# Venture Capital in China:

## Improving the Legal Framework on the Basis of the U.S. Experience

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# Venture Capital in China: Improving the Legal Framework on the Basis of the U.S. Experience

## Abstract

Venture capital (VC) is the investment by a financial firm in high-growth, high-risk, and high-tech private start-ups for high returns in the future. Since the importance of VC for the high technology sector and the economy as a whole has been widely accepted in China, it follows that a successful VC industry is an important tool for China to further develop and strengthen its economy and high technology industry. A well designed legal system will attract more investors to engage in China's VC industry, while a poorly designed legal regime will throw obstacles in the way of investments for the industry. This study offers evidence on how a proper legal framework may be established for China's VC industry.

The main problems of China's VC legal system include those of fundraising, overly complex foreign VC investment restrictions, limited exit channels, and ineffective governmental stimulus. In an attempt to solve these problems, this study examines six key factors that influence the nature and performance of a proper VC legal framework. These factors include the formation and fundraising of VC firms, the usual life cycle of VC investment, the impact of economic and political policy on VC development, the governance of ventures, an established financial market, and governmental VC stimulus.

Since the future of China's VC industry is likely follow the model presented by the VC industry in the U.S., which is seen by most commentators as the best VC industry in the world, China should study the important lessons learned in the century of VC legal

experiences in the U.S. This study compares the Chinese VC legal system with that of the U.S. in four aspects: funding, governance in ventures, exits, and stimulus.

Although China's legal and policy environment for the VC industry is improving, Chinese policy makers who wish to promote VC in China need to increase the regulatory supply of and legal demand for VC. Against the background of this study of the experiences of the U.S. VC industry, it becomes clear that some VC legal techniques employed in the U.S. should be adopted in China. Based on the lessons learned in the U.S., China should improve its financial liberalization, create new legal techniques for VC governance in ventures, promote its exit channels, and provide a proper stimulus policy.

風險投資是指針對高成長、高風險的高科技民營企業進行的一種投資形式。由於風險投資對高科技和社會經濟發展的促進作用，所以有必要通過風險投資產業建設以推動中國經濟和高科技的發展。一個完善的法律體系將吸引更多的投資者參與中國風投產業的建設，反之，一個存在缺陷的法律體系只能對中國風投產業的發展設置障礙。本文論證了如何在中國建立一個完善的風險投資法律體系。

中國風投法律體系的問題主要體現在基金募集、過度嚴格的外資管制、缺乏退出管道以及尚不健全的政府引導機制等方面。爲解決上述問題，本文論述了六個決定風投法律體制建設的要素：基金募集、風投運作週期、經濟和政治因素對風投發展的影響、對被投企業的治理、資本市場建設以及政府引導機制建設等。

由於中國風投產業在很大程度上學習了美國風投發展的模式，加上美國風投產業是世界上發展最成功的風投產業，所以中國應當深入研究美國風投法律體系發展的經驗。本文從基金成立與募集、對被投企業的治理、退出機制和政府引導機制等四個方面，將中國和美國的風投法律體系進行了比較。

雖然中國風投法律體系已經得到很大的提高和完善，但是中國仍需對該法律體系進行不斷改進。本文證明，中國應當移植部分美國風投法律技術，以推進自身法律體系的發展。在研究、比較美國經驗的基礎上，本文建議中國應當加大金融流動的自由度、創設先進的風投治理方法、加強退出機制建設，以及創建良好的政府引導機制。

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# Abbreviations

**1940 Act**: Investment Company Law of 1940

**1958 SBIA**: Small Business Investment Companies Act in 1958

**1974 ERISA**: Employee Retirement Income Security Act of 1974

**1985 DRST**: 1985 Decision to Reform the Chinese Science and Technical System (《关于科技体制改革的决定》)

**1985 RULPA**: 1985 Revised Uniform Limited Partnership Act

**1991 STC Provision**: 1991 Interim Provisions on Certain Policies Concerning High and New Technology Industry Development Zones (《国家高新技术产业开发区高新技术企业认定条件和办法》)

**1997 PCEIFIE**: 1997 Several Provisions on Change in Equity Interest of Investors in Foreign-invested Enterprise (《外商投资企业投资者股权变更的若干规定》)

**1997 State Council Circular No. 21**: Circular on Further Strengthening Administration of Share Issuance and Listing of Joint Stock Company outside the Mainland China (《国务院关於进一步加强在境外发行股票和上市管理的通知》)

**1998 PARSOEUFI:** 1998 Tentative Provisions on Asset Reorganization by State-owned Enterprise Using Foreign Investment (《关于国有企业利用外商投资进行资产重组的暂行规定》)

**1999 SAT Circular 273**: 1999 Circular on Tax Issues in Implementing State Council's "Decision on Strengthening Technological Innovation, Developing High-tech and Realizing Industrialization" (《国家税务总局关于贯彻落实<中共中央国务院关于加强技术创新，发展高科技，实现产业化的决定>有关税收问题的通知》)

**1999 State Council Opinion No. 105**: 1999 Several Opinions on Establishment of China's VC Mechanism (《国务院办公厅关于建立风险投资机制若干意见的通知》)

**2000 CSRC Circular No. 72**: 2000 Circular of Issues Concerning the Overseas Issuance and Listing of Shares by Overseas Companies with Interests in Mainland China (《关于涉及境内权益的境外公司在境外发行股票和上市有关问题的通知》)

**2000 State Council Circular No. 18**: 2000 Several Policies on Encouraging the Development of the Software and Integrated Circuit Industries (《国务院关于印发鼓励软件产业和集成电路产业发展若干政策的通知》)

**2001 HODGP**: 2001 Procedures for Handling Official Documents in the Administrative Departments of the Government (《国家行政机关公文处理办法》)

**2001 MDFIEP (Revised)**: 2001 Merger and Division of Foreign-invested Enterprises Provisions (Revised) (《关于外商投资企业合并与分立的规定（修订）》)

**2001 ULPA**: 2001Uniform Limited Partnership Act

**2002 PGOFI**: 2002 Provisions on Guiding the Orientation of Foreign Investment (《指导外商投资方向规定》)

**2003 FVCP**: 2003 Provisions on Administration of Foreign-Invested VC Enterprises (《外商投资创业投资企业管理规定》)

**2004 State Council Opinions No. 3**: Some Opinions of the State Council on Promoting the Reform, Opening, and Steady Growth of Capital Markets (《国务院关于推进资本市场改革开放和稳定发展的若干意见》)

**2005 DVCM**: 2005 Interim Measures on the Administration of Venture Capital Enterprise (《创业投资企业管理暂行办法》)

**2005 SAFE Circular No. 11**: Repealed 2005 Circular on Issues of Improving Foreign Exchange Administration for Mergers and Acquisitions with Foreign Investment (《关于完善外资并购外汇管理有关问题的通知》)

**2005 SAFE Circular No. 29**: Repealed 2005 Circular on Registration of Overseas Investment by Individual Residents in China and Foreign Exchange Registration for Merger and Acquisition with Foreign Investment (《国家外汇管理局关于境内居民个人境外投资登记及外资并购外汇登记有关问题的通知》)

**2005 SAFE Circular No. 75**: 2005 Circular on Foreign Exchange Control in Respect of Fund Raising and Round-trip Investments by PRC Residents through Special Purpose Vehicles (《国家外汇管理局关于境内居民通过境外特殊目的公司融资及返程投资外汇管理有关问题的通知》)

**2006 MGFISME**: 2006 Provisional Measures for Administration of the Guiding Funds for Investment in Technology-based SMEs (《科技型中小企业创业投资引导基金管理暂行办法》)

**2006 PEL**: 2006 PRC Partnership Enterprise Law (《中华人民共和国合伙企业法》)

**2006 MOFCOM Provisions No. 10**: 2006 Provisions on Mergers of Domestic Enterprises by Foreign Investors (《外国投资者并购境内企业暂行规定》)

**2007 MOF Opinion No. 8**: 2007 Several Guiding Opinions on Experimenting with VC in Industrial Technology Research and Development Funds (《财政部、国家发展改革委关于产业技术研究与开发资金试行创业风险投资的若干指导意见》)

**2007 SAFE Circular No. 106**: 2007 Circular on Issues Related to Foreign Exchange Control in Respect of Fund Raising and Round-trip Investments by PRC Residents through Special Purpose Vehicles (《国家外汇管理局综合司关于印发《国家外汇管理局关于境内居民通过境外特别目的公司融资及返程投资外汇管理有关问题的通知》操作规程的通知》)

**2007 SAT Circular No. 31**: 2007 Circular on relevant Taxation Policies Concerning Promoting the Development of VC Enterprises (《国家税务总局关于促进创业投资企业发展有关税收政策的通知》)

