accountable partner when the limited partnership's interests have been infringed; (7) initiation of legal action in one's own name to safeguard the limited partnership's interests where the partner responsible for the conduct of partnership affairs has neglected the exercise of his rights; and (8) providing guarantee for the limited partnership."

[222] Investment and Cooperation, [Touzi yu Hezuo] "China LP" http://money.163.com/08/0806/10/4ILIMEGP00252GKH.html

and two LPs, and decisions are made by a majority vote.[223] Other recent developments include allowing only GPs to form the investment strategy committee, limiting the role of LPs to that of an advisory role in an advisory committee,[224] or explicitly restricting and limiting interference with investment decisions of the GPs.[225]

(2) Compensation

In the U.S. venture capital market, the most popular distribution rule of GP's compensation is the so-called "2/20 Rule". The GP's compensation comprises two parts: an annual management fee for its services of 2 to 2.5 % of the committed capital; and a carried interest of 20 to 25 % of the profits realized by the fund.[226] As an industry-wide practice, it has long been accepted that the 2/20 rule serves an effective mechanism to align the interests of the LP and the GP. This is because the carried interest is dependent on the success of the fund and thus provides a powerful performance incentive mechanism to the GP.

While a large number of Chinese funds follow the international practice on the compensation to GP and LP, there is also some special practice in China, particularly in state-owned venture capital firms, which are established and owned by the state. These firms exist a hierarchical system under which promotion of investment professionals are not based on their performance, but mainly by their seniority and positions.[227] For example, senior management are generally not entitled to own shares of the firm and the appointment of the executives is made by the respective state asset supervision authority. In order for a Vice President to be promoted to a partner, they have to serve for a certain period of time and the promotion is subject to the substantial change of the organizational structure and overall performance of the fund.[228]

In the case of Shenzhen Capital Group Co. Ltd ("SZC"), its senior management does not own shares of the firm and the appointment of the executives is made by the State-owned Assets Supervision and Administration Commission of Shenzhen Government.[229] With regard to the distribution of profits, substantial profits of SZC are distributed to the largest shareholder, the state-owned Assets Supervision and Administration Commission of Shenzhen Government, while only 8% of profits are distributed to the employees and 2% of profits from specific funds are given as a

223 *Id.*
224 *Id.*
225 *See* Zou, *supra* note 55, at 77.
226 Kate Litvak, "Venture Capital Partnership Agreements: Understanding Compensation Arrangements," University of Chicago Law Review, Vol. 76, pp. 161-218 (2009) at 161
227 Pan Wei, "" 21 Centry Economic Report, May 13, 2013, http://pe.pedaily.cn/201305/20130513348320.shtml
228 *Id.*
229 *Id.*

performance bonus to the investment team.[230] Arguably, this form of performance-based compensation structure is less attractive than the usual 2/20 rule, and hence may not be able to sufficiently incentivize the GP. Consequently, this has been regarded as one of the major reasons for the high-turnover rate of the management of SZC as witnessed by the fact that three chief executives of the company have left the firm since 1999.[231] Another example would be the case of Fortune Capital, which is also a renowned state-owned venture capital firm like SZC. The largest shareholder of Fortune Capital is Hunan TV and Broadcast Intermediary Co.Ltd, while the other key founding partners only hold 25% of shares of the firm. Further, GPs of the funds are only entitled to a 5% carried interest, which is significantly lower than the 20% market standard.[232]

In addition, a GP's compensation in these state-owned firms generally consists of four components: basic salary, performance-related pay (*jixiaogongzi*), return on co-investment (*xiangmugentoushouyi*) and carried interests.[233] Performance-related pay is derived from the management fees, after deduction of operation costs and expenses; and the final amount of bonus distributable is calculated based on the net profits and economic performance of the firm.[234] Empirical evidence shows that performance ratios (i.e. performance-related pay / total pay) is directly correlated to the management level of the manager.[235] For example, 60% of the total pay to chief managers/partners is performance-related pay whereas the equivalent figure for junior investment managers is only 20%.[236]

In addition, there is a variation of the 2/20 rule in several local venture capital firms, such as the project bonus (*xiangmu jiangjin*), which includes the "fund raising bonus" (*xiangmujiangjin*). This bonus ranges progressively from 3%-5% of the total raised fund depending on the size of the fund.[237] There is also an investment bonus (*touchengjiaing*), which is awarded to those responsible for the investment projects eventually made into portfolio companies, and this typically ranges from 0.5%-1% of the investment amount; or comes in the form of a fixed bonus, depending on the investment amount.[238] Although the above bonus schemes are designed to incentivize GPs, their effects are questionable. A 2011 survey shows there is a large pay gap between GPs from local firms and those in foreign firms, particularly in

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[230] Yao xuanjie, PE Xinchou Jizhi Qidi (May 18, 2013) China Securities News (Zhongguo zhengquanbao) http://finance.ce.cn/rolling/201305/18/t20130518_17113444.shtml
[231] *Supra* note 227.
[232] *Id.*
[233] *Id.*
[234] *Supra* note 230.
[235] *Id.*
[236] China Securities News (Zhongguo zhengquanbao) http://finance.ce.cn/rolling/201305/18/t20130518_17113444.shtml
[237] *Supra* note 234.
[238] *Id.*

terms of carry received. Indeed, one of the major reasons for GPs to leave the firm is due to dissatisfaction with the compensation package.[239]

(3) Other Problems and Suggestions

Besides the issues relating to control of the limited partnership venture capital fund and the compensation structure for GPs, the Chinese Limited Partnership model contains other special features and limitations that may create problems or concerns in venture capital practice.

(a) Upper limit on the total number of partners

Unlike other jurisdictions such as US-Delaware[240], the UK[241], and Singapore[242] which do not impose an upper limit on the number of partners in the limited partnership, the Chinese Limited Partnership has a requirement of at least two partners and the number of LPs must not exceed fifty in total (unless otherwise provided by law).[243] The major concern of the drafters is that investors may engage illegal fundraising if there is no upper limit on the number of investor partners.[244] In practice, there is a lesser cause for concern relating to the upper limit by the general partner as the entity that manages the venture capital fund is usually a company (the corporate general partner). The corporate general partner combines the advantages of corporate identity and limited liability of companies with the contractual flexibility and tax advantages of partnerships.[245] However, the maximum number of partners unduly constrains the size of the fund and the number of investors.

Even if practitioners are able to get around the abovementioned rule by establishing a parallel fund or fund of funds[246], these arrangements are time-consuming and costly. These efforts may also lead to a breach of Art 88 of the PRC Securities Investment Fund Law 2003, which provides that the total qualified investors in a closed fund shall not exceed 200; otherwise it will be regarded as a public issuance of securities. As such, it is suggested that the restriction on the number of partners be removed from the PEL.

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239 zero2ipo research centre, May 9, 2011, http://finance.ifeng.com/gem/vcyj/20110509/3998228.shtml

240 See *Delaware Revised Uniform Limited Partnership Act* § 17-101.

241 Although the UK used to impose an upper limit on the number of partners, there is no longer such a limit for all types of partnerships since 2001. *Singapore Limited Partnership Report*, at para. 8.4.1.

242 *Singapore Limited Partnership Report*, *id* at para. 8.4.

243 Nevertheless, some interviewees said that this restriction was not an obstacle in fund raising, especially when the investor is an institutional investor. Given that the national pension fund has been approved by the State Council to engage in venture capital/private equity investment, it is assumed that the limitation on the number of limited partner will not have considerable side-effect in fund raising.

