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Re-Engineering a Venture Capital Market: The Case of China

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Re-engineering A Venture Capital Market: The Case of China

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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 U.S. experience in the creation of a venture capital market confronts a "simultaneity problem" as coined by Prof. Ronald Gilson – the "simultaneous availability" of three central inputs: capital with the appetite for high-risk, high-return investments, specialized financial intermediaries which incentivizes all participants in the venture capital market, and entrepreneurs.

China is now the second largest country in venture capital investment, ranking only after the U.S. China offers a fascinating example of engineering a national venture capital market. The article contributes to the literature by exploring the role of law and government efforts in building up the Chinese venture capital market. It shows that unlike the U.S. venture capital market which "developed organically" without government design, the Chinese government has played a significant role in shaping the underpinning legal and regulatory infrastructure of the venture capital market. Based on empirical and comparative evidences, the article finds that the simultaneity problem has been gradually solved with legislative efforts and the government's plan is a step in the right direction, particularly in providing venture capital funding; introducing necessary specialized financial intermediaries; and creating an active capital market. It concludes that the Chinese government's progress in engineering a venture capital market has been relatively successful. This can largely be attributed in its increasingly flexible evolvement in its role from a direct participant in capital allocation process to a facilitator by merely providing seed funding. Nonetheless, in order to fully realize its potential, there still a wide range of social, legal, and economic institutions areas that can be improved on.

Keywords: Venture Capital, Venture Capital Market, 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 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 specialized financial intermediary which incentivizes all participants in the venture capital market, especially the venture capitalist and the entrepreneur.[3] In addition, Black and Gilson argue that the vibrancy of the 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").[4]

Duplicating American success in creating a strong venture capital market is an important challenge for China, being a developing economy with an underdeveloped equity market. However, this does not seem as an unreachable dream. After nearly three decades of development, China is now the second largest country in venture capital investment, ranking only after the U.S.[5] As Ernst & Young noted, China had the highest rate of growth in median deal value and also recorded the highest

[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] 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).

[5] 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.

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median value across all markets in 2014.[6] Also, China had the second largest number of mega investments (more than USD 50 million) globally after the U.S.[7] In 2014 alone, 258 new venture capital funds were set up in China to raise USD 19 billion worth of fresh capital eligible for investment, surging 174.9 percent from the previous year, according to consultancy Zero2IPO Group.[8] Further, 444 venture capital exits were achieved in 2014,[9] with exits via IPO raising USD 7.1 billion and exits via mergers & acquisitions ("M&A") raising USD 6.5 billion.[10] Billions have been injected into various vital and emerging industries, in particular the Technology, Media and Telecommunications ("TMT") segment.[11] 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.

There has been extensive literature discussing the legal infrastructure of venture capital and the contractual designs that are used to address the agency problem within the venture capital cycle.[12] However, the roles of law and government 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 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 to engineer a venture capital market and will be of

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

[7] *Id.*, at 3.

[8] 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.

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

[10] *See* Ernst & Young, *upra* /note 6, at 2.

[11] 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/.

[12] *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.

interest to policymakers, as a number of jurisdictions such as Germany, Israel, Chile, India 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 takes will involve juxtaposing two of the largest venture capital markets in the world – that of the U.S. and China. The reasons 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[13], and has also been the source of inspiration for the 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.[14]

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 venture capital industry in China, the evolving role of the government in this process, as well as China's legislative framework governing venture capital. Part III will examine the Chinese experience by focusing on three areas: First, legislative efforts in providing venture capital funding; second, introducing necessary specialized financial intermediaries; and third, creating an active capital market, based on empirical evidences. It will also point out salient issues and suggest improvements that can inspire further growth and progress of venture capital in China. Part IV will conclude that the Chinese government's progress in engineering a venture capital market has been relatively successful. This can largely be attributed in its increasingly flexible evolvement in its role from a direct participant in capital allocation process to a facilitator by merely providing seed funding. However, in order to fully realize its potential, there still several key areas that can be improved on.

[13] PAUL GOMPERS AND JOSH LERNER, THE VENTURE CAPITAL CYCLE, 10 (MIT Press, 2004.

[14] 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. A questionnaire will be prepared for the interview. The interviewees come from the six cities that are the major places 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.

II. The Chinese Venture Capital Market

A. Why Venture Capital in China

There are many factors that demonstrate the importance of venture capital to the Chinese economy. First, high-tech startups are major sources of innovation and knowledge economy of a nation. However, for a long period, start-ups were unable to growth in China because they were capital constrained. On the one hand, due to the long-exercised planned economy and public ownership structure, Chinese capital markets have long been unable to serve as a viable equity financing channel for companies, especially small companies. China's corporate sector thus remains largely dependent on debt financing from banks. On the other hand, given the administrative interference from central or local governments, Chinese state-owned banks have long been supporting large state-owned companies with relatively low interest rate,[15] while small and private companies without collateral would have enormous difficulties in securing bank loans. This has inadvertently contributed to the high demand for venture capital, which is the only viable financing alternative for the high-tech and high-growth start-ups. Accordingly, with the venture capitalists taste for high-risk, high-return investments, they have been instrumental in providing the necessary cash to fund rapid expansion plans of these companies, most of which require extraordinary large up-front investments.[16]

Second, since the launch of various state programs for science and technology, such as the 985 Program[17] and the Torch Program in 1980s, aiming to "improve China's competitiveness in science and technology in the 21st century",[18] Chinese innovation and IT infrastructure has largely improved and there is a sudden sprout of internet and high-tech companies in recent times. For example, Beijing's Zhongguancun district, the so-called "Chinese Silicon Valley", birthed 49 start-ups daily in 2014.[19] As of March 2015, the tech startup industry in China has more than 1,600 technology incubators supporting more than 80,000 startups, more than 115 university technological centres, and created more than 170,000 jobs.[20] China now has 1,000

[15] 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.

[16] 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 venture capital in general venture capital market).

[17] 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.

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

[19] 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*].

[20] 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.*

organizations investing in start-ups with capital exceeding 350 billion yuan (USD 56 billion).[21] New ventures have enabled a surge in technological innovation in China. In 2014, China saw 660,000 effective invention patents, up 12 % from a year earlier.[22] 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[23], Sohu[24] and Alibaba[25], have received venture capital backing in their early days. This has substantally increase the demand for venture capital in the high-tech industry.

Third, the gross domestic product (GDF) grew consistently in China over the past decades, increasing overall by 7.7% from 2010-2014. The number of businesses and registered companies have been increasing, particularly after the government efforts that streamlined the process for starting businesses in 2014 under the revised PRC Companies Act. In the first quarter of 2015, 844,000 new companies were registered, a 38.4 percent rise from the same period last year.[26] The healthy economic environment and expanded domestic market encourages stronger buying behavior of consumers, thus facilitates the development of small businesses and in turn increases the need of venture capital.