**2008 NDRC Opinion No. 10:** 2008 Guiding Opinions of Establishing and Operating Venture Capital Governmental Guiding Funds (《国家发改委关于创业投资引导基金规范设立与运作的指导意见》)

**2008 SAFE Circular No. 142**: 2008 Circular on Relevant Business Operations Issues Concerning Improving the Administration of the Payment and Settlement of Foreign Exchange Capital of Foreign-funded Enterprises (《国家外汇管理局关于完善外商投资企业外汇资本金支付结汇管理有关业务操作问题的通知》)

**2008 SAT Circular No. 159**: 2008 Circular on Income Tax Issues Related to the Partners in Partnership Enterprises (《国家税务总局关于合伙企业合伙人所得税问题的通知》)

**2008 SAT Circular No. 985**: Circular on 2008 Enterprise Income Tax for High-and New-technology Enterprises (《国家税务总局关于高新技术企业 2008 年度缴纳企业所得税问题的通知》)

**2008 State Council Opinion No. 126**: Several Opinions on Providing Financial Support for Economic Development (《国务院办公厅关于当前金融促进经济发展的若干意见》)

**2009 FIPM**: 2009 Administrative Measures for the Establishment of Partnership Enterprises by Foreign Entities or Individuals in China (《外国企业或者个人在中国境内设立合伙企业管理办法》)

**2009 SAT Circular No. 87**: 2009 Circular on Income Tax Preferences for Startup Investment Enterprises (《国家税务总局关于实施创业投资企业所得税优惠问题的通知》)

**ARD**: American Research and Development Corporation

**CCP**: Communist Party of China

**CJV**: Cooperative joint venture

**CSRC**: China Securities Regulatory Commission

**CVCA**: China Venture Capital Association
**DRULPA**: Delaware Revised Uniform Limited Partnership Act

**DVCF**: Domestic VC firm

**EIT**: Enterprise income tax

**EJV**: Equity joint venture

**ESOT**: Employee stock ownership trust

**EVCA**: European Venture Capital Association

**FIE Holding Company**: Foreign-invested holding company

**FIE**: Foreign-invested enterprise

**FIP**: Foreign-invested partnership

**FLP**: Foreign-invested limited partnership

**FVCF**: Foreign-invested VC firm

**GEM:** Growth Enterprise Market of China

**GPs**: General partners

**GPG**: Shenzhen Green Pine Growing Limited Partnership

**GPVC**: Shenzhen Green Pine Venture Capital Co., Ltd

**SEHK**: Stock Exchange of Hong Kong

**IPO**: Initial public offering

**JV:** Joint venture

**LLC:** Limited liability company

**LPs**: Limited partners

**M&A:** Mergers and acquisitions

**MOF:** Ministry of Finance

**MOFCOM**: Ministry of Commerce

**NCCUSL**: National Conference of Commissioners on Uniform State Laws

**NDRC**: National Development and Reform Commission

**NMVC**: New Markets Venture Capital

**NPC**: National People's Congress

**NSSF**: National Social Security Fund

**NVCA**: National Venture Capital Association

**OECD**: Organization for Economic Co-operation and Development

**PE**: Private equity

**PRC**: People's Republic of China

**PRC EIT Law**: PRC Enterprise Income Tax Law

**R&D**: Research and Development

**RI**: Requisite Investor

**SAFE**: State Administration of Foreign Exchange

**SAIC**: State Administration for Industry and Commence

**SAT**: State Administration of Taxation

**SBA:** Small Business Administration

**SBIC**: Small Business Investment Company

**SBIR**: Small Business Innovation Research

**SME**: Small and medium-sized enterprise

**SOE**: State-owned enterprise

**SPV**: Special purpose vehicle

**STC**: Committee of Science and Technology

**SZCG**: Shenzhen Capital Group Co., Ltd.

**VC**: Venture capital

**VCs**: Venture capitalists

**Ventures**: VC-backed companies

**WFOE**: Wholly foreign-owned enterprise

**WTO**: World Trade Organization

# Chapter I. Introduction

## 1.1 Overview

### 1.1.1 Background

Venture capital (VC) is the investment by a financial firm in high-growth, high-risk, and high-tech private start-ups for high returns in the future.[1] These start-ups have high technology, but often have a business size, assets, cash flow, or business history records that are much less substantial than established competitors.[2] These disadvantages make it very difficult for them to raise money from banks or public markets. However, professional organizations operating VC investments find it attractive to invest in these start-ups as shareholders, employing sophisticated valuation and financial contracting with the entrepreneurs of the start-ups.[3] After a fixed duration, these VC organizations will exit the start-ups by merging them into or having them acquired by larger companies, or causing them to launch an IPO.[4] By exiting these start-ups with proper channels, these VC organizations can reap high returns. Therefore, the VC industry entails accepting high financial risk in funding a start-up, especially in the high-tech industry, so as to obtain very high returns in the future.[5]

Since the 21st century is considered to present an economic change from a traditional economy to a knowledge-based economy, high technology and innovation play a significant role in this new economy.[6] It is understandable that the importance of VC in the process of promoting entrepreneurs and the growth of high-tech start-ups has been

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1 Black & Gilson (1998: 245). In the U.S., VC firms will mainly invest in high-tech start-ups. But Chinese VC firms will also invest in traditional industries besides the high-tech sector.

2 Ibid.

3 Ibid.

4 Ibid.

5 Hill & Power (2001: 1).

6 Ibid.

widely accepted.[7] Thus, a mature and prosperous VC system will be an important tool for a country to develop its new economy and to raise the level of its high technology.

China needs a mature and proper VC industry because of its current economic condition. While China has experienced continued high economic growth in the past four decades,[8] the country depends too much on export, which is an economic problem.[9] China's export depends on large numbers of low value-added products. That means it will be very difficult to keep competitive advantage in the international market. Though currently China is retaining the highest investment rate in the world,[10] it has serious environmental and social problems such as pollution.[11] These problems indicate that China should change its current means of economic growth to keep the country's future economic advantage in the international market.[12] High technology will be a good choice for China. Currently, China's high technology development is still far behind that of the developed countries. Therefore the Chinese government's policy of attracting foreign investment and using foreign VC is associated with its need for foreign advanced technology.[13] As Deng Xiaoping has said,

> Our experience shows that China cannot rebuild itself behind closed doors and that it cannot develop in isolation from the rest of the world. It goes without saying that a large country like China cannot depend on others for its development; it must depend mainly on itself, on its own efforts. Nevertheless, while holding to self-reliance, we should open our country to the outside world to obtain such aid as foreign investment capital and technology.[14]

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7 Yu (2007: 68).

8 Wolff (2008: 1).

9 Lu, Tan, and Chen (2007: 230).

10 Lim, Spence, and Hausmann (2005).

11 Lu, Tan, and Chen (2007: 231).

12 Ibid.

13 Lam (2000: 216-217).

14 Deng (1993: 152).

Thus, "opening up its economy to the outside world, China aimed to acquire modern technology and foreign investment funds from the advanced Western countries especially the U.S…."[15] In 2004, the State Council had stated that "developing capital markets is a task of strategic importance linked to the fulfilling of the strategic goal of quadrupling China's GDP within the first two decades of this century."[16] A developed capital market will encourage the development of the private economic sectors of China.[17] Since the private investment and private enterprises, including millions of start-ups, are playing a critical role in creating jobs, to strengthen independent innovation, The Chinese government now further encourages private capital to invest in economic sectors that are currently mainly controlled by the state-owned enterprises, including infrastructure for transport, telecommunications and energy, public utility, scientific and technological programs for national defense, and the building of affordable housing as well as technology research centers.[18] The government also states that the private companies are welcome to participate in the reform of state firms by purchasing a stake in them."[19] Such change means private start-ups and VC investors can enter into some economic sectors which were controlled by the state-owned enterprises.

An institutional situation in China, however, that creates difficulties for the development of high technology and VC investment is the lack of legal protection for corporate investors and the fact that "assets can be seized and held with little recourse to the owners."[20] Although these characteristics have not completely prevented China from producing a growing market for VC, a mature and developed VC industry needs a proper legal framework.[21] China's policymakers have noticed the situation and they have adopted some laws related to high-tech and VC industries in order to promote

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15 Lam (2000: 217).