244 Li Fei, *Interpretation of Partnership Enterprise Law of the People's Republic of China* (Beijing: Law Press China, 2006, at 100.

245 J Rinzer, "English Private and Public Limited Company as Managing General Partner in a German Limited Partnership" (1994) Comp Law 285.

246 Chinese venture capitalists usually would set up a collective trust investment scheme to serve as the limited partner in the fund. And then investors would invest into the fund through purchasing trust units of the scheme.

(b) Restrictions on the general partner

The restrictions on the type of GPs have created huge obstacles in fund-raising, registration and do not accord well with international practice.[247] The PEL does not allow wholly state-owned companies, state-owned enterprises ("SOE"),[248] listed companies,[249] charitable institutions[250] and social organizations to serve as GPs in a limited partnership.[251] This is because GPs bear unlimited liability for the debts of the partnership, and allowing these firms to serve as GPs may place national assets and public funds at risk.[252] There is also a great degree of uncertainty as the PEL is silent on whether the subsidiary or branches of the listed companies or SOEs can serve as GPs[253], and there are different regulations on the types of companies that can be considered as "SOEs".[254]

(c) Contributions

In contrast to the DRULPA[255] that allow LPs to contribute in kind by rendering services, LPs of a Chinese Limited Partnership can only contribute in cash, tangible goods, intellectual property, land use rights or other property rights.[256] The drafter of the PEL asserts that firstly, LPs do not participate in the management of the fund and enjoy limited liability to the contribution to the firm, and hence there is no need for LPs to contribute in service. Secondly, allowing LPs to make contributions in kind may create difficulties in evaluating of their partnership shares.[257] However, in the context of venture capital funds, the expertise and industrial experience of the LPs

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[247] See *German Commercial Code* §161-§176; *French Commercial Code* Art. L222- 1- L222- 12; the *UK Limited Partnership Act 1907* and the *Delaware Revised Uniform Limited Partnership Act*.

[248] The National People's Congress has defended this proposition on the basis that allowing state-owned companies to be general partners may trigger the stripping of state-owned assets and that allowing listed companies to be general partners may also unduly prejudice the interests of shareholders. The latter's investment in the company may then be exposed to 'double risks' in that the company will have to bear unlimited liability not only for the debts incurred by the limited partnership but also liability for its own corporate debts. See *Partnership Enterprise Law 2006 (PRC)* Art. 24; See also Li, *Interpretation of Partnership Enterprise Law*, *supra* note 244, at 4.

[249] In fact, the PRC company law and PRC security laws have provided sufficient mechanisms to protect the shareholder interests. Moreover, the requirement that partners be registered will in principle provide the means for any third party who deals with (or propose to deal with) the LP to easily identify whether the listed company is a general partner in the firm. There is no need to prevent the listed company from being a general partner.

[250] The preclusion of charitable institutions and social organizations from being general partners has been justified by the National People's Congress on the ground of protection of 'public interest'. As many activities of these organizations involve the public and publicly donated funds, it may be inappropriate to expose such organizations to potential unlimited liability.

[251] Art 4, Partnership Enterprise Law of PRC.

[252] Li Fei, *Interpretation of Partnership Enterprise Law, supra* note 244, at 6.

[253] The practical view I s that subsidiaries of a listed company can serve as general partner of a limited partnership as the listed company is only liable for the contribution in its subsidiary but does not need to bear unlimited liability for the debts of the partnership.

[254] These relevant regulations include: *Guanyu shishi shangshigongsi guoyougudong biaozhiguanli zhanxingguiding youguanwentide han* [关于实施上市公司国有股东标识管理暂行规定有关问题的函]（Guozitingchanquan [2008] No. 80）； NDRC Guquan touzi qiye beian weijian zhiyin[股权投资企业备案未见指引]中的[3.2 股权投资企业合伙在协议指引], [8.2 股权投资管理企业合伙协议指引]; guanyu huafen qiye zhuce leixing de youguan guiding [关于划分企业注册类型的有关规定] guotongzi[2011]No.86.

[255] *Delaware Revised Uniform Limited Partnership Act* §17-501.

[256] *Partnership Enterprise Law* 2006 (PRC) Art. 64 read with Art.16.

[257] Li Fei, *Interpretation of Partnership Enterprise Law of the People's Republic of China* (Beijing: Law Press China, 2006) at 105-106.

are invaluable assets to the success of the fund. It is recommended that the PEL should be amended to allow LPs to make contributions in the form of service.[258]

(d) Transfer of Shares

Under the Chinese Limited Partnership, the general partner and the limited partner are allowed to transfer their partnership shares to outsiders (subject to different requirements).[259] An assignee of a general partner will become a general partner himself, and be subject to the rights and obligations in accordance with the amended agreement and the PEL.[260] In stark contrast, the assignee's position is weaker under the US law. A transfer in whole or in part of a partner's transferable interest in the partnership does not entitle the transferee to participate in the management of the partnership business.[261]

The general partner in a venture capital fund plays a crucial role in the management of the fund, such as the selection of portfolio companies, making investments and deciding exit strategies. Arguably, any change of the identity of the general partner is likely to result in to serious consequence for the existing fund. In addition, a change in general partner will have adverse effects on creditors' interests since they rely on the personal liability of the general partner to pay the debts of the fund, especially when the fund uses leverage in the investment. Therefore, it is submitted that the PEL should not entitle the transferee, during the continuance of the partnership, to participate in the fund's management.

(e) Newly Admitted Partners

The UK and the US do not require a newly admitted partners to be personally liable for the prior obligations of a partnership.[262] Logically, the newly-admitted partner ought not to bear any liability for the prior debts of the firm since he was not a partner then and has not been involved in any management of the firm. However, like its German[263] and Japanese[264] counterparts, a general partner in a Chinese

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[258] Where capital contribution that takes the form of in-kind benefits, intellectual property, land use rights or any other form of property rights requires valuation, the *Partnership Enterprise Law 2006* (PRC) Art.16 additionally provides that all the partners may determine the value of the contribution or appoint a statutory organization to conduct the valuation. It is submitted that allowing the partners to determine the value of their own contributions is inappropriate since such practice will invariably prejudice the interests of any third party dealing with the LP firm. In particular, the venture capitalist's contribution in a venture capital LP firm is usually non-monetary property and it is suggested that the partners should appoint a neutral party instead to perform the appraisal.

[259] *Partnership Enterprise Law 2006 (PRC)* Art. 22 and 73. A general partner must obtain the consent of all the partners before the transfer (unless otherwise provided by the partnership). A limited partner may transfer his partnership shares according to the partnership agreement; however, he is required to give 30 days' notice to the other partners before transferring his partnership shares.

[260] *Partnership Enterprise Law 2006* (PRC) Art. 24; See also Li, *Interpretation of Partnership Enterprise Law*, *supra* note 244, at 37.

[261] *Uniform Partnership Act* §503 (1997).

[262]See *Partnership Act 1890 (UK)* s.17 (1); *Delaware Revised Uniform Partnership Act* §15-306 (b); Uniform Partnership Act §306 (1997).

[263]*German Commercial Code* §130 provides that a new partner is liable as the other partners for partrnership obligations incurred before he joined. *German Commercial Code* §173 also provides that a new limited partner shall be liable for partnership obligations incurred before he joined.