On the supply side, the number of high-net-worth individuals and families is increasing with large amounts of available capital in China. China currently has the second-highest number of high-net-worth individuals in Asia with about 1.3 million, holding a combined wealth of USD 4.3 trillion.[27] The increased economic prosperity and the recent boom of venture capital have attracted 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. By launching various foreign investment programs,[28] more foreign investors are now permitted to make equity investments in China. Meanwhile, more and more institutional investors have been gradually allowed to make equity investments in recent years, providing a major source of funding to the venture capital industry.[29]

Moreover, a new generation of entrepreneurs – the "post-90s" generation entrepreneurs (generation born in 1990s) has emerged in China. As "bold digital

[21] *Id.*
[22] *Id.*
[23] Sina is a Chinese online media company for Chinese communities.
[24] Sohu is a Chinese Internet company
[25] Alibaba is a Chinese e-commerce company that provides consumer-to-consumer, business-to-consumer and business-to-business sales services via web portals.
[26] http://www.chinadaily.com.cn/china/2015-04/22/content_20510974.htm
[27] 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.
[28] *See* infra text accompanying note 98 to 99.
[29] *Ibid.*

natives" brought up in the founding era of domestic Internet giants such as Tencent and Alibaba,[30] they tend to be young and unafraid of failure. It is reported that 2.3% of the university graduate of 2013 have chosen to start businesses. This figure was higher among high school or college's graduates, with 3.3% choosing to be entrepreneurs.[31] The interests of young entrepreneurs in venture capital is further spurred by a guideline[32] issued in March 2015 on "Mass Entrepreneurship and Innovation" (dazongchuangye, wanzongchuangxin), [33] aiming to promote entrepreneurship and boost employment of the nation.[34]

In short, China's rapid economic development has resulted in a greater emphasis on innovation and IT infrastructure, a huge increase in investors with excess capital and are eager to invest, and has produced a generation of entrepreneurs. This mix of factors exemplifies the need for venture capital as the factors translate to a strong demand for high-risk high return investments, an increasing supply of entrepreneurs, and this had led to an increase in the number of small businesses. Therefore, it is evident that the creation of a viable and vibrant platform for the venture capital industry is crucial to the future development of China.

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

The concept of venture capital (*chuangye touzi*) was first mooted in China in 1985, in the central government's "Decision to Reform the Science and Technology System".[35] Prior to this development 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.

Today the Chinese understanding of the "venture capital" 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.[36] Also, as a subset of private equity, the term venture capital generally does not include buyout financing where the private equity firm acquires majority control of an existing or mature firm

[30] China Daily, "China's Post-90s Entrepreneurs", http://www.chinadaily.com.cn/china/entrepreneursinchina/
[31] Chen Zhengfei, "Post-90s Entrepreneurs", http://www.juece.net.cn/content-7-1009-1.html
[32] 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
[33] See infra text accompanying note 69-70.
34 China Daily, New Policies Encourage Entrepreneurship, Boost Employment, (April 22, 2015) http://www.chinadaily.com.cn/china/2015-04/22/content_20510974.htm
[35] 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.
[36] ZOU JING, PLACEMENT AND OPERATION OF PRIVATE EQUITY-LEGAL PRACTICE AND CASES 11 (LAW PRESS CHINA, 2014).

from its current owners.[37]

Nonetheless, 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.[38] 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.[39] 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.[40]

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

Over the years, governments around the world have made initiatives to re-engineer a national venture capital market, such as Germany, Japan, Israel, Chile and Taiwan.[41] However, the effects of government programs in venture capital financing vary among jurisdictions (see Appendix 1 for detailed comparison).[42] According to Professor Gilson, while some government programs, such as Israel's Yozma Programme [43] and Chile's Corporation for the Incentive of Production ("*CORFU*") [44] have been successful, there have been unsuccessful programmes such as Germany's Deutsche Wagnisfinanzierungsgesellschaft ("WFG"). [45] Therefore, it is pertinent to examine the factors that differentiate the success in different countries.

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[37] *See* Gilson, *supra* note 1; *see also* Brander, Du & Hellmann, *supra* note 12.
[38] *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.
[39] *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.
[40] 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.
[41] *See* Gilson, *upra* note 1, at 1068; *see also* Brander, Du & Hellmann, *supra* note 12; 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).
[42] 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.
[43] Gilson, *supra* note 1, at 1097-1098.
[44] Gilson, *supra* note 1, at 1098-1099.
[45] *See* Gilson, *supra* note **Error! Bookmark not defined.**

There are three key factors that affect the effectiveness of these programs: (1) Role of government; (2) Incentives for financial intermediary to monitor portfolio companies; and (3) Means for financial intermediary to monitor portfolio companies. The common thread amongst the three factors is the involvement of market forces in engineering a venture capital market.[46] Accordingly, this is illustrated in Chile and Israel's successful venture capital engineering programs, which emphasize the need for market force instead of Germany's heavy government involvements in capital allocation during the venture capital investments.[47]

In relation to the Chinese venture capital programs, the Chinese government has sought to duplicate American success in developing an effective venture capital market. In contrast to the U.S., where the venture capital market is developed mainly out of private ordering,[48] the Chinese government plays a significant role in creating a venture capital market, especially in shaping the underlying legal, regulatory and entrepreneurial infrastructure, as well as building up a capital-centered system for venture capitalists to exit. The Chinese government's support for the venture capital market includes: provision of capital, tax incentives, outright subsidies, preferential regulation, and developing national incubators.[49]

This section aims to highlight the most important governmental efforts that have been made in the creation of venture capital market in China. In general, the growth of China's venture capital industry is closely correlated to and constrained by the development of the stock market, and has aligned effectively with China's financial and economic reforms. Meanwhile, the Chinese venture capital industry has also grown with the evolving mindset of the governments towards this emerging market. Evidence below shows that the government's role has been changed from both a capital provider and financial intermediary in 1980s -2000s to a pure facilitator that merely provides seed funding through government guidance funds and policy incentives, while leaving capital allocation decision largely on private ordering (2014 onwards).

1. Emerging Phase (1985-1990)

Unlike the US, which has over 70 years of experience in venture capital since the 1940s,[50] 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

[46] *See* Gilson, *supra* note 1, at 1094-1096.
[47] *See* Gilson, *supra* note 1, at 1094-1099.
[48] *See* Gilson, *supra* note 1.
[49] *Zongli han ni lai chuangye*, http://news.pedaily.cn/zt/20150522383087.shtml#m005 (last visited May 30, 2015).
[50] *See* Gompers & Lerner, *supra* note 13, at 8.

set up as a government-initiated project.[51] 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.[52]

2. Experimentation Phase (1990-2000)

Since 1990, a series of government policies and legislation was issued to facilitate the development of venture capital, including the Strategy of Invigorating China through Science and Education (*kejiaoxingguo*) and the Law on Promoting the Transformation of Scientific and Technological Achievements.[53] 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.[54] Meanwhile, 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.[55]

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[51] *See* Zhu Shaoping & Ge Yi, *he Amendment of the Partnership Enterprise Law of People's Republic of ChinaR*, (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).

[52] Cheng Siwei, *Cheng Siwei on Venture Capital* (Renmin University Press, 2008), at *Preface.*

[53] 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.

[54] 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.

[55] 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/.