16 Sec. 1, 2004 State Council Opinions No. 3.

17 Ibid.

18 Xinhua Net (2010).

19 Ibid.

20 Ahlstrom, Bruton, and Yeh (2007: 249).

21 Ibid.

China's growth and maintain its high economic development. These laws encourage Chinese entrepreneurs and start-ups to develop high technology and innovation through the support of VC. China also intends to establish a mature VC system to support the development of high-tech and innovation.[22] Criteria are given by scholars to verify whether a mature VC system is high quality, for instance, a proper VC system should be market-centered, with a proper framework of laws for business organizations and a highly regulated capital market that can offer VC investors exit channels and promote VC investment.[23] Unfortunately, according to these criteria, the current Chinese VC system is still in the primary stage.

Three premises can be formulated for why China needs to establish a mature VC system and a proper VC legal framework. The first is that the Chinese realize that high technology plays a very important role in China's economic development. The second is that the role of financial tools in economic development is more important than ever before because these financial tools, including VC, can promote China's financial system. The third is that in China the role of law in the financial sector is beginning to be understood in recent years. Chinese, especially Chinese governments, recognize that "law, legal institutions, and regulation systems are fundamental to financial sector development, which, in turn, are essential to economic growth and development." [24]

This dissertation sets out on the basis of these three premises. One task of China is to establish a proper VC legal framework to improve its VC industry. Though many scholars concern themselves with China's VC industry, few of them focus on the Chinese VC legal framework.[25] The purpose of this dissertation is to explore how to establish a proper VC legal framework in China. In pursuit of this aim, this study

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22 Ibid.

23 Fu (2001: 514).

24 Arner (2007: 13).

25 For example, Fu suggests how to develop VC laws in China based on lessons learned from the U.S., Germany, and Japan in 2001. Vaughn tries to set up a regulatory framework for China's VC in 2002. The most recent research is conducted by Lu, Tan, and Chen in 2007. They all give suggestions on the VC laws in China.

examines some key factors that influence the nature and performance of a proper VC legal system. These factors include the form of VC firms, the usual life cycle of VC investments, the economic and political impact on VC development, the governance of VC investment, the financial market infrastructure, and governmental VC stimulus.

### 1.1.2 Problems of the Current Chinese VC Legal Framework

Only a few scholars have examined the elements of the Chinese legal system that support VC activity. For example, Fu criticized that there were many barriers to developing a mature VC industry in China. The Chinese government has created a less than favorable VC investing climate by limiting foreign VC investment in some economic areas in China.[26] The development of securities regulation in China has tended to protect primarily state interests rather than shareholder interests.[27] The current share trading structure, in which shares are divided into A and B classes, and traded separately, limits VC investment.[28] The differences between the VC industry in China and in the West are also explored in some research. The results of this research show that China's socialist tradition limits VC-backed companies ("Ventures") to acquire and allocate resources and conduct operations, and China's regulations are largely issued and interpreted by local government and not the central government.[29] VC investors, especially foreign VC investors, have to expend more resources to seek to build relationships with local governments in order to understand applicable local rules.[30] In practice, VC investors often complain that some Chinese regulations provide unclear guidance, and are not widely and evenly enforced, and that shareholder rights for foreign VC investment in China are limited in scope because the regulations in China do not require the same level of protection of shareholder rights as occurs in the

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26 Fu (2001: 514).

27 Fu (2001: 515).

28 Fu (2001: 515-524). China has stipulated regulations about limited partnership and foreign-invested limited partnership respectively in 2007 and 2009. But it is still not clear how to set up foreign-invested VC limited partnership under current laws. The details of the issues are discussed in Chapter III.

29 Bruton & Ahlstrom (2003: 234, 241-244).

30 Ibid.

U.S.[31] Further, two main problems were found in the Chinese VC industry: a problem of entry and a problem of exit.[32] There are some restrictions on foreign VC investment entering into some sensitive areas like aviation, telecommunications, or insurance. The procedural requirements to structure a foreign-invested venture are also very complex. Strict listing requirements make it impossible for not-yet-profitable ventures to issue shares on the domestic markets of Shanghai or Shenzhen. On the other hand, China's mergers and acquisitions market is underdeveloped, decreasing the chances of finding a buyer for the venture. That means it is hard for VC investors to exit their ventures efficiently.[33]

Therefore, China still lacks a successful VC environment, including large capital, liquidity, incentives, labor, and risk tolerance.[34] The problems of China's VC legal system can be listed as: firstly, the current Chinese business organization laws, including PRC Company Law and PRC Partnership Enterprise Law, are inadequate to the full development of domestic and foreign VC firms; secondly, the strict policies limiting foreign investment impede international VC investors from operating VC investments in China; thirdly, China lacks a mature exit market for VC investment, including stock markets and M&A markets; fourthly, China does not have a national VC law or related regulation to govern the activities of VC investors, central and local

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[31] Ibid.

[32] Firstly, "before the promulgation of the new PRC Partnership Law in 2007, China did not have the legal form for limited partnership which is a mainstream legal form for VC firms in the U.S. VC industry. That meant VCs could not raise money from other investors via LP form. The VC industry could not develop well if the VC firms should only be organized as corporations." (See Vaughn (2002: 241-244)). Though the new PRC Partnership Law created the legal form of LP and there is no any laws prohibit a VC firms with limited partnership form to be the shareholder of a company limited by shares, this type of VC firms are not allowed to be the shareholder of a listed company by the CSRC by 2009. Before 2009, the direct result of such decision of CSRC is the limited partnership VC firms have to transfer their shares to their affiliates which are limited liability companies before these companies limited by shares could go to IPOs. In 2009, the government allows limited partnership VC firm to open account in securities companies. The allowance shows that the limited partnership VC firm could be the shareholder of a listed company in China.

[33] Vaughn (2002: 241-244).

[34] Lu, Tan, and Chen (2007: 244-271).

governments, and other business firms; and finally a mature governmental VC stimulus mechanism has not been set up as it has in other developed counties.[35]

### 1.1.3 The Venture Capital Legal Framework of the U.S.

The problems listed above can be solved only by setting up a proper VC legal framework in China. In designing such framework, Chinese legal scholars and legislators can look both at their own efforts and those of other countries, such as the U.S. Because the U.S. comprises about half of the VC activity in the world, most scholars research much more about the U.S. VC industry than that of any other country.[36] For that reason, this study will first focus on the history of and data on the U.S. VC industry, refer to the U.S. VC theories and experience, and discuss the U.S. legal structures of the VC industry as possible tools that China may borrow. This U.S. focus does not limit the applicability of the research, because most VC scholars and professionals consider U.S. VC practices to be best practices. Furthermore, the general financial and legal concepts of VC investing are universal.[37] All these factors make it possible to explore possible improvements to China's VC legal framework based on the experiences of the U.S.

VC activity has played a considerable role in the growth of the U.S. economy:[38]

> Over the three decades from 1970 through 2000, American venture capitalists invested $273.3 billion into 16,278 companies in all 50 states, with no less than $192 billion of that investment coming during the six-year period 1995-2000. Venture capital-backed firms employed 12.5 million people and contributed nearly $1.1 trillion to national GDP during 2000, representing about one-ninth of the respective U.S. national totals. If supporting businesses are included, the total employment impact increases

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[35] Ibid.

[36] Metrick (2007: 11).

[37] Ibid.

[38] Milhaupt (1997: 866).

by a factor of 2.2, to 27 million people--or almost one-quarter of the non-farm U.S. work force.[39]

Furthermore, ventures had "around twice the sales, paid nearly three times the federal taxes, created nearly twice the exports, and invested nearly three times as much in R&D per $1,000 in assets as did the average non-VC-backed companies."[40] According to the report of the National Venture Capital Association (NVCA), ventures in the U.S. create more than 12 million jobs (see Chart 1.1) or 11% of total private sector employment (see Chart 1.2).[41] Specifically, in recent decades, VC has also been the engine that pushed the amazing rise of the Internet and the high-tech industry in the U.S.[42] On Aug. 5, 1995, Silicon Valley, Netscape Communications Corporation received a great success from its IPO.[43] In 1999, VC investment in the U.S. reached $54,052.77 million, up 150% from 1998.[44] In 2009, the amount of total VC investment decreased to $17,680.25 million, only due to the financial crises.[45] However, the data for the fourth quarter of 2009 did show "increases in the number of first-time and Early stage deals completed, potentially marking the beginning of an uptick in investment levels for 2010."[46]

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39 Megginson (2004: 90).