Limited Partnership will assume joint liability with the existing partners for the debts incurred by the firm before he joins the firm. Correspondingly, a new limited partner will bear liabilities to the extent of her capital contribution even for the partnership's debts incurred before he joined the firm.[265] Arguably, this restriction would reduce the attractiveness to the venture capitalists and investors in the limited partnership regime.

(f) Conversion

The PEL does not provide any rule specifying how an existing company or partnership may convert to a limited partnership or *vice versa*. Nevertheless, there is a real practical need for venture capital limited partnerships to be able to convert into companies, because portfolio companies invested in by limited partnership-type funds are not allowed to listed on the stock exchange under the current Chinese law.[266] Empirical evidence also shows that a number of funds have had to deregister as limited partnerships and establish as themselves as companies in order to realize their exits. Therefore, in order to meet the business needs of venture capital funds, the Chinese legislature should provide a seamless process for the conversion of limited partnerships to companies.[267] At the same time, the restrictions relating to the listing of companies backed by venture capital limited partnerships should be removed so as to offer these firms better access to capital markets.

(g) Dissolution

Another distinct feature of the PEL relates to the requirement of having to dissolve the limited partnership and convert to a general partnership in the event that the firm is left with only LPs after the departure of all GPs.[268] However, equivalent provisions are not found in its German, French and US counterparts.[269] It is suggested that a Chinese Limited Partnership with only one general partner should be allowed to continue operating over a grace period so as to explore possible options and attract incoming LPs. Also, as a typical venture capital fund usually lasts

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[264] *Japanese Commercial Code* Art. 82 provides that in a corporate partnership (*Gomei Kaisha*), "a corporate member which joined the corporation after its establishment is also liable for the obligations of the corporation arising before the corporate member joined the corporation."

[265] *Partnership Enterprise Law 2006* (PRC) Art. 44 and 77.

[266] 阳光, "人民币基金变脸 GP 高比例出资回归公司制成趋势" 《融资中国》(2009 年 6 月 2 日) [Yang Guang, "RMB Funds Change Face: A Trend to Convert Back to Companies through Increasing Capital Contribution by GP" *Chinese Venture* (2 June 2009), online: *Zero2ipo* news http://news.zero2ipo.com.cn/n/2009-6-2/200962104146.shtml] [Yang].

[267] It is suggested that the law drafter may consider Delaware's rules for the conversion process: before a certificate for 'conversion' to LP can be filed with the Secretary of State, the proposal for conversion should be approved internally by the company or partnership and there should be a partnership agreement that includes the approval of those who have agreed to be the general partners of the LP after the conversion process. See *Delaware Revised Uniform Limited Partnership Act* §17-217.

[268] *Partnership Enterprise Law 2006* (PRC) Art. 75; *Partnership Enterprise Law 2006 (PRC)* Art. 24; See also Li, *Interpretation of Partnership Enterprise Law*, *supra* note 244, at 122

[269] For example, under the *Delaware Revised Uniform Limited Partnership Act* § 17-801, the LP will not be automatically dissolved if the sole remaining partner is either a limited partner or a general partner; instead, the Delaware LP is allowed to appoint another limited or general partner within a grace period of 90 days (or such other period as provided for in the partnership agreement).

for ten years and makes long-term investments in a number of portfolio companies, forcing a limited partnership to be dissolved would create unnecessary costs and negatively affect the operation of the invested portfolio companies, which largely relies on the funding and management by the venture capital fund.

2. The Company as an Alternative to the Limited Partnership

In China, a domestic company-type venture capital fund can be set up as a Limited Liability Company or a Joint Stock Company under the 2005 PRC Company Law. Foreign-invested venture capital funds may choose another business form specially designed for foreign related investments - the venture capital investment enterprise ("VCIE").[270] As compared to a domestic company-type venture capital fund which is subject to double taxation, the VCIE enjoys substantial tax incentives in the form of a 70% tax deduction of its total investment in target enterprises from the venture capital enterprise's taxable income if it makes equity investments in private high-tech and new technology SMEs for more than two years.[271]

One advantage of the company-type fund as compared to limited partnership-type funds is that the liability of all investors in the former are limited, whereas the liability of GPs in latter is unlimited. Like ordinary shareholders in a company, investors in a company-type venture capital fund enjoy limited liability protection up to their contributions to the fund.

Second, shareholders in company-type funds are entitled to participate in the management of the funds through exercising various shareholders rights such as voting in shareholders' meetings and appointing directors of the fund. The company structure is more attractive to individual investors who are more active in the management of the funds as compared to a limited partnership, which generally does not allow investors to take part in the management of the fund under the default limited partnership rule.

Third, board of directors, supervisory board and management in the corporate form are usually subject to strict legal regulations under Chinese law (including the PRC Company Law, PRC Securities Law and soft law such as the listing manual of the

[270] This type of fund is regulated under the 2005 Interim Measures on Administrative Rules on Foreign-Invested Venture Capital Investment Enterprises (FIVCIE Rules).

[271] *See Minister of Finance and State Administration of Taxation Circular on Tax Policies Promoting Development of Venture Capital Enterprises 2007* Cai Shui. No. 31 (PRC) Art.1. The main criteria include the following: (1) The venture capital enterprise itself must be properly registered in China and be operating in compliance with the *Provisional Measures on Administration of Venture Capital Enterprises* issued in 2005; (2) The size of the investee is restricted to no more than 500 employees, and neither gross sales nor total assets can exceed RMB 200 million (about USD 32 million); (3) When the venture capital enterprise files the application for the special tax deduction, the investee must be certified as a "high-technology enterprise" in accordance with the relevant high-technology enterprise certification rules. These rules require that the investee's annual high-technology R&D expenditures represent at least 5% of the investee's gross annual sales, and that the aggregate income derived from technical services and sale of high-technology products represent at least 60% of the investee's annual gross revenues.

stock exchanges). For example, Article 6 of the PRC Company Law stipulates that directors, supervisors and senior management are subject to integrity and sound management duties and Article 147 provides that they are subject to statutory duties of loyalty, diligence, and restrictions from personal gains. However, GPs are not burdened with statutory duties of loyalty or due diligence under the PEL.

Nonetheless, in terms of internal governance structure, company-type funds are less flexible and efficient than partnership-type funds in venture capital context. PRC Company Law has various mandatory requirements on the corporate governance of a company, such as the composition of the board of directors and the board of supervisors. Also, China has the two-tier board system for companies, i.e. the board of directors and the supervisory board. Thus, a Limited Liability Company has to establish a board of three to 13 directors, as well a supervisory board composed of at least three members, or one to two supervisors instead of a supervisory board in small scale company comprising a small number of shareholders.[272] This is in contrast with the Chinese limited partnership, where the internal governance of the partnership and relationship between GPs and LPs are mainly based on the partnership agreement. Moreover, such a compulsory organizational structure under PRC Company Law may cause practical problems in the rapidly changing business world. In particular, when the number of shareholders increase, the governance framework in a limited liability company will have to be changed in order to meet the statutory requirement under PRC Compnay Law.[273] For example, a venture capital limited liability company will have to set up a supervisory board instead of having a supervisor when the size of the company is enlarged.