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 framework to venture capital practitioners, clear guidance and regulations were issued on the establishment, approval, management, supervision taxation and foreign investment[56] relating to venture capital.[57] The Small and Medium-sized Enterprise Board ("SME Board")[58] 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.[59]

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 tow-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)[60] 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.[61]

Another related "push" factor that increased the supply and demand into the Venture Capital market was the numerous local preferential tax policies for Venture Capital enterprises and their investors. This was intended to attract venture capital flow into their particular regions, promote local industry clustering, and boost the regional economy.[62]

In addition, the revision of the PRC Partnership Enterprise Law ("PEL") in 2006[63] was a significant milestone as it allowed a new business vehicle – limited partnership. Such measure further stimulated venture capital financing, as it allowed both

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[56] *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.
[57] The Interim Measures for Administration of Startup Investment Enterprises 2005.
[58] In 2004, the Small and Medium-sized Enterprise Board was launched at Shenzhen, China.
[59] China Venture Capital Yearbook 2007, *ibid*. at 247.
[60] However, unlike NASDAQ which is a mainboard, ChiNEXT is a secondary board.
[61] 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.
[62] http://en.pedaily.cn/Item.aspx?id=220259
[63] *See* Zou, *supra* note 36.

domestic and foreigners to set up partnership-type funds,[64] and broadened scope of eligible domestic and foreign investors in the venture capital market through updated foreign investment catalogues and foreign exchange policies.[65]

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

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.[66] 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 yuan (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.[67] 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.[68]

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.[69] It has also issued guidance on the development of the Group Innovation Space ("GIS", *zongchuangkongjian*) and offered new platforms for innovation and business startups.[70]

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[64] 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.

[65] 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.

[66] 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.

[67] *Id.*

[68] *Id.*

[69] Xinhua News, *China Issues Opinions to Encourage Mass Entrepreneurship, Innovation* (Mar. 11, 2015), http://news.xinhuanet.com/english/2015-03/11/c_134059020.htm.

[70] 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*] (Mar. 2, 2015), http://www.gov.cn/zhengce/content/2015-03/11/content_9519.htm.

Additionally, the excessive local tax policies issued in the past decade have yielded distortionary economic effects in China's venture capital industry. It subverted market forces characterized by the practice and principle of "survival of the fittest", by allowing several poor-performing venture capital enterprises to survive on tax incentives and governmental subsidies, while depriving small start-ups that require support from obtaining government funding[71].

Furthermore, the intention of enabling market forces to play a more decisive role in capital allocation was demonstrated in the State Council's official Notice on November 27, 2014.[72] The Notice aimed to revoke the preferential policies pertaining to tax incentives, fiscal subsidies, preferential policies that local governments have provided for venture capital enterprises.[73] This entails widespread revocation of the contracts, agreements, memoranda and meeting or talk minutes that the local governments have signed with particular enterprises as well as requests, reports and approvals in case-by-case form.[74]

The stated official objective of the Notice is to ensure that the attractiveness of local areas to the venture capital and private equity industry will no longer be determined by tax and fiscal incentives. Rather, venture capital will be drawn to local areas because of hard and soft power factors such as governmental reforms, as well as the local business environment, legal systems, and innovation climate.[75] Following the Notice, local governments such as Shenzhen, Beijing and Tianjin have already revised their venture capital-related preferential tax policies. For example, under the new tax policy of Shenzhen,[76] the individual income for natural person limited partners (LPs) is no longer levied at a tax rate of 20.0%, but classified as part of the production and business gains of individually-owned businesses and levied at the 5.0%-35.0% five-level progressive tax rate in excess of specific amount.[77]

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[71] http://en.pedaily.cn/Item.aspx?id=220259

[72] Notice of the State Council on Clearing up and Regulating Tax and Other Preferential Policies (GF [2014] No.62)

[73] 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.

[74] http://en.pedaily.cn/Item.aspx?id=220259

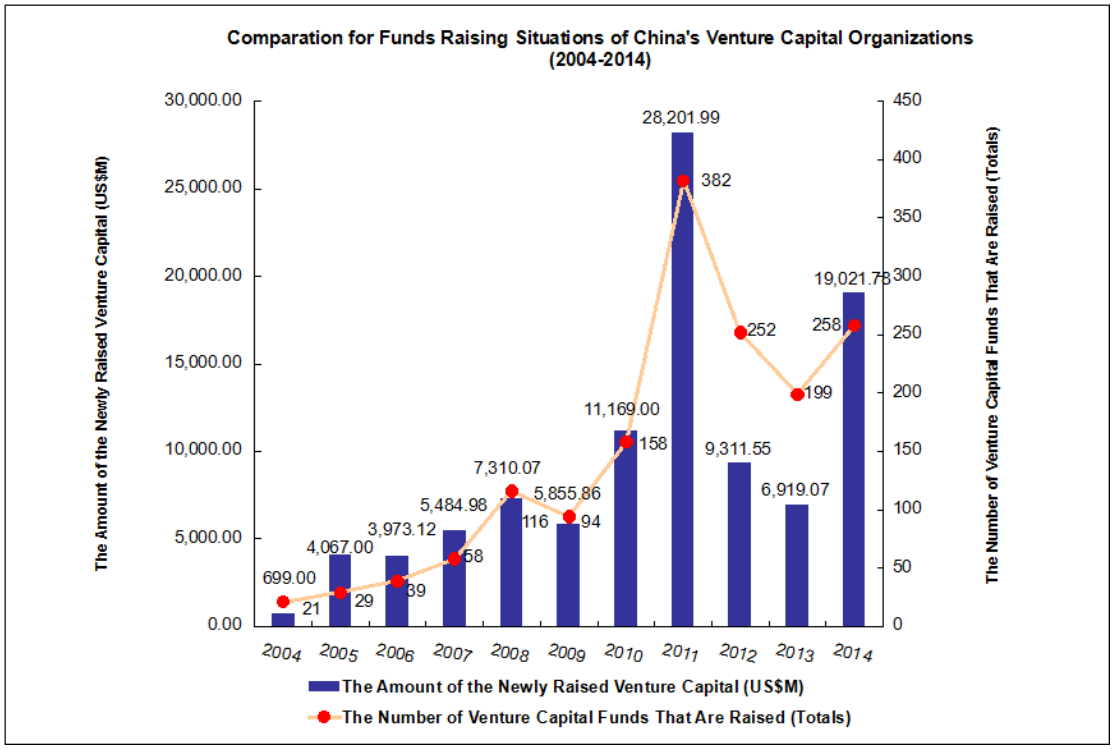
[75] http://en.pedaily.cn/Item.aspx?id=220259

[76] 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. http://en.pedaily.cn/Item.aspx?id=220259

[77] 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

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

Source: zero2ipo



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"), [78] (2)

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. http://en.pedaily.cn/Item.aspx?id=220259

[78] 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.

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"),[79] and (3) local regulations promulgated by the local legislature. Before the Startup Measures were issued, local 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*).[80]

With regards to the regulatory regime of venture capital, a key aspect of the Chinese regime that is different from that of the US[81] 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 National Development and Reform Commission ("NDRC") and CSRC have been competing to take charge of supervision of the private equity and venture capital industry in China.[82] 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.[83] 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 AMAC (AMAC Measures)[84] and the Interim Measures for Supervision and Administration of Private Investment Funds (CSRC

[79] 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.

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

[81] 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.

[82] 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

[83] *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).

[84] Taking effect on 7 February 2014.

Interim Measures) 2014.[85] 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 - Asset Management Association of China ("AMAC")[86].