40 Taylor, Brooks, and Hodge (2002).

41 NVCA & IHS Global Insight (2009: 7-8).

42 Milhaupt (1997: 870).

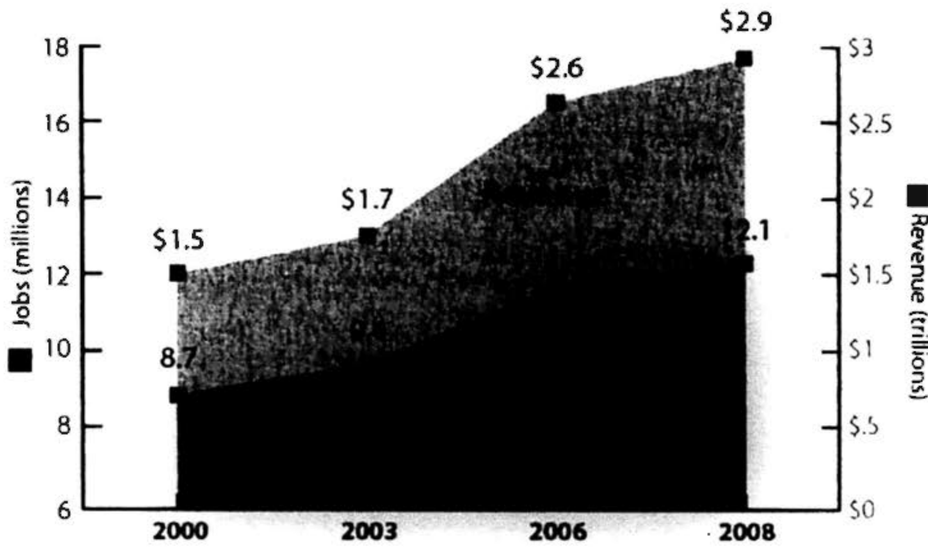
43 Fu (2001: 487). The scholar says in her article: "on that day, Netscape's underwriters initially priced the 3.5 million shares to be offered at US$ 12 dollars to US$ 14 dollars per share. As the IPO date approached, however, demand for the stock was so high that the offering was expanded to five million shares, and the price was increased to US$ 28 dollars per share. Nevertheless, even doubling the price of the offering, a virtually unprecedented occurrence in an IPO, the underwriters still did not aim high enough. At the opening bell on the NASDAQ the stock went out at US$ 71 dollars per share and rose as high as US$ 75 dollars in the same day before settling down around the US$ 50 dollars, making venture capitalist Jim Clark the first "Internet billionaire," and netting Netscape's co-founder, 24-year-ord Marc Andreessen, a fortune close to US$ 100 million." (see Fu (2001: 487))

44 Venture Capital Basics (2000).

45 NVCA (2010).

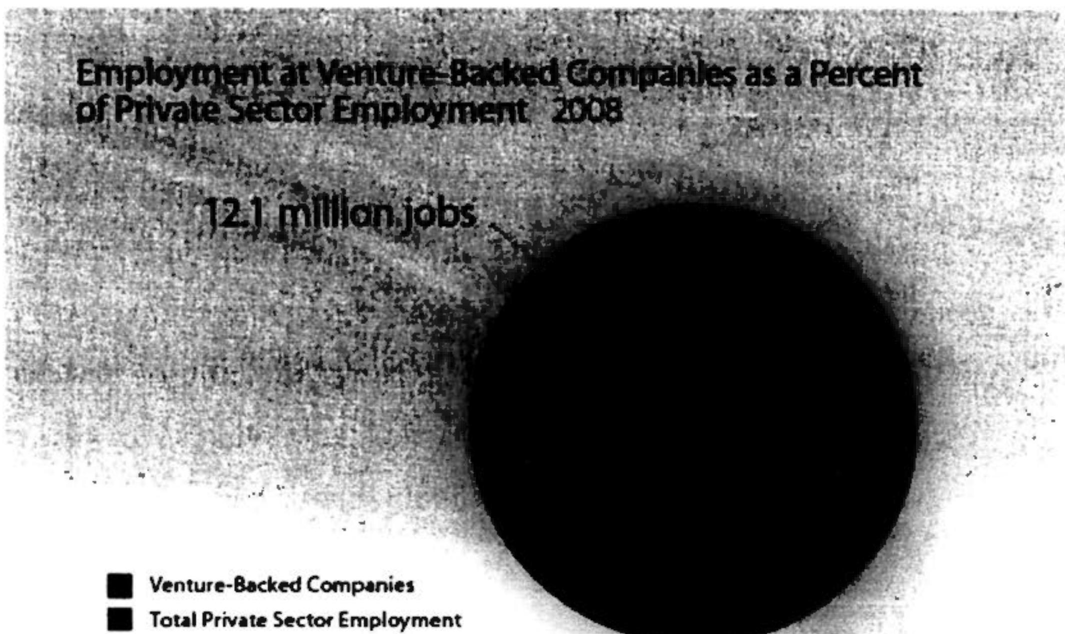
46 NVCA (2010: 1).

**Chart 1.1 Economic Benefit of U.S. Ventures 2000-2008**




Source: NVCA & IHS Global Insight (2009: 7)

**Chart 1.2 Employment at Ventures as a Percent of Private Sector Employment 2008**




Source: NVCA & IHS Global Insight (2009: 8)

Several milestones of VC development in the U.S. should be remembered and studied in any review of its VC history. These milestones prove that a proper legal framework, including legislation and government stimulus programs, which are the cornerstones of the U.S. VC industry, are very important to the development of the VC market. The first milestone is that the world's first formal institutional VC firm was set up in 1946 in the U.S., namely the American Research and Development Corporation (ARD).[47] Before the ARD, it was very hard for start-ups to raise money from traditional investment firms. The institutional VC firm thus serves a serious financial need of start-ups. But there is no doubt that a single private VC firm cannot solve all the problems of an industry. For this reason the U.S. government began its original VC efforts in 1958. The 1958 Small Business Investment Companies Act (SBIA) was promulgated to encourage private investors to help start-ups by long-term loans through the Small Business Investment Company (SBIC) program. In the late 1970s, the Labor Department interpreted the "prudent man" provision of the 1974 Employee Retirement Income Security Act (ERISA) to permit pension funds to invest in the VC industry if such investments meet the standard under which a fiduciary must act. According to the interpretation, the fiduciary is required to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[48] After this reinterpretation, pension funds began to invest money into the VC industry. The interpretation is viewed as one of the most important reasons why the U.S. VC industry is so successful. In 1822, New York State passed the first Limited Partnership Act in the U.S. In 2001, a new limited partnership act, the 2001 ULPA, was drafted and proposed by the NCCUSL. Now, the limited partnership form is a mainstream VC form in the U.S. given its advantages, including pass-through taxation, simple structure, and limited liability of limited partners. In 2001, the U.S. government created the New Markets Venture Capital (NMVC). The program encourages VC investment in low-income communities of the U.S. in order to create jobs and start-ups in these places. The details of these milestones are explained in Chapter III.

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[47] Gupat (2000: 6).

[48] Sec. 2550.404a-1(a), 29 C.F.R.

Besides these milestones, China can learn more from the experiences of the U.S. VC industry. Some scholars have explored key elements of the VC legal framework for setting up a successful VC project based on the U.S. VC experience. For example, the success of the U.S. VC industry is attributable to the existence of VC laws, including limited partnership laws, securities laws, investing laws, corporation laws, and tax laws.[49] The legal elements of the U.S. VC projects include the VC legal form, VC funding, laws of VC investment, and laws of VC exit, including laws regulating IPOs, and laws governing mergers and acquisitions.[50]A number of legal factors will affect VC strategy,[51] and these elements can be considered a part of the legal elements of VC projects. These factors include VC fund's formation, tax factors, securities law requirements for a VC's IPO plans, liquidity of the ventures, and underwriter support for IPOs of ventures.[52]

Some factors related to the legal elements of VC are also examined. The findings are that active involvement of the VC firms in company management through board control, use of shares that are redeemable at the option of the VC investors, recourse to the limited partnership form as the best vehicle to protect the interests of VC investors, and creation of a viable exit mechanism, including the possibility of an IPO, are extremely important to the development of VC projects.[53] Moreover, a good financial reporting system will let VC investors spend less time gathering information to monitor their investment and reduce their risks.[54] Seeking co-investors from among the active pension funds also provides advantages for the other VC investors.[55]

Some scholars list three "pillars" of the VC legal structure. The central pillar focuses on company laws, which regulate the registration and formation of limited companies, their

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49 Fu (2001: 492).

50 Fu (2001: 492-501).

51 Cumming & Macintosh (2002: 80).

52 Ibid.

53 Jeng & Wells (2000: 241-245).

54 Ibid.

55 Ibid.

organization and operation, the distribution of powers and decision-making procedures, issuance of convertible preferred stock, avenues of exit and dissolution, requirements for disclosing information and the fiduciary duties applicable to the boards of the VC ventures.[56] The second pillar is composed of contractual mechanisms which could protect the interests of VC investors in the ventures, including contractual rights in the articles of association provided in company law, investor rights agreements, and shareholder agreements.[57] The final pillar is the best-practice principles to help VC investors organize and manage their investment in the most effective manner.[58]

For the purposes of this study, the key elements of the U.S. VC legal framework are addressed with the following dichotomy:

The first element is the formation of the VC firm and VC funding recourses. Most VC firms in the U.S. are organized as limited partnerships,[59] whose advantages are discussed in Chapter III. The U.S. laws also give some exemptions for VC firms from complex registration requirements. These flexible policies encourage the development of the VC industry in the U.S.