In summary, although there is little doubt that the adoption of the limited partnership in China marks a milestone in the development of the venture capital industry, there are still various issues that require further legislative attention for the limited partnership-type venture capital firms. In particular, there are certain obstacles that may discourage the use of the limited partnership in venture capital context, such as the fact that limited partnership-type management companies (which are GPs in venture capital funds) are not allowed to be listed on stock exchanges.[274]

C. Stock Market

Venture capital exit is the stage where venture capital investments are returned and profits are realized. Extensive literature has found that a prerequisite for an attractive venture capital market is the existence of a highly liquid exit option that

[272] Arts 44 and 51 of PRC Company Law.
[273] *See* Zou, *supra* note 55, at 64.
[274] See Hu Xuewen, "How Far is IPO from PE" Securities Times (Zhengquan Shibao), 14 November 2014.

enables investors to cash out,[275] though the importance of a national stock market for the development of venture capital market has been questioned.[276] The close links between a deep and liquid stock market and the venture capital market has also been widely tested empirically.[277] As Black and Gilson argue, the presence of a well-developed stock market, which would permit venture capitalists to exit through an IPO, is a precondition to a substantial venture capital market.[278] Indeed, an IPO exit also presents an opportunity for an implicit contract over control to be struck between the venture capitalist and the entrepreneur, in the sense that the successful entrepreneur can reacquire control of his own company from the venture capitalist upon the IPO[279]. It has also been proven that the venture capital industry tends to be stronger and more vibrant in stock market-centered systems, like the U.S., as compared to bank-centered systems, such as Germany and Japan.[280]

One of the concerns of venture capitalists interviewed when considering investment in China is the difficulty to exit.[281] China's stock markets have long been blamed as largely underdeveloped in terms of history, structure and products. Due to the public ownership structure and the planned economy system, the stock market was not established till 1990. Since then, it has been developing alongside with the economic reform and served specific political mission. Scholars have also argued that Chinese private equity market is developed with a weaker and premature stock market as compared to the counterpart in the U.S.[282]

Nonetheless, although it seems a myth that Chinese venture capital industry was developed without a deep and liquid stock market, the CSRC has recently taken substantive steps to create an active stock market. The following section discusses the recent changes and their potential implications in the context of China's venture capital market.

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[275] Marc-Oliver Fiedler and Thomas Hellmann, "Against All Odds: The Late but Rapid Development of the German Venture Capital Industry". The Journal of Private Equity (2001) at 39.

[276] Marc-Oliver Fiedler and Thomas Hellmann, "Against All Odds: The Late but Rapid Development of the German Venture Capital Industry". The Journal of Private Equity (2001), at 32-33 (Fiedler and Hellmann argued against this theory in the context of Germany. They contended that there were a number of "push factors that made entrepreneurship and venture capital more attractive to German, not just the stock market."). Armour, John and Cumming, Douglas J., *supra* note 4.

[277] Jeng, Leslie A. and Wells, Philippe C., The Determinants of Venture Capital Funding: Evidence Across Countries (May 1998). Available at SSRN: http://ssrn.com/abstract=103948 or http://dx.doi.org/10.2139/ssrn.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)

[278] *See* Black & Gilson, *supra* note 10 at 1.

[279] *Id.*

[280] *Id.*

[281] Interview with Mr. X, a vice president of a Shanghai venture capital firm; a lawyer, Ms Y, in a Shenzhen law firm specialized venture capital deals.

[282] See Wei, Shen, Adapting Private Equity to Company Law or Vice Versa? – Understanding Some Key Determinants of a Strong Private Equity Market in the China Context (2011). (2011) 8(3) International and Comparative Corporate Law Journal 44-72.

1. Introduction of Preference Shares

First, convertible preference shares is an important tool for venture capital financing as it offers venture capitalists a preference in distribution of profits and liquidation in the exit of the high-risk industry. It also allocates control to the entrepreneur when things are going well, but allow the venture capitalists to assert control if the portfolio company is doing poorly. Therefore, a venture capital fund's equity investments in portfolio companies typically take the form of convertible preference shares.[283] Numerous economic theories have suggested that such complex securities are beneficial to all parties concerned in a venture capital cycle, as they allow control over the firm to be transferred to the party that can make the best use of them.[284]

However, the Chinese stock market has long been featured with "one share one vote" system with only one class of shares, i.e. the ordinary share. Preference shares were not available till the State Council of China issued the Guiding Opinions on the Pilot Launch of Preference Shares on 30 November 2013. As a result of the lack of preference shares, the Valuation Adjustment Mechanism ("VAM") agreement is widely used by venture capitalists in Chinese venture capital market,[285] by which the venture capitalist may exercise the right to adjust the valuation when the conditions are satisfied.

Since November 2013, listed companies and unlisted public companies were allowed to issue preference shares in both public and private markets in China for the first time.[286] Ten ministries and committees of the State Council jointly enacted a regulation entitled "Interim Measures for the Administration of Startup Investment Enterprises", where Article 15 explicitly stipulates that venture capital may make investments by way of shares, preferred shares and convertible preferred shares when provided in the agreement with venture enterprises.[287]

Arguably, the introduction of the preference shares has adequately met the needs of the Chinese investors, especially the venture capitalists in Chinese market. The followings parts examines China's recent reforms to its stock market towards enhancing its venture capital exit regime, through the introduction of the Small and Medium Enterprise (SME) Board, followed by ChiNext (*chuangyeban*) and New Third Board (*xinshanban*). Some interesting empirical findings on venture capital exit in China will also be offered.

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283 China Securities Regulatory Commission, *Diyijie zhongguo ziben shichang de mengsheng (1978-1992)*, http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/ebook/zgfzbg01_01_01.html.

284 Lerner, *supra* note 18 at 94.

285 Interview with a vice president of a shanghai venture capital firm.

286 Hogan Lovells, *China Launches Landmark Preference Share Pilot Program* (Jan 2014), http://www.hoganlovells.com/files/Uploads/Documents/China_Preference_Share_Pilot.pdf.

287 *See* ZHANG LIN, CHINA'S VENTURE CAPITAL MARKET: CURRENT LEGAL PROBLEMS AND PROSPECTIVE REFORMS 50 (Elsevier 2015).

2. SME Boards

The SME Board was launched in 2005, for the purposes of the establishment of a multi-tier capital market system and providing a new fundraising platform for SMEs. However, the SME Board's ten-year experience has proven that it does not provide a suitable exit channel for venture capitalists. This could be attributed to one of its major obstcales – stringent listing requirements, where the listing requirements and investment threshold are almost the same as the Main Boards. For example, the issuer shall gain profits in the last three consecutive years and its net profits for the last three years shall be no less than RMB 30, with overall cash flow in the past three accounting years as above 50 million RMB in aggregate or the annual revenue over 300 million RMB in the past three accounting years. As such, these stringent requirements filter out most venture capital-backed firms.

3. ChiNext

ChiNext, literally means "China Next", also known as the Growth Enterprise Board (*chuangyeban*), was a new secondary board established in October 2009 on the Shenzhen Stock Exchange ("SZSE"). Although it is very often considered as the "NASDAQ in China", ChiNext is different from NASDAQ in that aimed only at attracting high-growth sectors and high-tech firms to meet the pent-up demand for small companies with difficulties in securing bank financing. Wihle NASDAQ does not focus on a particular industry or type of firm. ChiNext has now become an important exit channel for venture capitalists. As of October 23, 2014, 397 companies were listed on *ChiNext*, with raised capital of 270.489 billion RMB. The market capitalization of the listed companies on ChiNex has dramatically increased by 1400%, from 150 billion RMB in 2009 to 2.2 trillion RMB.[288] In a five-year span since ChiNext was launched, 519 exits were made via ChiNext, with a market return of 743.4 billion RMB.[289] As of October 23, 2014, 519 companies that were backed by venture capital/private equity have already been listed on ChiNext.[290]

A major factor that led to the extraordinary rise of ChiNext stemmed from the more relaxed listing requirements as compared to the Main Board and SME Board. For Example, a company is only required to have a share capital of not less than 30 million RMB after IPO; as compared to 50 million RMB for Main Board and SME Board. ChiNext's profit requirements are also lower than the Main Board and SME Board.