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.[87] 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 Professor Ronald Gilson, the creation of a venture capital market requires the following central inputs: (1) investors with the funds and the taste for high-risk, high-return investments (the funding), (2) a specialized financial intermediary to serve as the nexus of a set of sophisticated contracts; and (3) entrepreneur.[88] Accordingly, if a country's legal and market institutions lacks any of these factor, the country cannot develop a viable venture capital market. At the same time, a strong stock market is also necessary for an effective venture capital industry based on the empirical studies done by Black Bernard and Ronald Gilson.[89] This part examines the legislative efforts in providing these factors in the context of China,[90]and argues that the Chinese experience in solving the engineering problems offers a pragmatic guide to countries that are still in the Genesis of venture capital.

[85] 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.
[86] Since 2013, the NDRC has been empowered to compile policies for the development of the private equity and venture capital industry.
[87] 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.
[88] Gilson emphasis three elements in the Engineering article
[89] *See* Black & Gilson, *supra* note 4. *See also* Rock, *supra* note 4.
[90] Gilson, *supra* note 1, at 1072.

A. Sources of Funding

1. 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.[91] However, as shown from Table 1 & Table 3, the current composition of venture capital investors (i.e. limited partners) differs 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 investors (who are LPs in venture capital funds), 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 management companies and funds of funds.[92] In particular, there is a growing number of wealthy Chinese companies with their own venture funds, primarily focusing on consumer-and internet-related enterprises.[93]

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.[94]

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.[95]

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[91] These institutional investors constitute, on average, 75% of VC fundraising in the US from 1993 to 2002 (The Venture Capital Cycle, supra note 13).

[92] 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.

[93] *See* Ernst & Young, *supra* note 5, at 20.

[94] 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.

[95] 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).

Nonetheless, as will be further discussed below,[96] 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 rights.[97] 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.

2. 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, 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")[98] scheme, the Renminbi Qualified Foreign Institutional Investor ("RQFII") program[99], as well as the Renminbi Qualified Foreign Limited Partner ("RQFLP") programe.[100]

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[96] See infra text accompanying note 173 - 176.

[97] 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).

[98] 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.

[99] Under the RQFII, Hong Kong subsidiaries of approved PRC securities firms were permitted to raise RMB funds

Regulators, notably CSRC, China Insurance Regulatory Commission ("CIRC") and CBRC have also removed previous restrictions on NSSF, insurance companies, commercial banks and trust companies[101] 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.[102]

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. [103] As for National Social Security Funds, up to only 10 % of its total assets can be used for venture capital and private equity investments.[104] Also, local pension funds have not been allowed to make equity investments in China, though proposals have been made to enable pension funds inject fundings to China's venture capital funds.

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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.

[100] 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.

[101] 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).

[102] http://www.zgctrz.com.cn/shownews-29840.html

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

[104] This ratio at the end of August 2014 was only 2.26%, with ample room to be growth.
http://m.licai.com/zixun/content?id=60577

Table 1: Percentage Of Capital Raised By Limited Partners in China's Venture Capital and Private Equity Market
(By Investor Type)[105]
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
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)[106]
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

[105] "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.
[106] "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.

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

3. Government Funding

Government funding is recognized as one of the most important sources of funding for fueling entrepreneurship, after bank credit.[107] Many countries provide 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 Program, Chile's CORFU, Germany's WFG, and the recent Singapore Early Stage Venture Fund ("ESVF") scheme[108]. 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. For example, the German WFG program ultimately proved to be a failure due to the limited incentives provided, while the Chilean CORFU program was much more successful due to the greater incentives provided as well as making available means of monitoring through private ordering (See Appendix 1).

Similarly, the Chinese government provides venture capital funding to tech startups

[107] *See* Ernst & Young, *he EY G20 Entrepreneurship Barometer 2013*i (2013). *See also* Ernst & Young, *supra* note 5, at 14.
[108] 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/.

through various kinds of government backed programs, such as the Innovation Fund for Technology Based Firms ("IFTBF", *kejixing zhongxiaoqiye jishu chuangxin jijin*),[109] the Industrial Investment Fund ("IIF", *chanye yindao jijin*) and the Government Guidance Funds ("GGF", *zhengfu yindao jijin*).[110] Data from 2008 demonstrates that 80% of the venture capital funding was government backed.[111]

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. 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.[112] The establishment must be approved by NDRC.[113] The remainder of this section will focus on the GGF.

a) Government Guidance Funds

The first form of the GGF began in 2002 when the Zhongguancun Management Committee set up the first government funded Venture Capital Guided Fund.[114] However, the role and definition of GGF had been vague until the promulgation of several departmental regulations,[115] especially 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

[109] *Keji Xing Zhongxiao Qiye Chuangxin Jijin Guanli Zhongxin*, http://www.innofund.gov.cn/ (last visited May 30, 2015).

[110] 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.

[111] Xinhuawang (新华网), *hongguo Fengxian Touzi de Lishi ji Xianzhuang (投中国风险投资的历史及现状)* (May 13, 2008), http://news.xinhuanet.com/theory/2008-05/13/content_8156697.htm.

[112] Zou Jing, supra note 36 at 104-106.

[113] 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.

[114] 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.

[115] 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.

capital into the venture capital industry and supporting venture capital companies.[116]

Pursuant to the 2008 GGF Guide, the key feature of the GGF is that it is market oriented, and hence the government is not directly involved in the venture capital business or selection of portfolio companies.[117] The GGF is designed to increase the supply of venture capital funding and channel more venture capital funds from growth and mature companies towards seed funding and initial stage funding. The roles of the GGF include,[118] *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 (supporting early-stage and technology SMEs) with guidance and grants with a second round of grants as insurance.[119] With regards to the source of funding, the GGF was kick started by government funds as well as through the encouragement of investors such as 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.[120] However, despite the positive progress and swift development seen above, GGFs have not been without its problems.

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[116] *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 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.

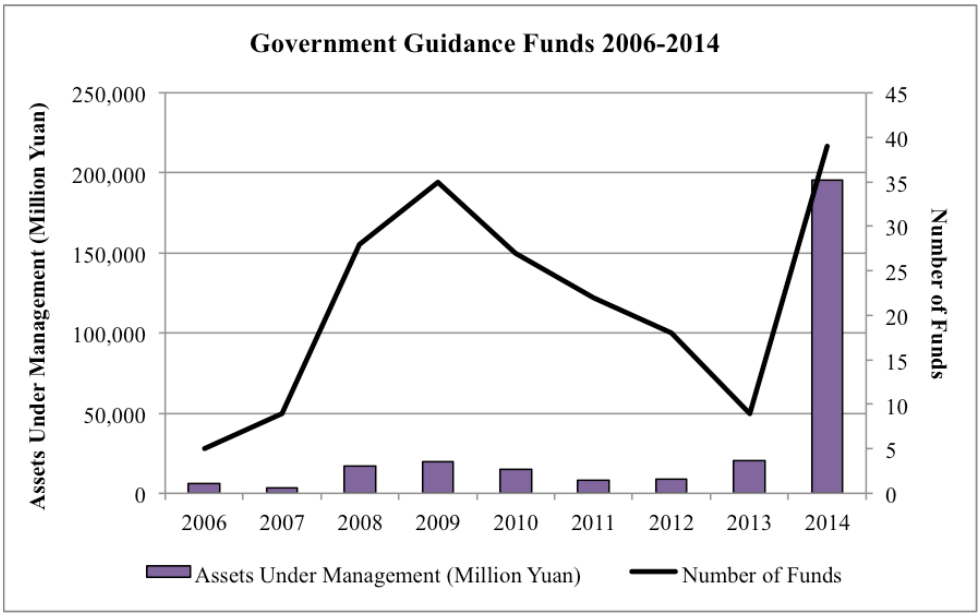
[117] Art 3 of Venture Capital Fund Specifications and Operational Guide 2008.