The second element is composed of the theories and practical measures of VC investment and governance. During VC investments, one goal is very important for VC investors, to reduce agency risks in VC investments. In practice, U.S. VC investors use a series of measures to promote quality management and to reduce agency risks during the investment, including control rights, management rights, appointment rights, and information rights, staging the investments, syndication, and exits. VC investors monitor the venture's management and reduce investment risks by using these measures.

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56 McCahery & Vermeulen (2006: 24).

57 Ibid.

58 Ibid.

59 Gilson (2003: 1070).

The last element is governmental stimulus. The U.S. VC industry could not have been so successful without the support of the government, which provided stimulus programs in the form of equity stimulus, investment regulations, and tax incentives.

The SBIC program, created in 1958, was the first direct initiative of the U.S. federal government to encourage the development of the VC industry. In 1992, the Small Business Equity Enhancement Act promoted the program by removing the tax liability for exempt VC investors and allowing the SBA to participate in the program's risks and benefits.[60] Another program is the Small Business Innovation Research (SBIR) program. This program was established under the Small Business Innovation Development Act of 1982 to support start-ups' R&D. The U.S. government created the NMVC program in 2001 to encourage VC investment in low-income communities, so as to promote start-ups in those areas and thus create local jobs.[61] The goal of the NMVC program is to create a source of VC for high-growth businesses in low-income urban and rural areas, and to tie access to this program to the creation of local jobs with livable wages and benefits for low-income individuals.[62]

Other legislation and policies of the U.S. government also play a key role in supporting VC investment and promoting VC projects. One key investment regulation stimulus was the clarification of the 1974 ERISA "prudent man" rule in 1978, which allowed pension funds to invest part of their money into the VC industry, giving appropriate consideration to all relevant facts in making VC investment choices.[63] As mentioned, after the reinterpretation, U.S. pension funds and insurance funds began to invest in public and private VC funds. In 1999, the Financial Modernization Act (also known as the Gramm-Leach-Bliley Act) attempted to give more "freedom" to the financial

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60 The SBA is the "U.S. Small Business Administration, which was created in 1953 as an independent agency of the federal government to aid, counsel, assist and protect the interests of small business concerns, to preserve free competitive enterprise and to maintain and strengthen the overall economy of the U.S." See the website of the SBA at http://www.sba.gov/aboutsba/index.html.

61 Sec. 108.10, NMVC program.

62 Sec. 108.10, and § 108.130, Ibid.

63 Art. 404a-1(a), Sec. 2550, 29 C.F.R.

services industry. The Act allowed banks, insurance companies and securities firms in the U.S. to affiliate and sell each other's investment products.[64] That meant more capital could be collected from the public and then invested in VC funds through these financial institutions.

U.S. VC investment has been stimulated by both low capital gains tax rates and targeted tax incentives. The reduction in the capital gains tax rate encouraged the development of the U.S. VC industry. In 2000, the federal government launched the NMTC, which permits taxpayers to receive a credit against their federal income taxes for making qualified direct investments, including VC investments, in low-income communities.

### 1.1.4 Improving the Venture Capital Legal Framework of China

Based on a comparison with the U.S. VC legal framework, China may promote the following aspects to improve its legal framework for VC projects.

Firstly, China should complete its financial liberalization and rethink the role of foreign VC investments. Foreign VC investors would bring many international standards and advanced rules of VC governance into ventures, thereby advancing the level of Chinese VC development.[65] An absolute financial liberalization might be dangerous to both the Chinese and world economy. But it does not mean China could dismiss its problems between liberalization and restrictive laws. China could loosen its current foreign exchange control policies, especially the control over capital inflow and outflow of foreign VC investors.[66] In the VC industry, a transparent and flexible legal framework for Chinese VC funding should also be established. The legislation should widen VC investment sources and expand the investment areas of both Chinese and foreign investors. China should continue to encourage foreign VC investors with reforming the current legal system. Foreign VC firms could be given more freedom to enter China's VC industry.

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64 Ibid.

65 CVCA (2009: 24).

66 Ibid.

Secondly, China should create new legal techniques for VC governance. For instance, China should protect VC investors against the failure of investments and potential damage from managers by establishing a good VC governance system.[67] Protecting investors' interests is the chief task of the legal framework. Therefore, China should create the legal techniques relevant to governance rights, including the rights of liquidation and dividend preferences, conversion rights, anti-dilution adjustment rights, and share transfer restriction rights.[68] In China, these techniques should be adopted in the company laws. China could also legally create convertible preferred stock, liquation rights, and dividend rights.

Thirdly, China should promote its exit channels for VC investments. Currently, the exit channels for the VC funds are still narrow and restricted by many rules and policies. China should promote its stock markets to support VC exit. China should protect the safe operation of capital markets and VC exit channels, including promoting the stock markets, preventing insider dealing, and stabilizing ventures' share prices. With the 2009 launch of the Growth Enterprise Market of China (GEM) in the southern city of Shenzhen, this situation has been improved. But, the GEM needs to be promoted from time to time, including verifying the monitor mechanisms and risk control systems, and considering to allow international companies to list on the GEM board. Further, the distinction between A and B shares, discussed in Chapter II, should be discarded for VC exit purpose. China could also renew its foreign investment and currency exchange policies and then promote the GEM as an international exchange.

Finally, Chinese governments could accommodate a mature stimulus policy to VC investors and entrepreneurs. In VC industry, the Chinese government's first mission is to accommodate stimulus supporting the industry with legal framework establishment and governmental guidance under a proper legal system.[69] China's government should

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[67] Ibid.

[68] Bagley & Dauchy (2003: 446-449).

[69] OECD (2003: 368).

strengthen the guiding functions of the governmental VC guiding funds and programs. China's government could set up governmental VC guiding funds at various levels.

## 1.2 Goal of the Dissertation

Venture Capital, an attractive financing instrument widely used in the U.S., has played a significant role in the growth of the American economy. Europeans also strongly believe that the VC industry can accommodate capital and business techniques to promote innovation, entrepreneurship, and the economy of a country.[70] The European Commission claims in 2010 that a prosperous European VC industry "is vital to Europe's economic recovery and competitiveness."[71] Likewise, China needs to supplement its traditional industries with high technology developed through VC, just as the U.S. and Europe do. But China lacks a mature and fully effective VC legal framework. This study examines the U.S. VC legal framework which governs all aspects of the VC investment process from formation, to entry, to governance, and to exit, including governmental stimulus.[72] The results of this examination will then be applied to a comparative policy analysis designed to reveal the changes that must be made in China to improve the effectiveness of its VC legal framework.

## 1.3 Methodology

### 1.3.1 Statute Review

In this dissertation, a major aim of the statutory review is to analyses statutes, regulations, and other legal documents of VC projects in China and the U.S. It includes Chinese domestic and foreign VC enterprise regulations, PRC and U.S. state Company Laws, U.S. and Chinese tax laws, the regulations of governmental VC guiding funds, applicable sections of U.S. and Chinese securities laws, U.S. and Chinese laws on investment funds, U.S. and Chinese partnership laws, and governmental stimulus regulations. This study discusses the sources of laws of China and the U.S. in relation to

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70 EVCA (2010: 1).

71 Ibid.

72 See Chapter III.

VC. These regulations contain important information about VC disputes and industry development. They also provide precious first-hand knowledge of how regulators rule their VC projects.

### 1.3.2 Available Data Review

Some observations, discussions, and comments in the study have drawn upon available data review. This study uses data of VC projects in China and the U.S. that were produced by other investigators for a similar research purpose. These data come from four broad categories, including public documents and official records, private documents, the mass media, and other social science data archives. There are several advantages as well as some limitations to research using available data. Available data provide the research with the best and often the only opportunity to study the past. For instance, to study some aspect of the U.S. VC projects fifty or more years ago, it might be almost impossible to conduct a survey of people who were involved in the business at that time. But, available data will offer useful information about past U.S. VC projects. Moreover, because the costs would have been prohibitive, field research was not conducted. The review of available data, however, is well suited to studies of VC development of each regime.