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[288] Securities Daily, *Chuangyeban wunian VC/PE yu 500 bi IPO tuichu huo 674.7 yi huibao* (23 October, 2014), http://finance.chinanews.com/stock/2014/10-23/6707553.shtml.
[289] *Id.*
[290] *See* Securities Daily (Zhengquan Ribao), *Five Year's ChiNext: VC/PE is the Biggest Winner* (*Chuangyeban Wunian, VC/PE Cheng Zuida Yingjia*) (Oct. 23, 2014), http://finance.people.com.cn/stock/n/2014/1023/c67815-25891706.html.

Nonetheless, as compared to NASDAQ which is an important exit venue for high-tech firms, the financial requirements and liquidity requirements of ChiNext are stricter and less flexible. Unlike NASDAQ which adopts 11 sets of standards for three different market tiers (i.e. NASDAQ Capital Market for firms with small market capitalization; NASDAQ Global Market for those with medium market capitalization and NASDAQ Global Select Market for those with large market capitalization); ChiNext adopts only two standards on the profitability requirement: the issuer shall gain profits in the last two consecutive years and its net profits for the last two years shall be no less than RMB 10 million and shall increase continuously; or the issuer shall gain profits in the last year, and the net profits shall be no less than RMB 5 million. In addition, revenue for the most recent year shall be over RMB 50 million and with at least 30% growth rate in the last two years.[291] While it is understandable that a high financial standard for a relatively young exchange is necessary to reduce speculation and increase investor protection, it is argued that the stringent listing requirement of ChiNext makes it difficult for a startup that has yet to be profitable to be listed on ChiNext.

4. New Third Board

The National Equities Exchange and Quotation (NEEQ) system, known as the New Third Board, is a national stock exchange designing for medium-and-small enterprises. Emerging in 2006 out of a trial Over-the-counter (OTC) program allowing a few high-tech enterprises in Beijing's Zhongguancun Science Park, the pilot program was expanded to cover all qualified companies nationwide and the market maker system reforms were also launched to advance the pilot program in 2012.

Amongst all stock markets in China, the New Third Board has the lowest standard for listing requirements. Listing on the New Third Board requires a company to have a valid existence for two years while the other three stock markets, i.e. Main Boards, SME Board and ChiNext required three years. For example, unlike the other three boards that have minimum profit requirements before IPO, the New Third Board only requires a company to have sustainable profitability. Also, while the other boards have a minimum requirement of 200 shareholders, companies listing on New Third Board may have less than 200. Furthermore, there is no requirement on cash flow, net assets or total share capital for companies listing on New Third Board. [292]

With a series of positive laws and policies being promulgated to facilitate the development of the New Third Board,[293] it has emerged as an attractive and important financing channel for small and medium sized companies. As of 11 June,

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291 Art 11, Administrative Measures for Initial Public Offerings and Listing on the Secondary Board.

292 CSRC, Interim Measures for the Administration of National Equities Exchange and Quotations Co., Ltd (2013).

293 Reuters, *CCID Consulting: China`s New Third Board Expansion Nears, Board Shift Will Take More Time* (13 June 2011), http://www.reuters.com/article/2011/06/13/idUS28915+13-Jun-2011+BW20110613.

2015, the number of companies traded on the New Third Board has risen from 343 at the start of the year of 2013 to 2559. The total fundraising reached Rmb 850 billion as of May 2015, up by 6.21 times from less than Rmb1.1 billion in the year of 2013.[294]

Last but not the least, the CSRC is also taking positive steps to advance reform of the IPO system from the current approval-based system to a registration-based one.[295] Under the registration-based system, the market, rather than the regulator, would play a decisive role in allocating resources.[296] It would also substantially reduce costs for startups backed by venture capital to exit via IPO.

5. Empirical Evidence on the Correlation between the Stock Market and the Venture Capital Market in China

a) The link between the Stock Market and Venture Capital Investment

In China's context, it seems the gradual ease of exit through IPOs has significantly encouraged the growth of venture capital investment. Table 4 illustrates the sheer volume of exits via IPOs in China from 2006 to 2014. In 2014 alone, 172 venture capital backed companies went public in China, raising over 19 billion USD. Regression analysis also shows that there is a statistically weak correlation between the number of venture capital-backed IPOs and capital contributions in China from 2006 to 2014 (Figure 4).

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294 Zero2ipo Rsearch Centre, (15 June 2015), "Latest Data on New Third Board 2015" http://research.pedaily.cn/201506/20150615384172.shtml

295 "China mulls draft law to ease regulation on securities" http://news.xinhuanet.com/english/2015-04/20/c_134166615.htm (In April 2015, a draft amendment to the Securities Law was read by the Standing Committee of the National People's Congress (NPC). The draft amendment outlined a stock issuance registration system that would replace the current examination and approval system. This would mean the stock issuance examination committee under the Securities Regulatory Commission will dissolved.)

296 *Id*. See also "Q&A by CSRC Spokesperson on the Opinions on Further Promoting the IPO System Reform" http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201401/t20140108_242271.html that under the registration-based IPO system, the CSRC said it would focus on compliance review of the new listing candidates without judging on the profitability of the IPO companies; the timing of new share issuance and how to issue shares will be determined by the market; valuations of new share offerings will better reflect market demand and supply.

Figure 4: Venture Capital-Backed IPOs And New Capital Commitments To Venture Capital Funds in China 2006 – 2014

Source: Zero2IPO

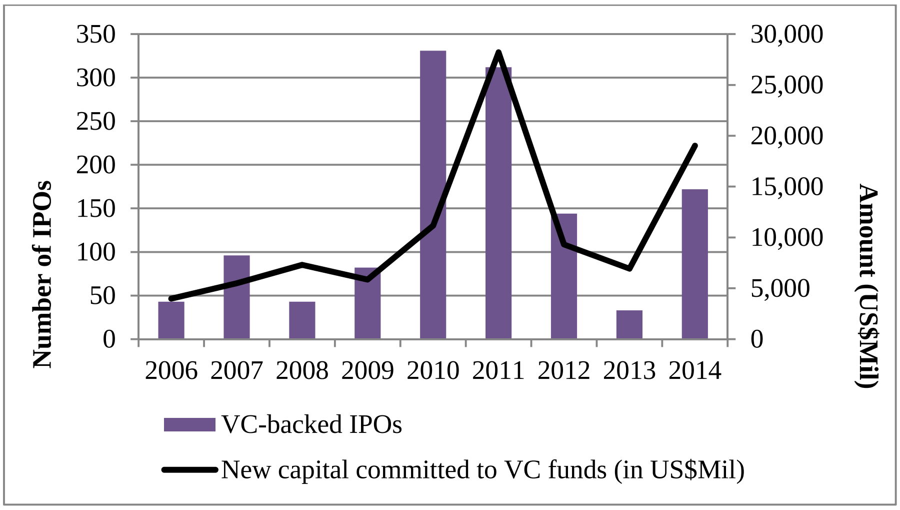

Table 4: China Venture Capital -Backed IPOs And New Capital Committed To Venture Capital Funds In China 2006 – 2014