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

[119] *See* Zou, *upra s*note 36, at 84.

[120] *See* Qingke Yanjiu Zhongxin, *supra* note 114.

Figure 2: Government Guidance Funds in China 2006-2014
Source: Zero2ipo



b) Problems with GGFs

The first problem is the conflict between governments and the venture capital firms with regards to compensation of venture capital firms. In contrast with the conventional 2/20 compensation rule in venture capital limited partnerships, under which a management fee of 2% of the fund's capital will be paid to the GP (venture capitalist), and a carried interest of 20% of the fund's profits will be distributed to the LPs (investors),[121] the profit sharing under GGFs varies significantly in China. 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 liquidation process of the venture capital fund.[122]

The second problem relates to internal governance of the GGFs due to the lack of expertise and experience of GGFs. Over the years, under the principle of "market operation + government guide", the GGFs' government guidance in fund management, whether from the central or local levels, has been far from perfect. Regional funds suffer constraints such as the unprofessionalism of the government authorities, especially in the areas of investment strategies, post investment management, and exit strategies.[123]

[121] A default of management fees of 2% fund's capital, and carried interest of 20% fund's profits
[122] *See* Qingke Yanjiu Zhongxin, *supra* note 123.
[123] 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.

The incompetence in fund management of GGFs is 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, such as serving as the 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 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 higher growth potential. This would lead to conflicts between the GGF and the venture capital firm, resulting in less and less venture capital firms willing to receive GGF assistance.[124]

Thirdly, the size of GGF is insignificant relative to the venture capital/ private equity industry. As of the end of 2014, there was USD 885.0 billion worth of investable equity assets in the industry, but only USD 17.5 billion worth of investable assets were attributed to GGFs, which accounts for merely 2.0% of the total investment amount.[125] Such a small total size of the fund is further exacerbated in rural places, where GGFs are so small that they do not play an effective role in guiding capital flow to startups.[126]

c) New Directions for GGFs

Being cognizant of the problems afflicting the operation of the GGF over the past decade, the Chinese government 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 shifting towards a market-oriented approach.[127]

This shift in strategy is complemented by a new wave of GGF creation and injection of funds.[128] The most significant development is the announcement made by the State Council regarding the creation of the 40 billion RMB State Venture Capital Investment Guidance Fund (SVCIGF) (*guojia xingxin chanye touzi jijin*) to support start-ups in emerging industries, foster innovation and develop industries.[129] The SVCIGF will be funded by the government's existing capital designated for the expansion of emerging industries, state corporations and private investors. Investment-wise, it will invite public tenders from private asset management institutions, with priority for returns given to private investors. The objectives of the

[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *See* Qingke Yanjiu Zhongxin, *upra* anote 114.
[128] 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.
[129] *See* Qingke Yanjiu Zhongxin, *supra* note 114.

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.[130]

A key feature of the SVCIGF is that the government actually relies on market forces (unlike the GGF) and does not participate in the management of the funds, for instance allocating capital and selecting portfolio companies.[131] 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. Furthermore, the ceding of control to the market forces mechanism also mitigates inefficiency and tackles operational problems arising from incompetence and unprofessional government authorities.

Another crucial feature of the SVCIGF is its ability to leverage on government funding by attracting private investors to participate in the SVCIGF.[132] Over time, more private capital and overseas capital will likely be drawn by the presence of government credit and enter the domestic venture capital industry.[133] It is hoped that the lower risk would also attract institutional investors such as pension funds and endowments, altering the composition of investors in the Chinese venture capital market. The 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.

As a consolidated GGF, 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.[134] This tackles the problem of inefficiencies arising from local governments, which may arise from artificial limitations set on investment locations or an inability to attract proficient fund management institutions. Lastly, 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 and support the growth of the venture capital industry. This is marked by various milestones, and most significantly, the establishment of the SVCIGF, which attempts to mitigate the various problems faced

[130] 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.
[131] *Id.*
[132] *See* Qingke Yanjiu Zhongxin, *supra* note 114.
[133] *Id.*
[134] *Id.*

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.

B. Specialized Investment Vehicles

The investment vehicles used by venture capitalists and investors vary from jurisdiction to jurisdiction. The limited partnership has been the predominant vehicle in the US since the 1970s,[135] while the company is the predominant vehicle in Taiwan's venture capital market.[136] In recent years, a number of jurisdictions such as Singapore, [137] New Zealand, [138] Taiwan, [139] Japan [140] and Switzerland [141] have introduced the limited partnership into their business menus. Some jurisdictions, such as the UK[142] and Australia[143] have 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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[135] *See* Gompers & Lerner, *supra* note 13, at 10.

[136] Christopher John Gulinello), *supra* note 41.

[137] Singapore has passed the Limited Partnership Bill on 18 November 2008. The Singapore Limited Partnership Act 2008 came into operation on 4 May 2009. Text available online: Statue Online < http://statutes.agc.gov.sg/>.

[138] 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), online: New Zealand Companies Office <http://www.companies.govt.nz/cms/other-registered-entities/limited-partnerships/introducing-limited-partnerships/>.

[139] 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).

[140] 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).

[141] 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.

[142] 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>.

[143] 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[144], and (3) limited partnership-type funds.[145] 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.[146]

This section discusses the two major types of investment vehicles that are used in the Chinese venture capital market: the limited partnership and company, 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[147].

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).[148] 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. [149] The Chinese legislature, knowing that the limited partnership had already been proven to be a popular business form for venture capital funds and had been introduced by a number of jurisdictions to develop their venture capital industries, decided to introduce the limited partnership in China so as to attract venture capital to high-tech growth enterprises and encourage the development of venture capital market in China.[150]

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[144] The trust-type private equity funds have emerged in China since 2007. In typical trust-type private equity fund, a trust company acts as a trustee of the fund and is responsible for fund raising and equity 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.

[145] *See* Lin, *supra* note 97, at 190.

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

[147] 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.

[148] 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 >].

[149] 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.

[150] 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.