### 1.3.3 Literature Review

Literature about how VC regulations are actually enforced, how VC projects work, and how VC has evolved in Chinese and American social, ideological, and political contexts helps the research to develop a deeper understanding of the two regimes and their VC projects. The literature used was obtained from textbooks, working papers, and law or economic journals, as well as reports and commentaries in leading newspapers and magazines. These sources provide background materials on the factors that have driven the development of VC regulations. For example, many scholarly articles contain insightful debates on the VC legal framework and process. Legislators and regulators sometimes explain, in leading journals and newspapers, the concerns and intentions they have when formulating new VC regulations. Secondly, many news reports disclose valuable information about, for example, the behavior-guiding incentives of the key

players in VC, and the reasons why many VC firms have or have not invested in a specific area.

### 1.3.4 Comparative Method

The comparative method is used in this study mainly to put the state of Chinese VC in perspective and to draw models and options that could potentially be employed as "off-the-shelf solutions" to current problems. Attempts to improve China's VC legal framework are well served by a comparative study of the U.S. system. The comparative study contained in this dissertation will also contribute to the project of discovering the common rules for the operation of VC, as well as knowledge about VC that goes to its essential nature, regardless of the country where it occurs.

## 1.4 Legal Definitions of Venture Capital Projects

### 1.4.1 Venture Capital

The Oxford English Dictionary defines VC as a "risky undertaking."[73] Black's Law Dictionary gives more detail. It explains that VC is "funding for new companies or others embarking on new or turnaround ventures that entails some investment risk but offers the potential for above average future profits. Venture Capital is often provided by firms that specialize in financing new ventures with capital supplied by investors interested in speculative or high risk investments."[74]

The NVCA explains that VC means the money offered by some professionals who invest in "young, rapidly growing companies that have the potential to develop into significant economic contributors."[75] The Hong Kong Venture Capital and Private Equity Association's definition is:

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73 Thompson (2008: 12).

74 See Black's Law Dictionary, at "Venture Capital".

75 See the website of NVCA at http://www.nvca.org/def.html.

> VC is a means of providing long-term equity funding to young fast growing companies. It is often called 'direct investment' or 'private equity investment.' VC is prepared to assume considerably higher risk by investing at the early stages of a company's development in the hope that they can reap higher returns if the company meets or exceeds its projections. VC firms will realize their returns when an investee company has built a successful track record to qualify for listing on the stock exchange. Other means of exiting from investments are management buy-backs through put options based on a pre-determined formula, private placements to interested third parties or an outright or partial trade sale.[76]

The European Venture Capital Association (EVCA) gives a broader definition of VC. Here, VC is viewed as "a professional equity co-invested with the entrepreneur to fund an early-stage or expansion enterprise. Offsetting the high risk the investor takes is the expectation of higher than average return on the investment."[77]

Since there is no standard definition of "Venture Capital,"[78] VC is defined by some scholars as the "investment by specialized venture capital organizations in high-growth, high-risk, often high-technology firms that need capital to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt."[79] VC is also classified as a kind of private equity which usually goes to start-up companies and other early stage investment.[80] Sometimes however, VC invests in some large companies to support a management buyout or buy-in.[81] VC investors could get very high returns from later-stage investments, since a well-developed company might need VC in order to finance its

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[76] See the website of the Hong Kong Venture Capital and Private Equity Association at http://www.hkvca.com.hk/hkvcpea/whatis.html.

[77] See the website of the EVCA at http://www.evca.eu.

[78] Bartlett (1999: 3).

[79] Black & Gilson (1998: 245).

[80] Gladstone & Gladstone (2002: 5-7).

[81] Coyle (2000: 2).

move from a domestic to an international market.[82] Further, the reasons "why VC is 'high risk'" are that the rate of start-up investing failure is high, and even if the business of the start-up is successful, the investment is still illiquid. A private company's shares cannot easily be resold, and their value accordingly will be less than the market price of shares in a listed company.[83] Therefore, VC investment can be categorized into four stages having different risk and reward profiles: (i) the early-stage, accompanied by high reward and high risk, (ii) the second-stage, accompanied by high reward and medium risk, (iii) the third-stage, accompanied by high reward and low risk, and (iv) the later-stage accompanied by low to medium reward and low risk.[84] The risk and reward profiles of VC in each stage will be discussed in the following sections.

Although someone has suggested that the earliest VC appeared in the Song Dynasty of China one thousand years ago,[85] it is generally agreed that the modern VC projects began in earnest in 1946, when General Georges Doriot, Ralph Flanders, Karl Compton, Merrill Griswold, and others organized the ARD, the first public corporation specializing in investing in illiquid securities of early stage issuers.[86] The details of the company are introduced in Chapter III. Some definitions of VC merely repeat ARD's rules of investing.[87] But, 64 years after the establishment of the ARD, the definition of VC should be broader. In sum, the term VC can be applied in a number of ways: to investments, people, or activities.[88] Thus, the characteristics of VC could be summed up as VC is "patient and brave" money that seeks young and growing companies and

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82 Thompson (2008: 12).

83 Coyle (2000: 2).

84 Thompson (2008: 13).

85 Thompson (2008: 5).

86 Bartlett (1999: 3). "In 1957, ARD invested $70,000 for 77% of the common stock of a new company created by four MIT graduate students. By 1971, that investment had grown to comprise $355 million in common stock in Digital Equipment Corporation, which today is a world leader in the computer industry." (See Bygrave & Timmons (1999: 1-2))

87 Bartlett (1999: 3).

88 Bartlett (1999: 5).

invests for the long term, often seven to ten years, for high returns in the end.[89] The VC investing process is highly organized and refined.[90]

Based on the above discussions and the purpose of this study, "venture capital" in this study is defined as the investment by financial firms in high-growth, high-risk private start-ups for high return in the future.[91] These start-ups may have high technology, know now, or new business models. VC can be described as a type of PE.[92] It is an investment in early stage, mid-stage, and late-stage enterprises based on different business purposes. It is a business form that always purchases preferred shares and assists in the development of the ventures. VC can also be treated as a financial vehicle which has higher risk than other investing vehicles. The professionals, namely VCs, are the managers who govern the VC investment. These VCs would raise money from other wealthy people or funds[93] and organize the VC firm as a limited partnership or other enterprise.[94] VC is also an investment for a period of seven years to ten years and an investment that expects to exit the ventures for higher returns via IPOs or mergers and acquisitions.

There has been a misunderstanding as to how the Chinese define and understand "venture capital." The point should be clarified before any further discussion about Chinese VC projects. As discussed above, in English, the word "venture" is defined as taking risk in a commercial context in order to create a new business.[95] In Chinese, however, the term "venture capital" is often understood as simply "risk capital," which

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89 Bygrave & Timmons (1999: 1).

90 Ibid.

91 Black & Gilson (1998: 245).

92 The differences of VC and other investment vehicles, such as angel investment, will be discussed in the following sections.

93 These people and funds could be private or public pension funds, corporations, wealthy individuals, foreign investors, and the VCs.

94 The structure of VC firms will be discussed in the following sections.

95 See Oxford Advanced Learner's Dictionary of Current English with Chinese Translation (New Edition), the item of "Venture", p. 1301

could include any equity investment or unsecured debt in a more established business.[96] Consequently, the more precise meaning of "venture" – taking risk to create a new business – is often lost in the translation. Given the contentious translation of "venture capital" it is generally wiser to accept that the Chinese definition of VC in Mainland China is "risk capital" in the western sense. Some Chinese VCs prefer to call China's VC industry "Enterprise Capital" in Chinese. Since the meanings of "venture capital" and "enterprise capital" are the same, this study uses "venture capital" to describe Chinese VC projects.

Another difference between the Western and the Chinese VC industries is that although the Chinese government has made considerable efforts to promote high-tech industry, up to now China has been more known for its low-cost manufacturing than its prowess in innovation and design.[97] This means that in comparison to more developed countries, there are not as many technologically innovative start-ups suitable for VC investment in China.[98] Consequently, in China VC firms tend to consider deals they would not otherwise do in the U.S. or Europe. That also means Chinese VC firms often invest in traditional industries, such as super market chains, energy, or agriculture, areas which would not be the focus of an American or European VC firm.[99] Furthermore, many Chinese companies, whether newly formed or well established, small-scale or national in size, when viewed in the context of China's rapidly growing and modernizing economy, can be seen as early or middle stage enterprises.[100] Therefore, VC investments in China are often made to companies which are already existing and enjoying high returns.

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96 Hu (2006: 1).