Source: Zero2IPO

Year	VC-backed IPOs	New capital committed to VC funds (US$Million)
2006	43	3,973.12
2007	96	5,484.98
2008	43	7,310.07
2009	82	5,855.86
2010	331	11,169.00
2011	312	28,201.99
2012	144	9,311.55
2013	33	6,919.07
2014	172	19,021.78

b) IPO as a Preferred Exit Option to M&A

Based on the empirical data shown in Table 5 below, more venture capital exits have taken place via IPO than M&A in China. In 2014, out of 444 venture capital exits in China, there were 172 exits via IPO (accounting for 38.7% of all venture capital exits) and 111 exits via M&A (25% of all venture capital exits).[297] This stands in contrast to the US, where a greater proportion of venture capital exits occur through M&A as compared to IPO (1996-2014). In 2015, the US venture capital industry saw 115 exits via IPO and 459 exits via M&A (see Table 6 below).[298]

[297] Zero2IPO Research Center, *2014 Venture Capital Annual Report* (Mar. 5, 2015),

[298] *National Venture Capital Association, Thomson Reuters & Buyouts Insider*, 2015 National Venture Capital Association Yearbook (18th ed. 2015) at 75.

Table 5: China Venture Capital Exits via IPO and M&A
Number of exits via initial public offerings, M&As and share transfers of venture-capital-backed companies, as well as the corresponding amount of new capital committed to VC funds, from 2006-2014
Source: Zero2IPO[299] & ChinaVenture[300]

Year	Methods of Exit			Total number of exits[301]	Amount of new capital committed to VC funds (in US$Mil)[302]
	IPO	M&A	Share transfer[303]		
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	96	13	-	142	5,484.98
2006	43	25	12	99	3,973.12

Table 6: US Venture Capital Exits via IPOs and M&A
Number of exits via initial public offerings and M&As of venture-capital-backed companies, as well as the corresponding amount of new capital committed to VC funds, from 2004-2014
Source: National Venture Capital Association & Thomson Reuters[304]

Year	Methods of Exit		Amount of new capital committed to VC funds (in US$Mil)
	IPO	M&A	
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
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

299 For data of 2008-2014.
300 For data of 2006-2007.
301 Total figure includes management buyouts and share buybacks.
302 *See* Zero2IPO, *supra* note 297.
303 "Share transfer" excludes management buyouts and share buybacks.
304 *See* National Venture Capital Association, *supra* note 298, at 27, 77 & 81.

There are various reasons explaining investor preference for IPOs in China, particularly during 2011 and 2012.

Firstly, IPO exits tend to give higher returns on investments as compared to M&As in China. The Growth Enterprise Market (a stock market set up by the Stock Exchange of Hong Kong for growth companies), and the SME Board (a special market section within the Shenzhen Stock Exchange for SMEs) enjoy high price-earnings ratios. In comparison, M&A exits promise lower returns than those expected from IPO on these two boards.

Secondly, M&A transactions tend to require a high level of professional assistance and this consequently places a higher level of demand on practitioners. The development of the M&A industry requires an ecosystem which can provide a suite of services, including experienced entrepreneurs and management within companies themselves (the integration of bidder and target pre- and post-deal is crucial), as well as professional intermediaries and investment banks which are able to create value, match, and even create transactions. Supporting capital markets services, such as leverage via debt financing, are also required. Additionally, external support to the company in the form of investment bankers or other advisors also play an instrumental role throughout the deal cycle, in helping the bidder identify the right target, negotiating the deal, and eventually reaching the right price.

However, one of the biggest obstacles to M&A exits in China is the shortage of M&A financial intermediaries which have the relevant expertise, due to the short history of China's M&A and venture capital industries. Chinese companies have not developed M&A capabilities in evaluating, executing, and integrating deals.[305] Given the limited domestic talent pool, banks have also struggled to find enough talent to sustain their operations.[306] Therefore, few M&A transactions have been entered into and these deals do not commonly succeed.[307]

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[305] *See, e.g.* The Boston Consulting Group, *The 2012 BCG 50 Chinese Global Challengers: End of Easy Growth* (2012), *available at* 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. … [Chinese companies] they suffer from a lack of experience. Many Western companies have spent 30 or more years developing capabilities in evaluating, executing, and integrating deals.")

[306] *See, e.g.* Pricewaterhouse Coopers, *PwC Foreign Banks in China 2013 Report* (2014), *available at* 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 operations… 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.")

[307] 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), *available at* https://www.kpmg.de/docs/china-outbound-investment-201010.pdf at 12.

The preference for IPOs may further be explained by a cultural factor. It has been observed that Chinese entrepreneurs are generally very attached to their companies, and are thus unwilling to completely let go of the company via M&A.

Nevertheless, it is worth noting that there is a trend towards a higher number of exits via M&A in the last two years, ie. 2013 and 2014. In the 2014 Chinese M&A market, there was a growth of 27.1% in transaction value and a 56.6% increase in transaction quantity. Specifically with respect to M&A exits in the VC/PE industry, there has been a twofold increase in transaction quantity from 446 in 2013 to 972 in 2014. Likewise, the growth in the value of M&A exits has doubled from USD 34,660 million in 2013 to USD 68,829 million in 2014.[308] The rapidly growing number of M&As from year to year suggests that M&A will grow in importance as an exit option for venture capital in years ahead.

Arguably, the growing experience and improving attitudes of investors also contribute to a smoother exit channel for venture capital investments. Findings from Deloitte have indicated 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.[309] Also, with these heightened expectations, Chinese investors have become more willing to involve professional advisors in their transactions, especially, in particular, resolution issues relating to post-merger integration, which is believed to be crucial to a successful transaction.[310]

IV. Other Determinants for a Venture Capital Market

A. Introduction

The engineering of a venture capital market is highly context-specific and dependent on national conditions. Nonetheless, the studies discussed earlier regarding how the Chinese government has addressed Gilson’s “three-factor simultaneity model” do have a variety of implications for other governments that are seeking to promote entrepreneurship and venture capital activity. Naturally, the next question would be:

[308] Zero2IPO report on China Equity Investment Market 2014 (Qingke Zhongguo Guquan Touzishichang 2014 Nian Quannian Huigu) at 42.

[309] *See* Deloitte, *More experienced buyers, higher return expectations: 2014 Greater China outbound M&A spotlight* (2014), *available at* http://www2.deloitte.com/content/dam/Deloitte/xe/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.” And “Large M&A transactions will probably happen more frequently. Chinese M&A investors expect mid- and large-sized M&A transactions (USD 150 million – USD 500 million) will happen more frequently in the coming year. The expectations of small-sized M&A transactions (USD 5 million – USD 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.)

[310] *Id.*

what are the other determinants of a successful venture capital market, especially for an emerging economy like China?

In addition to public efforts to solve the simultaneity problem, the growth of a venture capital market can also be attributed to real economic growth,[311]sound macroeconomic policies, political stability, a developed stock market, as well as financial and economic reforms. Meanwhile, a friendly entrepreneurial environment with conducive legal rules, strong investor protection,[312] and a large domestic market with customers willing to take a chance on young firms are also necessary to develop entrepreneurship and innovation in a country.[313]

Moreover, as observed by Armour and Cumming, a successful venture capital industry also requires a liberal personal bankruptcy regime. Liberal personal bankruptcy laws tend to encourage venture capital investment and increase the level of venture capital exits, thereby contributing to a healthy venture capital market. [314] Conversely, a stricter bankruptcy regime discourages potential entrepreneurs from taking risks and failed entrepreneurs from re-engaging in business.[315] In China, while there is an enterprise bankruptcy law, there is no personal bankruptcy law. In order to develop China's venture capital industry, it is crucial to provide an exit mechanism for individuals who have failed in their entrepreneurial venture. Personal bankruptcy law allows them to start afresh; while at the same time also ensures that creditors can obtain a fair share of the bankrupt's assets. Personal bankruptcy law would allow for better management of debt disputes and reduce the chances of a bubble occurring due to, for example, a proliferation of mortgage-backed securities, thereby helping to avert a future financial crisis.