Right after the enactment of the revised PEL on 1 June 2007, the very first Chinese Limited Partnership (*Nanhai Chengzhang Venture Investment Limited Partnership*)[151] was set up on 27 June 2007. Till the end of 2008, hundreds of private equity funds were registered as limited partnerships in China,[152] 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.[153] Today, the limited partnership has become the most common business vehicle in the Chinese venture capital market.[154]

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 partner ship. 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.[155] As for the general partnership, the unlimited liability of all the partners and the harsh tax burden[156] 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 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 and considerable lower formality costs. 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.[157]

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[151] Shanghai Securities News, *The First Venture Capital Limited Partnership was Established* (29 June 2007).
[152] 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>].
[153] *China Venture Capital Yearbook 2009*, *supra* note 146, at 252.
[154] *See* China Venture Capital Yearbook 2009, *supra* note 146 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.
[155] 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 (US$ 73000 and US$1450000) respectively.
[156] 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.
[157] *Ibid.*

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 [158] 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.[159] It has the right to hold assets, [160] to sue and be sued [161] and the partnership does not dissolved upon dissociation of partners. [162] 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.[163] In addition, there must be at least one expressly identified general partner who would bear unlimited liability for the debts of the firm,[164] and partners can be individuals and legal persons.[165]

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.[166] 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

[158] 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 51.
[159] *See id.*, Art 11.
[160] *Partnership Enterprise Law 2006* (PRC) Art. 20, 21 and 22.
[161] See *Civl Procedural Law 2007* (PRC) Art. 49.
[162] *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.
[163] *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*].
[164] *Partnership Enterprise Law 2006* (PRC) Art. 61.
[165] Art 2, Partnership Enterprise Law of PRC
[166] *See id.*, Arts 2, 67 and 68.

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.[167]

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 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.

(1) Control

Unlike LPs in US venture capital funds who are generally passive and do not participate in the control of the fund;[168] a pervasive problem in the Chinese venture capital market is that LPs are more active and are willing to take part in the management of the fund, especially in the selection of portfolio companies.[169]

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

[168] *See* Zou, *supra* note 36, at 79.
[169] *See* Lin, *supra* note 97.

through various kinds of internal committees.[170] 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.[171] 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.[172]

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[173] 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 and two LPs, and decisions are made by a majority vote.[174] 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,[175] or explicitly restricting and limiting interference with investment decisions of the GPs.[176]

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[170] *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.
[171] Zero2IPO Research, *Report for China Venture Capital and Private Equity Management Mechanism and Compensation Scheme 2011* (2012) at 13.
[172] Yang Yongxiang and Xu Xiaocheng, *Limited Partners in China* (2008) 8 *TopCapital 1*.
[173] Investment and Cooperation, [Touzi yu Hezuo] "China LP" http://money.163.com/08/0806/10/4ILIMEGP00252GKH.html
[174] *Id.*
[175] *Id.*
[176] *See* Zou, *supra* note 36, at 77.

(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.[177] 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 peculiar 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.[178] 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.[179]

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.[180] In 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 is distributed to the employees and 2% of profits from specific funds as performance bonus to the investment team.[181] Arguably, this form of performance-based compensation structure is more unattractive 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 contributors to the high-turnover rate of the company as witnessed by the fact that three chief executives of the company have left the firm since 1999.[182] In another case of Fortune Capital, which is also a renowned state-owned venture capital firms like SZC, the largest shareholder is the Hunan TV

[177] Kate Litvak, "Venture Capital Partnership Agreements: Understanding Compensation Arrangements," University of Chicago Law Review, Vol. 76, pp. 161-218 (2009) at 161
[178] Pan Wei, "" 21 Centry Economic Report, May 13, 2013, http://pe.pedaily.cn/201305/20130513348320.shtml
[179] *Id.*
[180] *Id.*
[181] Yao xuanjie, PE 薪酬机制起底 (May 18, 2013) China Securities News (Zhongguo zhengquanbao) http://finance.ce.cn/rolling/201305/18/t20130518_17113444.shtml
[182] *supra* note 178.

and Broadcast Intermediary Co.Ltd, while the other key founding partners only hold 25% of shares of the firm. Also, GPs of the funds will only be entitled to only 5% carried interests, which is significantly lower than the 20% market standard. [183]

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.[184] 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.[185] Empirical evidences show that the *higher management* level, the higher performance ratio (performance-related pay/total pay) a manager would have.[186] For example, 60% of the total pay to chief manager/partners is performance-related pay while the figure for junior investment managers is only 20%.[187]

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 include the "fund raising bonus" (*xiangmujiangjin*) distributing to those who. This bonus ranges progressively from 3%-5% of the total raised fund depending on the size of the fund. [188] There are also investment bonus (*touchengjiaing*), which is awarded to those whose responsive investment project is successfully made into the portfolio companies, ranging normally from 0.5%-1% of the investment amount; or in a form of fixed bonus, depending on the investment amount.[189] Although the above bonus schemes are designed to incentivize GPs, the effect is questionable. A 2011 survey shows there is a large pay gap between GPs from local firms and those in foreign firms, particularly in terms of carry received. And one of the major reasons for GPs to leave the firm is due to their unsatisfactory of the compensation package.[190]

[183] *supra* note 178.
[184] *supra* note 178.
[185] Yao xuanjie, PE 薪酬机制起底 (May 18, 2013) China Securities News (Zhongguo zhengquanbao) http://finance.ce.cn/rolling/201305/18/t20130518_17113444.shtml
[186] *Id.*
[187] China Securities News (Zhongguo zhengquanbao) http://finance.ce.cn/rolling/201305/18/t20130518_17113444.shtml
[188] *supra* note 185.
[189] *Id.*
[190] zero2ipo research centre, May 9, 2011, http://finance.ifeng.com/gem/vcyj/20110509/3998228.shtml

(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[191], the UK[192], and Singapore[193] which do not provide 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).[194] 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.[195] 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.[196] 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 parallel fund or fund of funds[197], these arrangements are time-consuming and costly. It may also lead to the 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. Therefore, it is suggested that the restriction on the number of partners be removed from the PEL.

(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. [198] The PEL does not

[191] See *Delaware Revised Uniform Limited Partnership Act* § 17-101.
[192] 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.
[193] *Singapore Limited Partnership Report*, *ibid* at para. 8.4.
[194] 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.
[195] Li Fei, *Interpretation of Partnership Enterprise Law of the People's Republic of China* (Beijing: Law Press China, 2006, at 100.
[196] J Rinzer, "English Private and Public Limited Company as Managing General Partner in a German Limited Partnership" (1994) Comp Law 285.
[197] 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.
[198] 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*.

allow wholly state-owned companies, state-owned enterprises (SOE),[199] listed companies,[200] charitable institutions[201] and social organizations are not allowed to serve as GPs in a limited partnership.[202] 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.[203] 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[204], and there are different regulations on the types of companies can be considered as "SOEs".[205]

(c) Contributions

In contrast to the DRULPA[206] 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.[207] The drafter of the PEL contends that firstly, LPs do not participate in the management of the fund and enjoy limited liability to the contribution to the firm, thus there is no need for LPs to contribute in service. Secondly, allowing them to make contributions in kind may also create difficulty in evaluation of their partnership shares.[208] However, in the context of venture capital funds, the expertise and industrial experience of the LPs is an invaluable asset to the success of the fund. It is recommended that the PEL shall allow LPs to make contribution in form of service.[209]

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[199] 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 195, at 4.

[200] 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.

[201] 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.

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

[203] Li Fei, *Interpretation of Partnership Enterprise Law*, *supra* note 195, at 6.

[204] 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.

[205] 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

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

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

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

[209] 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

(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).[210] An assignee (of general partner) will become a (general) partner and will be subject to the rights and obligations according to the amended agreement and the PEL.[211] 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.[212]

The general partner in a venture capital fund plays a crucial role in the management of the fund, such as 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 creditors' interests since they rely on the personal liability of the general partner to pay the debts of the fund, especially when the fund use leverage in the investment. Therefore, 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 partner to be personally liable for the prior obligations of a partnership.[213] 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[214] and Japanese[215] counterparts, a general partner in a Chinese 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

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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.