97 Kan & Chen (2002: 64).

98 Cheng (2007: 28).

99 Cheng (2007: 35).

100 Hu (2006: 165).

### 1.4.2 Venture Capitalist

The venture capitalists, or VCs, play one of the most important roles in VC projects. In the projects, they are individuals managing VC investing activities in the VC firms.[101] The NVCA defines VCs as wealthy financiers who want to fund start-up companies.[102] These financiers invest money in high risk start-ups, in return for securities, with the aim of generating substantial capital gains by selling these securities to other investors or the public.[103] The EVCA describes the VCs as the managers of PE a firm who manage the investment of the firm in a venture.[104] Therefore, the clearest role of VCs is to finance start-ups by bridging institutional funds and some young companies which might find it difficult to raise money from public or other investors.[105] During the investments, VCs will employ some financial or legal professionals to manage the investment with the management team or entrepreneurs of the ventures.[106] VCs may also be required to have educational backgrounds appropriate to understand the industries in which they invest, such as a doctorate in biochemistry or a master's degree in electrical engineering.[107] Thus, VCs bring in not only money, but also professional knowledge, financial tools, legal protection, and strategic advice.[108]

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101 Some authors give more interesting descriptions on "what VCs look like." They say that in the U.S. "VCs look like everybody else. They are part of the great American middle class. Most VCs act and dress like investment bankers on Wall Street. Some of them dress and act like bankers in any major metropolitan bank. In some of the smaller VC firms in small towns, they act and dress much as you would expect any small town banker to act and dress." (See Gladstone & Gladstone (2002: 142-143)).

102 See the website of NVCA at http://www.nvca.org/def.html (visited on Oct. 27 2008)

103 Pearce & Barnes (2006: 6).

104 See the website of EPEVCA at http://www.evca.eu/toolbox/glossary.aspx?id=982 (visited on Oct. 27 2008)

105 Klausner & Litvak (2001: 1).

106 Pearce & Barnes (2006: 6).

107 Gompers & Lerner (2004: 299).

108 See the website of EPEVCA at http://www.evca.eu/toolbox/glossary.aspx?id=982 (visited on Oct. 27 2008)

### 1.4.3 Venture Capital Firm or Venture Capital Fund

#### 1.4.3.1 Definition

The VCs may be employed by a VC organization to provide investment to target companies. For the purpose of the study, such VC organization is called a "VC firm." In the early days of U.S. VC investment, in the 1950s and 1960s, the VCs were the only "classical" VC investors.[109] The modern VC firm has replaced these individual VC investors as the dominant VC investment vehicles, although the latter have not totally disappeared today.[110] Today, a VC firm often works with other VC firms in putting together a total funding package for an investment.[111] As VC investment is a long-term investment, not just of money, but of time and effort, the VC firms' aim is to enable ventures to be the top enterprises in their industries and receive high returns from future business success.[112] The history of U.S. VC firms will be discussed briefly in Chapter III.

Some scholars replace the term "VC firm" with "VC fund" when examining VC projects.[113] For the purpose of this study, the concept "VC firm" and "VC fund" are defined differently. Metrick says that a VC firm is an "independent legal entity that serves as the general partner in a VC fund," and the VC fund is "a financial pool used for VC investment by a VC firm and other non-VC investors."[114] In VC projects, "VC firm" could mean a VC corporation which is organized by VCs and other non-VC shareholders, or a VC limited partnership which is organized by VCs – GPs, and other non-VC investors – limited partners (LPs), or a management or consultant VC company established by VCs. The meaning of "VC fund" is restricted to the latter instance.

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109 See the website of NVCA at http://www.nvca.org/def.html.

110 Ibid

111 Coyle (2000: 2).

112 Coyle (2000: 2-3).

113 Black & Gilson (1998: 245).

114 Metrick (2004: 540-541).

For example, Shenzhen GPVC is a Chinese VC corporation established by Mr. Luo Fei and Mr. Li Wei in 2007.[115] In 2008, the company established a limited partnership "VC fund" called Shenzhen GPG.[116] Before an amendment of the 2006 PEL, Chinese VC investors could not set up limited partnership VC funds in China due to the absence of such form in the Chinese legal system. After the modification, Mr. Luo and Mr. Li could enjoy pass-through tax treatment (which will be discussed in Chapter II) by operating their VC business through a limited partnership vehicle. In GPG, GPVC is general partner and the other 22 non-VC investors are limited partners. In this business, the shareholders, Mr. Luo and Mr. Li are called VCs. GPVC is a VC firm, but it is not a VC fund. GPG can be referred to either as a VC fund or VC firm. Another example regards VC corporations. Shenzhen Capital Group Co., Ltd. (SZCG) is one of the best VC corporations in China.[117] Its legal structure is not a limited partnership but a Chinese corporation.[118] Its shareholders include some big state-owned companies whose major businesses are not in the VC industry.[119] Under this structure, VCs are individuals and employees of the company. SZCG will not pool a new VC fund with other non-VC investors as GPVC does. It invests in target companies by itself directly. Thus, SZCG can be called a "VC firm" as well as a "VC fund."

In conclusion, the scope of "VC firm" is boarder than "VC fund." The study, hence, uses the term "VC firm" when discussing the legal structure of each VC entity and uses the term "VC fund" when researching the stage and capital-raising of VC investment.

### 1.4.3.2 Main Legal Form of Venture Capital Firm

Though a VC firm may take many forms in the industry,[120] in the U.S., Europe, and China, most mainstream VC firms are organized as limited partnerships in which the

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[115] See the website of GPVC at www.pinevc.com.cn.

[116] Ibid

[117] See the website of SZCG at http://www.szvc.com.cn/en/eng_coporate.asp.

[118] See the registered information of the company from the website of Shenzhen Administration of Industry and Commerce at http://app.szaic.gov.cn/aiceqmis.webui/generalsearch.aspx.

[119] See http://www.szvc.com.cn/en/eng_coporate.asp

[120] They are limited partnership, corporations, and limited liability companies in the U.S. (LLCs).

VCs serve as the GPs and other investors are LPs.[121] The LPs invest their money in the VC funds during the first two or three years, and the funds will then put this money into start-ups gradually in the following four to seven years. That means the VC fund will be liquidated in seven to ten years by GPs and LPs based on their prior agreement.[122] The details of the process can be found in Section 1.6.1. The capital provided by the LPs is called committed capital.[123] Once the LPs enter into the limited partnership, they transfer all operating power over its operations to the GPs. Under the previous U.S. limited partnership laws and Chinese partnership law, the nature of the limited partnership structure prohibits the LPs from participating in the management of their investments.[124] In the funds, the GPs run the day-to-day management and operate the investments.[125] Thus the LPs are passive investors with little or no control over where the VC funds are invested.[126] Once the GPs get the full amount of committed capital, the fund will invest in start-up companies and draw down capital over several years.[127] Some scholars say the reason why the limited partnership form has become so popular in the VC industry is because of the form's advantageous flexibility and transparency.[128] The details will be discussed in Chapters II and III.

## 1.5 Differences between Venture Capital Projects and Angel Capital Investments

### 1.5.1 Angel Investor

VC projects and angel capital investments are often mentioned together. But they are actually quite different financial projects. Angel investors are individuals with large wealth who invest in start-ups in return for equity.[129] These individuals who conduct

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121 See the website of NVCA at www.nvca.org/def.html.

122 Gladstone & Gladstone (2002: 9).

123 Typically, GPs will provide 1% of the committed capital in the U.S.

124 Sec. 302, 2001ULPA. Art. 68, 2006 PEL.

125 Gladstone & Gladstone (2002: 9).

126 Ibid..

127 Gompers & Lerner (2004: 65).

128 Perace & Barnes (2006: 15).

129 Horvath (2001: 3). "Angel investors are wealthy individuals who invest their personal funds in

angel capital investments are called angel investors. The capital provided by angel investors is an important financial source for start-ups.[130] These investors are important not only for the quantity of funds they provide to start-ups, but for the time it is provided—at a critical stage in the start-up's growth that allows the entrepreneurs to build the financial bridge between family funding and VC.[131] Angel investors also invest in the high-risk, high-growth potential of start-ups, just as VCs do, but only at an earlier stage.[132] There is no technical definition of an angel investor or angel capital investment. Most descriptions of angel investors focus on one characteristic, namely angel investors are wealthy individuals who own a fund and invest their own money in start-ups, as compared to the VCs, who raise capital from others.[133]

There are generally considered to be two types of angel investors. One is called an "unsophisticated investor."[134] These investors purchase common stock, high-yield notes, or other securities of the start-ups and do not impose limitations on the entrepreneurs.[135] Others are "sophisticated angel investors" who view the investment as a business. Under the U.S. securities laws, such investors will also be qualified as "accredited investors," if they have over $1 million in net worth, or income over $200,000 in each of the last two years (or $300,000 with spouse) and reasonably expect to reach the same income level in the current year.[136] The details of these investors are discussed below.