Further, arguably, all countries have a unique and dynamic aspect, that of culture, which may shape the evolution of the venture capital market. For example, the culture of doing business in Silicon Valley was profoundly shaped by the pioneering firms in the early decades of the twentieth century.[316] Becker and Hellmann also emphasized the importance of culture in the development of the German venture

[311] Armour, John and Cumming, Douglas J., *supra* note 4, at subsection 5.2.
[312] *Id.,* at 597. (Armour and Cumming's empirical findings show that the 'investor friendliness' of a country's legal and fiscal environment is a significant determinant of the supply of venture capital investment to entrepreneurial firms.)
[313] Lerner, *supra* note 18 at 181-182.
[314] Armour, John and Cumming, Douglas J., *supra* note 4 at subsections 5.2 and 5.4.
[315] Armour, John and Cumming, Douglas J., *supra* note 4, at subsection 3.3; J Armour, 'Personal Insolvency Law and the Demand for Venture Capital' (2004) 5 European Business Organization Law Review 87.
[316] Lerner, *supra* note 18 at 33.

capital market.[317] However, it is extremely difficult to empirically test the significance of culture in the development of a venture capital market.

In China, the entrepreneurial culture is evolving. The first generation of entrepreneurs experienced the Cultural Revolution and suffered tremendous financial hardship. Consequently, after China opened up her economy, these entrepreneurs entered the business world with the simple purpose of making money. However, unlike their parents, the second-generation entrepreneurs in China are more inclined to pursue their dreams and achieve self-actualization through setting up their own businesses. These young entrepreneurs, born after 1990, are experiencing a very different social and economic environment as compared to that of their parents – governmental policies are now highly supportive of business, and the cost of starting a business is much lower than before. Further, having received a good education and grown up in the age of the internet and the rise of China, these young entrepreneurs are also able to adapt quickly and creatively to changes in the environment, better meeting the needs of young consumers. Nevertheless, as these second-generation entrepreneurs are still relatively new and inexperienced in the venture capital market, the future challenge would be attracting skilled venture capitalists, experienced mentors and sophisticated engineers who have the necessary startup management tools and the willingness to nurture this entrepreneurial culture. Creating a sustainable venture capital ecosystem will very likely be an important task for China in the upcoming years.

As it is beyond the scope of this article to examine every possible determinant in the context of China, the following discussion will highlight two more areas that may require greater legislative efforts in order to further develop the venture capital market.

B. Tax Consideration

First, a favorable tax environment is a related "push" factor that has increased the supply and demand in the Venture Capital market.[318] For example, there has been a consistent finding that reductions in capital gains tax encourage venture capital activity.[319] This is because lower taxes translate into higher profits for the investor.

Historically, many local governments and departments have offered various preferential tax policies for venture capital firms and their investors. This was intended to attract venture capital flow into their regions, promote local industry

[317] Becker, Ralf and Hellmann, Thomas (2005) *The Genesis of Venture Capital - Lessons from the German Experience.* In: Kanniainen, Vesa and Keuschnigg, Christian, (eds.) Venture Capital, Entrepreneurship, and Public Policy (CESifo Seminar Series). MIT Press, pp. 33-68.
[318] Armour, John and Cumming, Douglas J., *supra* note 4 at section 4.
[319] *Id.,* at subsection 5.2.

clustering as well as boost the regional economy.[320] However, the excessive implementation of such tax policies has yielded distortionary economic effects: market forces based on the survival of the fittest principle have been subverted, unfair competition among venture capital firms is rampant, and the macro-economic influence of the central government has been weakened.[321] This policy environment has allowed several poor performing venture capital firms to survive on tax incentives and governmental subsidies, while depriving small startups that require support from government funding.[322]

In order to give market forces to play a more decisive role in allocating capital, the State Council released an official Notice in November 2014[323] to revoke preferential policies pertaining to tax and fiscal subsidies which local and regional governments have been providing to venture capital firms.[324] This entails revocation of numerous agreements and memoranda that local and regional governments have signed with specific enterprises, as well as the annulment of many more requests, reports and approvals.[325]

The officially stated objective of the Notice is to ensure that the attractiveness of specific localities to the venture capital industry will no longer be determined by tax and fiscal incentives. Instead, the focus will be on hard and soft power factors such as government reforms, as well as the local business environment, legal system and climate of innovation.[326]

Following the Notice, locally developed policy incentives are to be gradually removed. The nation-wide unification of tax rates appears to be an inevitable development: local governments such as in Shenzhen, Beijing and Tianjin have already revised their preferential tax policies relating to venture capital. For example, under Shenzhen's new tax policy, the individual income for a limited partner is no longer levied at a tax rate of 20%, but classified as part of the production and business gains of individually owned business and levied at a five-tier

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[320] Gui Jieying , Zero2IPO Research Center, "Cancellation of PE Tax Incentives Causes a Stir amid the Trend of Market Innovation and Mass Entrepreneurship", available at: http://en.pedaily.cn/Item.aspx?id=220259
[321] *Id.*
[322] *Id.*
[323] Notice of the State Council on Clearing up and Regulating Tax and Other Preferential Policies (GF [2014] No. 62).
[324] According to the Notice, no local area or department can offer enterprises preferential fiscal policies without approval from the State Council. All the preferential fiscal expenditure policies developed against the law or regulations and linked to tax or non-tax income payment by enterprises and their investors shall be firmly cancelled, including refund after collection, budgeted collection and expenditure, fiscal awards or subsidies, reduction or exemption of land transfer income in the form of withholding or granting subsidies. Other preferential policies shall be regulated step by step, such as covering social insurance premiums and other operational costs for enterprises, offering electricity and water price discounts, encouraging enterprises in other areas to settle down or pay taxes locally through fiscal awards or subsidies, and keeping or returning the increment in local fiscal income in some areas.
[325] Gui Jieying, *supra* note 320
[326] *Id.*

progressive tax rate of 5% to 35% in excess of a specific amount.[327] Nevertheless, the removal of tax incentives for individual investors is likely to discourage individual investment in the venture capital industry. The Chinese government will have to tackle this complex challenge of regulating the national tax environment while simultaneously attempting to stimulate entrepreneurship and investment.

C. General Conformity with Global Standards

Second, conformity to global standards, in terms of securities regulation and stock structures, is arguably crucial in replicating a U.S. venture capital market. These standards reflect practices that have been tried and tested and are thus likely to inspire confidence in global investors.[328] The earlier parts of this article explored the mismatch between global standards and local practices in the areas of funding and investment vehicles, particularly regarding investor activism in the management of a limited partnership and the inconsistence between Chinese practice and international practice in terms of remuneration of venture capitalists. A lot of investors interviewed in the past held the view that they are the parents of the enterprise because the portfolio companies would not survive without their money. However, the situation today has changed. With an increase in the number of angel investors and institutional investors, a promising entrepreneurial firm can now easily choose from a pool of investors, giving the entrepreneur freer rein to manage the enterprise.[329] Arguably, the increased sophistication of the investors and the increasing number of experienced professionals who are able to advise on the negotiation of agreements will help further align China's venture capital practice with global standards, especially in contractual designs and enforcement of contracts by the venture capital practitioners.