[210] *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.

[211] *Partnership Enterprise Law 2006* (PRC) Art. 24; See also Li, *Interpretation of Partnership Enterprise Law*, *supra* note 195, at 37.

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

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

[214] *German Commercial Code* §130 provides that a new partner is liable as the other partners for partnership 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.

[215] *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."

debts incurred before he joined the firm.[216] 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 real practical need for venture capital limited partnerships to convert back to companies, because portfolio companies invested by limited partnership-type fund are not allowed to listed on the stock exchange under the current Chinese law.[217] Empirical evidence has also shown that a number of funds have to convert back to companies so as to realize the exit. Therefore, in order to meet the business needs of the venture capital funds, the Chinese legislature should provide a seamless process for the conversion of limited partnership to companies.[218] 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.[219] However, equivalent provisions are not found in its German, French or US counterparts.[220] It is suggested that a Chinese Limited Partnership with only one general partner should be allowed to continue operating over a longer grace period so as to explore possible options and attract incoming LPs. Also, as a typical venture capital fund usually lasts for ten-year 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.

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

[217] 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].

[218] 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.

[219] *Partnership Enterprise Law 2006* (PRC) Art. 75; *Partnership Enterprise Law 2006 (PRC)* Art. 24; See also Li, *Interpretation of Partnership Enterprise Law*, *supra* note 195, at 122

[220] 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).

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 *PRC Company Law 2005*. Foreign-invested venture capital funds may choose another business form specially designed for foreign related investments - the venture capital investment enterprise ("VCIE").[221] 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.[222]

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, in terms of internal governance structure, company-type funds are less flexible and efficient than partnership-type funds. Under Chinese law, the rights, responsibilities and liabilities among shareholders, board of directors, supervisory board and management in the corporate form are usually subject to strict legal regulations (including the PRC Company Law, PRC Securities Law and soft law such as the listing manual of the stock exchanges). For instance, Article 6 of the PRC Company Law stipulates that directors, supervisors and senior management are

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

[222] *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 US$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.

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. This is in contrast with the limited partnership, where the internal governance of the partnership and relationship between general and LPs are mainly based on the partnership agreement and GPs are not burdened with statutory duties of loyalty or due diligence.

Moreover, under the PRC Company Law, a special feature of the company-type venture capital fund is the two-tier board system, i.e. the board of directors and the supervisory board. Thus, a venture capital Limited Liability Company may establish a board of three to 13 directors, as well a supervisory board composed of at least three members. However, the Limited Liability Company usually only has an executive director with one to two supervisors instead of a board of directors or a supervisory board because it is relatively small in scale and comprises only a relatively small number of shareholders.[223]

In a venture capital company, the shareholders' meeting is crucial for the approval of the annual financial budget, distribution of profits and recovery of losses, appointment and dismissal of managers, as well as settlement of remuneration issues. In comparison, venture capitalists who serve as investment managers in the company are generally responsible for investment decisions and other management related issues. The board of directors or executive directors in a small Limited Liability Company is in charge of the supervision of the investment manager, such as employing investment consultants and accountants. It is worth noting that such an organizational structure is more suitable for Limited Liability Companies than Joint Stock Companies. As the number of shareholders increase, the governance framework is also likely to change.[224]

Fourth, company-type funds may have less powerful managerial incentives than limited partnership-type funds, where GPs' compensation is generally based on the 2/20 Rule - the GPs are entitled to 2% of the fund capital as management fees and 20% of fund profits as carried interest.

C. Capital Markets

Venture capital exit is the stage where venture capital investments are returned and profits are realized. A prerequisite for an attractive venture capital market is the

[223] *See* Art 51 of PRC Company Law (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective Jul. 1, 1994, revised Dec. 25, 1993 and Aug. 28 2004).
[224] *See* Zou, *supra* note 36, at 64.

existence of a highly liquid exit option that enables investors to cash out.[225] The close links between the stock market and the venture capital market has been extensively discussed in literature, though the importance of a national capital market for the development of venture capital market has been questioned.[226] 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.[227] 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[228]. 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.[229]

China's capital 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 capital market was not established till 1990. Since then, it has been developing alongside with the economic reform and served specific mission. The following section discusses the recent changes and their potential implications in the context of China's venture capital market.

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. Therefore, a venture capital fund's equity investments in portfolio companies typically take the form of convertible preference shares.[230] 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, allowing listed companies and unlisted public companies to issue preference shares in both public and private markets in China for the first time.[231] Ten ministries and committees of the State Council jointly enacted a regulation entitled "Interim

[225] 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.
[226] 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."). .
[227] *See* Black & Gilson, *supra* note 4 at 1.
[228] *Id.*
[229] *Id.*
[230] http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/ebook/zgfzbg01_01_01.html
[231] China Launches Landmark Preference Share Pilot Program, http://www.hoganlovells.com/files/Uploads/Documents/China_Preference_Share_Pilot.pdf

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.[232]

The introduction of the preference shares has adequately met the needs of the Chinese practitioners in China. Nonetheless, since detailed regulations such as issuance procedures or principal terms are yet to be provided by governmental agencies, convertible preference shares remain practically unusable in China. Even if such regulations are clarified, its application is restricted to companies limited by shares but not limited liability companies.[233] This is because only companies limited by shares can issue shares, whereas limited liability companies' equity system is based on the percentage of capital contributions under PRC Company Law. This limitation is not illusory, as there are fundamental differences between the two corporate forms, such as a much higher minimum capital threshold for companies limited by shares.[234]

The followings parts examines China's recent reforms to its capital 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.

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.

[232] *See* ZHANG LIN, CHINA'S VENTURE CAPITAL MARKET: CURRENT LEGAL PROBLEMS AND PROSPECTIVE REFORMS 50 (Elsevier 2015).
[233] *See* Jing Li, *Venture Capital Investments in China: Usage of Offshore Financing Structure and Corporate Relocations*, 1(1) MICH. J. PRIVATE EQUITY & VENTURE CAPITAL LAW 1, 27-37 (2012), at 13.
[234] *Id.*, at 15-16.

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.[235] In a five-year span since ChiNext was launched, 519 exits were made via ChiNext, with a market return of 743.4 billion RMB.[236] As of October 23, 2014, 519 companies that were backed by venture capital/private equity have already been listed on ChiNext[237].

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.

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.[238] While it is understandable that a high financial standards for a relatively young exchange is necessary to reduce speculation and increase investor protection, it is argued that the stringent listing

[235]Securities Daily (23 October, 2014), http://finance.chinanews.com/stock/2014/10-23/6707553.shtml
[236] *http://finance.chinanews.com/stock/2014/10-23/6707553.shtml*
[237] *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.
[238] Art 11, Administrative Measures for Initial Public Offerings and Listing on the Secondary Board

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.

With a series of positive laws and policies being promulgated to facilitate the development of the New Third Board,[239] it has emerged as an attractive and important financing channel for small and medium sized companies. As of 11 June, 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.[240]

As the New Third Board targets at high-tech and high-risk enterprises, the threshold requirement for investors are higher than those invested in the other three boards, with at least 5 million RMB registered capital for legal person-type investors and 5 RMB million paid-up capital for partnership-type investors. Individual investors are also strictly restricted to those possess securities asset value of at least 3 million RMB and have a minimum 2-year securities investment experience or relevant training or background in accounting or finance.[241] Due to the high threshold requirement presently, investors of New Third Board are mainly institutional investors, such as securities companies, insurance companies, securities investment

[239] Reuters, (13 June 2011) http://www.reuters.com/article/2011/06/13/idUS28915+13-Jun-2011+BW20110613
[240] Zero2ipo Rsearch Centre, (15 June 2015), "Latest Data on New Third Board 2015" http://research.pedaily.cn/201506/20150615384172.shtml
[241] http://stock.sohu.com/20140514/n399511601.shtml

funds, private equity funds, venture capital funds qualified foreign institutional investors and corporate pension funds.

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

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

In China's context, the 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 confirms that there is a statistically significant correlation between the number of venture capital-backed IPOs and capital contributions in China from 2006 to 2014 (Figure 4). This correlation is consistent with Black and Gilson's theory about the link between the stock market and the venture capital market.

Figure 4: Venture Capital-Backed IPOs And New Capital Commitments To Venture Capital Funds in China 2006 – 2014
Source: Zero2IPO

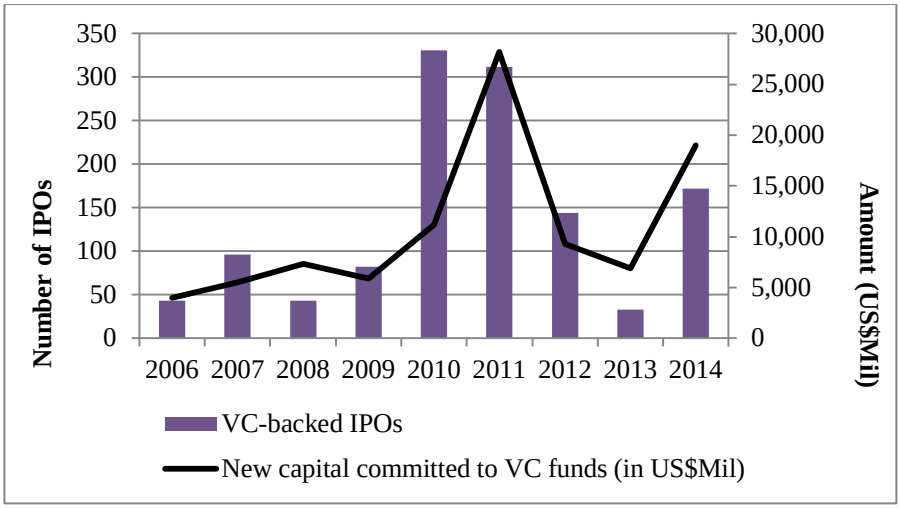

Table 4: China Venture Capital -Backed IPOs And New Capital Committed To Venture Capital Funds In China 2006 – 2014
Source: Zero2IPO

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).[242] 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).[243]

[242] Zero2IPO Research Center, *2014 Venture Capital Annual Report* (Mar. 5, 2015), http://research.pedaily.cn/report/free/985.shtml.
[243] *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[244] & ChinaVenture[245]

Year	Methods of Exit			Total number of exits[246]	Amount of new capital committed to VC funds (in US$Mil)[247]
	IPO	M&A	Share transfer[248]		
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[249]

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

[244] For data of 2008-2014.
[245] For data of 2006-2007.
[246] Total figure includes management buyouts and share buybacks.
[247] *See* Zero2IPO, *supra* note 242.
[248] "Share transfer" excludes management buyouts and share buybacks.
[249] *See* National Venture Capital Association, *supra* note 243, 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 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.[250] Given the limited domestic talent pool, banks have also struggled to find enough talent to sustain their operations.[251] Therefore, few M&A transactions have been entered into and these deals do not commonly succeed.[252]

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[250] *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.")

[251] *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.")

[252] 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.[253] 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.[254] 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.[255]

IV. 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 institutions in building up the Chinese venture capital market. It shows that unlike the U.S. venture capital market which "developed organically" without government design, the Chinese government has played a significant role in shaping the underpinning legal and regulatory infrastructure of the venture capital market. At the same time, the role of the PRC

[253] Zero2IPO report on China Equity Investment Market 2014 (Qingke Zhongguo Guquan Touzishichang 2014 Nian Quannian Huigu) at 42.
[254] *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 (US$150 million-US$500 million) will happen more frequently in the coming year. The expectations of small-sized M&A transactions (US$5 million-US$50 million) dropped significantly in the 2014 survey, showing Chinese investors were developing an appetite for larger transactions, especially for targets with higher valuations or with a leading position in their particular industry.)
[255] Ibid.

government has also been evolving – from a direct participant in the 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 solved with legislative and policy efforts and it seems as though 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 it from realizing its true potential of the venture capital industry. Further, on top of funding, financial intermediaries, entrepreneurship and a robust capital market, an effective venture capital market also requires a wide range of complex social, legal, and economic institutions, specifically competent courts, reputational and sophisticated accounting and legal profession, an effective reputation market, as well as informational transparency. 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. And if that is the case, its successful re-engineering may continue to expand.

Appendix 1: Comparison Of Pro- Venture Capital Government Programmes

	USA's Private Ordering	Germany's Deutsche Wagnisfinanzierungsgesellschaft ("WFG")	Israel's Yozma Programme	Chile's Corporation for the Incentive of Production ("*CORFU*")	China's State Venture Capital Investment Guidance Fund ("*SVCIGF*")
Role of government	*Minimal role* Minimal role of the government – the VC market was engineered through private ordering and contracting.	*Substantial role for the 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 Chinese government is to provide capital funding to the SVIGF (40 billion RMB, or approx. US$ 6.5 billion), and this encourages private investment in the fund by leveraging on government credit and boosting investor confidence. Professional fund managers are invited, through a public tender, to manage the fund, free from government intervention.
Incentives for financial intermediary to monitor portfolio companies	*Good incentives in place* 20% carried interest based on a 1% capital contribution incentivized VC fund managers to	*Little incentives provided* WFG and the investing banks had little incentive to monitor VC investments: (1) protection was provided via government guarantee, (2)	*Good incentives in place* Yozma provided no guarantee against loss, thereby incentivizing fund managers and private investors to carefully	*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	*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

	monitor portfolio companies. Fund managers' concern about raising subsequent funds also incentivized them to monitor their investments. Significant control and equity incentivized fund managers to provide noncapital inputs to portfolio companies.	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.	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.	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.	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	*Monitoring through control* Venture Capitalists obtain greater control relative to their proportion of equity holdings in the portfolio companies. Venture	*Little control obtained* WFG made passive investments through minority investments, with no control rights received.	*Control rights vested in the financial intermediary instead of Yozma* While Yozma did not make investment decisions and its investments were passive, these investments were made by highly	*Control rights vested in the financial intermediary and not CORFU* 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	*Control rights vested in the financial intermediary and not the government* Similar to both the Israeli and Chile programmes, whereby the means to monitor are through control rights in portfolio companies which

	Capitalists obtain veto rights over major decisions, retain continuation decisions, and typically control a majority of the board.		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.	companies using their control rights.	are held by the financial intermediary and not the government.