V. Conclusion

China offers an important and paradigmatic example of engineering a national venture capital market. The article contributes to the literature on venture capital by exploring the role of law and related public efforts in building up the Chinese venture capital market. It shows that the Chinese government has played a significant role in shaping the underpinning legal and regulatory infrastructure of the Chinese venture capital market, in particular, providing public funding, encouraging private funding, promoting entrepreneurship through reduced taxation, introducing new investment vehicles and developing stock market. At the same time, the role of the Chinese government has also been evolving – from a direct participant in the

[327] Shenzhen Local Taxation Bureau issued the Kind Notice about Stopping the Execution of Preferential Local Income Tax Policies for Partnership-based Equity Investment Fund Enterprises, saying it would follow the State Council requirements on regulating tax and other preferential policies and withdraw the individual income tax incentives targeted at natural person LPs as specified in the Notice on Some Provisions for Promoting Development of the Equity Investment Fund Industry released on July 9, 2010. See Gui Jieying, *supra* note 320

[328] *See* Lerner, *supra* note 18.

[329] Interviewed with CEO of a Hangzhou entrepreneurial firm.

capital allocation process, to a facilitator that merely provides seed funding without interfering in the fund's capital allocation.

While it is too early to conclude whether the Chinese government is a good engineer in developing the market, the simultaneity problem of an effective venture capital market has been gradually addressed with legislative and policy efforts and it appears thus far that the government's plan is a step in the right direction.

Despite China's tremendous progress towards cultivating a favorable regulatory environment for venture capital, the discussed minor impediments at various stages of the venture capital cycle may prevent the venture capital industry from realizing its true potential. Further, on top of funding, specialized investment vehicles, entrepreneurship and a robust stock market, an effective venture capital market also requires a wide range of complex social, legal, and economic institutions, specifically competent courts, effective judicial enforcement, as well as an effective reputation market. Indeed, further research can be done into these particular areas in the future, as well as the issues of balancing the relationship between the role of the government and market forces, and ways of maximizing the effectiveness of contractual design. Ultimately, it remains to be seen whether the Chinese venture capital market can replicate the success of the U.S. market in the long run.

Appendix 1: Comparison Of Pro-Venture Capital Government Programmes

	Singapore's Early Stage Venture Fund (*"ESVF"*)[330]	Germany's Deutsche Wagnisfinanzierungsgesellschaft (*"WFG"*)[331]	Israel's Yozma Programme[332]	Chile's Corporation for the Incentive of Production (*"CORFU"*)[333]	China's State Venture Capital Investment Guidance Fund (*"SVCIGF"*)[334]
Relationship between government and fund	*Providing capital co-funding* Government invests S$10 million (approx. USD 7 million) on a 1:1 matching basis in VC funds that invest in Singapore-based early stage high-tech companies.	*Heavy role for government* German federal government pressured German banks to contribute capital to WFG. Government provided a guarantee and insured up to 75% of WFG's losses. A mixed board committee, formed from WFG's 12-member board which consisted of 3 government officials, selected projects to be funded.	*Providing capital co-funding* Government founded Yozma Ltd, which created venture capital funds to invest alongside private investors (matching up to 40% of capital invested privately). Beyond provision of capital, minimal government intervention. Government also provided attractive tax incentives for foreign VC investments in Israel.	*Providing capital co-funding in the form of "loans"* CORFU, a government agency, would invest in privately managed VC funds organized largely similar to the US model. CORFU's investments were "loans" that leveraged the private investors' and fund manager's equity stakes in the fund. Beyond capital provision, minimal government intervention.	*Providing capital co-funding* The SVCIGF, to be set up by the Chinese government, will comprise of 40 billion RMB (approx. USD 6.5 billion) of capital funding, with 10-15 billion RMB coming from the government, matching the remainder coming from other investors such as private enterprises and large financial institutions Professional fund managers are invited, through a public tender, to manage the fund, free from government intervention. The SVCIGF will be run as a fund of funds.

330 *See* National Research Foundation, *Early Stage Venture Fund* (Aug 18, 2014), http://www.nrf.gov.sg/innovation-enterprise/national-framework-for-research-innovation-and-enterprise/early-stage-venture-fund.
331 *See* Gilson, *supra* note 1, at 1094-1096.
332 *Id.*, at 1097-1098.
333 *Id.*, at 1098-1099.
334 *See* Qingke Yanjiu Zhongxin, *supra* note 130; *see also* Sina Finance, *supra* note 154.

Incentives for financial intermediary to monitor portfolio companies	*Good incentives in place* Requirement for 1:1 matching for certain co-investment programmes ensure intermediaries have some s kin in the game and are incentivized to monitor their investments VC funds have the option of buying out the government's share of the fund within 5 years by returning the government's capital with interest	*Little incentives provided* WFG and the investing banks had little incentive to monitor VC investments: (1) protection was provided via government guarantee, (2) profits were limited by the entrepreneur's call option. WFG personnel were not incentivized to provide technological or management assistance to portfolio companies due to the restriction of profits placed on WFG.	*Good incentives in place* Yozma provided no guarantee against loss, thereby incentivizing fund managers and private investors to carefully monitor portfolio companies. Returns to the financial intermediary not capped, as the call options on Yozma's investments were held by the private investors (and not the entrepreneur), thereby increasing the private investors' incentive to monitor the portfolio companies and ensure their success.	*Good incentives in place* Each fund had to have at least 5 unrelated investors holding at least 10% of the fund's equity each, thereby promoting internal investor monitoring of the fund manager. Fund manager required to invest at least 15% of its total assets in the managed fund to ensure that it has a share of the downside. Upon fund liquidation, CORFU's return is capped at an annualized rate of 9% after which the remaining funds are paid out to private investors, thereby incentivizing investors and managers to actively monitor portfolio companies to maximize portfolio company performance and profits.	*Good incentives in place* Priority for investment returns is given to private investors, including fund managers, and this incentivizes them to monitor the fund's portfolio companies. Government does not participate in fund management, relying on incentivized financial intermediaries instead. Being a consolidated fund, the SVCIGF is not restricted to one particular project (as might the case with GGFs in the past), hence incentivizing fund managers to take a more hands on approach with the fund's investments which are no longer artificially limited.

Means for financial intermediary to monitor portfolio companies	*<u>Monitoring through control</u>* Financial intermediary, through its equity stakes, holds the control rights that provide the means to monitor portfolio companies	*<u>Little control obtained</u>* WFG made passive investments through minority investments, with no control rights received.	*<u>Control rights vested in the financial intermediary instead of Yozma</u>* While Yozma did not make investment decisions and its investments were passive, these investments were made by highly incentivized fund managers and private investors who bore the investment's risk and return and possessed the control rights to directly monitor the portfolio companies.	*<u>Control rights vested in the financial intermediary and not CORFU</u>* Similar to the Israeli Yozma programme, while CORFU remained a passive investor, the fund manager and investors were highly incentivized and hence actively monitored the portfolio companies using their control rights.	*<u>Control rights vested in the financial intermediary and not the government</u>* Similar to both the Israeli and Chile programmes, whereby the means to monitor are through control rights in portfolio companies which are held by the financial intermediary and not the government.