### 1.5.2 Venture Capital Projects vs. Angel Capital Investments

While not as sophisticated as VCs, angel investors regularly conduct serious due diligence investigations of their investments and invest only in businesses they fully

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high-tech start-ups throughout the U.S." (See Ibrahim (2008)).

130 Chemmanur & Chen (2006: 2).

131 Jeng & Wells (2000: 241-245).

132 Ibrahim (2008).

133 Ibid

134 Coyle (2000: 2-3).

135 Perace & Barnes (2006: 15).

136 Art. 501 (a), Sec. 230, 17 C.F.R.

understand.[137] Sophisticated angel investors tend to purchase preferred stock or convertible notes rather than common stock of the start-ups, so they will be senior to the entrepreneurs who hold common stock.[138] Because contributing their own money, sophisticated angel investors are more likely to become involved in the day-to-day management or to participate in the strategic planning of the business, rather than just have a seat on the board of directors as some VCs do.[139] In the U.S., the entrepreneurs have to have strict restrictions in the investing agreements with sophisticated angel investors, who act as professional VCs.[140]

Compared to VC firms taking strong positions in start-ups, either unsophisticated or sophisticated angel investors are individuals. They invest much smaller amounts than do VCs in start-ups.[141] Further, VC firms will tend to focus their investment on a limited number of industries, including IT or high-tech industries, since they tend to develop experiences in these industries which allow them to add value and build up reputations.[142] In contrast, the investments of angel investors would not be limited to only a few industries because they are not as concerned with value addition.[143]

VCs and angel investors invest in start-ups in different stages. Some VCs would like to fund some later stage enterprises, while angel investors only focus on early stage projects.[144] This is the most important difference between VCs and angel investors. Therefore, when obtaining its initial capital during the early stage, the start-up often gets investment from an angel investor rather than from a VC firm. The angel investments may be less than $ 1 million in the U.S., for instance, and if early stage angel investments are successful, the start-up could then ask for more investments from VC

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137 Lu, Tan, and Chen (2007: 231).

138 Ibid.

139 Milhaupt (1997: 866).

140 Bruton & Ahlstrom (2003: 234, 241-244).

141 Wong (2002: 27).

142 Ibid.

143 Chemmanur & Chen (2006: 40).

144 Chemmanur & Chen (2006: 39).

firms before IPOs or mergers and acquisitions.[145] While VCs offer services such as connections to professional managers to start-ups, angel investors provide informal advice and counseling.[146] Many angel investors in the U.S. are ex-entrepreneurs themselves, who will give seasoned advice to promote an early-stage start-up.[147] VCs may well become angel investors if their investment proposals cannot be undertaken through the VC fund in which they work. Mr. Li, a venture capitalist participant in the VC firm, Green Pine, shares his own experience about this issue. Rong Technology Company was an early stage start-up in Shenzhen which produce cell phones. Mr. Li was going to invest in this company based on his prior investigation, but the board of Green Pine vetoed his suggestion since other partners thought the company's business was too risky. In the end, Mr. Li invested in Rong Company by using his own money. In this case, Mr. Li acted as an angel investor more than a venture capitalist.

In conclusion, angel investors are individuals but VCs represent institutional firms. Angel investors use their own money to invest in start-ups, but VCs always use other people's money to conduct investments. The start-ups in which angel investors invest are at the early stage. VCs will not only focus on the early stage, but will also invest at middle and late stages based on the purposes of the investment and the amount of expected returns.[148]

## 1.6 The Life Cycle of VC Projects

Any research on VC projects must clearly understand the "life cycle of VC." Two central characteristics define the life cycle of VC projects: it happens in "reasonably well-defined stages," and recurs once the final stage is finished.[149] VC investments start by raising VC funds from investors, next they select projects and invest in them, during which investment they may manage, advise and guide the relevant entrepreneurs; the

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145 Rotolo & Wainwright (2003: 2).

146 Benjamin & Margulis (2000: 187).

147 Osnabrugge & Robinson (2000: 69).

148 Ibid.

149 Gompers & Lerner (2004: 29).

VC funds will then attempt to exit the venture at an appropriate time to receive high returns for their investors.[150] After all these have been completed, the VCs will set up new VC funds for the next round investment.[151] The life cycle of VC projects consists of two parts, the life cycle of the VC fund and the life cycle of VC investment.

### 1.6.1 The Life Cycle of the VC Fund

As discussed above, VC firms act as intermediaries between investors and entrepreneurs.[152] The investors search for investment opportunities and the entrepreneurs need capital to develop their start-ups.[153] To fulfill the needs of the investors and the entrepreneurs, the VCs will raise money from the investors for setting up several VC funds to invest in selected start-ups with a fixed duration, which is usually about seven to ten years.[154] This is the life cycle of a VC fund. This cycle can be divided into four phases (see Chart 1.3). In the first two phases, the VCs will make the investments, and manage the funds and the ventures.[155] In the last two phases, they will design exit strategies from the investment and start to raise money for establishing new funds for a new investment round.[156] The possibility successfully to raise a new fund depends on reputation, i.e., the outcomes of the earlier VC investments.[157] If returns from earlier VC investments are high, many investors will want to entrust their money to the VCs who operated the earlier VC funds and investments.[158] Therefore, VCs always conduct their current business with an eye on their future ability to raise funds from outside investors. In the U.S., these investors include wealthy individuals, pension funds, investment banks, insurance companies, and university endowment

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150 Gompers & Lerner (2004: 3).

151 Ibid.

152 Berkery (2008: 34).

153 Ibid.

154 See the website of NVCA at http://www.nvca.org/def.html. The funds' duration may also be extended up to an additional four years. See also Fenn (1997).

155 VC investing process includes several stages, such as early stage, middle stage, etc. which will be discussed in Chapter III.

156 Gilson (2003: 1085-1086).

157 Gilson (2003: 1093).

158 Berkery (2008: 117).

funds.[159] The institutional investors will ask for a return of between 25% and 35% per year over the duration of the fund.[160] Typically, the VCs will raise new funds every two to three years in the U.S.[161] Since the mainstream VC business form in the U.S. is a limited partnership, the following explanation focuses on the life cycle of limited partnership VC funds.

At the beginning of the first phase, the VCs will send a series of documents, including a private placement memorandum and a limited partnership agreement, to potential investors.[162] These potential investors will negotiate with the VCs for more detailed information on the partnership and its business plan if they are interested VCs' proposal.[163] The period of such negotiation will take between six to twelve months in the U.S. from the issue of the documents to the establishment of the fund.[164] The VCs would generally have a meeting with the LPs at least once a year.[165] The LPs have rights to review monthly or quarterly reports of the fund and the investments.[166] Further, the LPs have rights to set up an advisory committee to monitor the GPs' activities and management.[167] The details of the legal relationship between VCs/GPs and LPs are discussed in Chapter II and Chapter III.

The second phase is to select investments. After the fund has been created, the VCs begin to search for and evaluate qualified investment targets.[168] During such selecting process, the chief task of VCs is to screen a large number of start-ups and select the

159 Zider (1998: 5).

160 Ibid.

161 Pearce & Barnes (2006: 10).

162 See Gerpott (1999: 216). The author says that the VC "investing begins with VCs prospecting for new opportunities and does not end until contracts between VC firms and start-up companies have been signed."

163 Jeng & Wells (2000: 241-245).

164 Coyle (2000: 2-3).

165 Perace & Barnes (2006: 15).

166 Coyle (2000: 2-3).

167 Milhaupt (1997: 866).

168 Rearce & Barnes (2007: 15).

most promising.[169] It is not easy for VCs to pick the right start-ups in this phase because most start-ups are at the early stage with limited business record and cash flow.[170] Only a few ventures will be successful in the end because the success opportunities for these early stage ventures are extremely uncertain.[171] That is why this industry is called "venture capital." The VCs set up a strict selecting procedure based on their investment experience to verify investment targets. The VCs will check all aspects of the start-ups, including the technology of the entrepreneurs, production and management teams, and financial and legal structure.[172] In the U.S. only 1% of the start-ups will receive VC investments.[173]

The third phase is to manage the ventures. Once the VC firm decides to invest in a start-up, it will play an active role in managing and monitoring the business of the start-up.[174] Since the VC firm will generally exit a venture in seven to ten years, such management and monitoring ensures the ventures are successful and could have high profits. The VC investors will help the ventures to build up a broad network of customers, and suppliers, find other new investors, and design the business strategy.[175] The VC investors will also employ some legal measures which include control rights,

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169 Sorabella (2000: 18-19).

170 Sorabella (2000: 19).

171 Levinthal (2002: 19). The author also points out that "in fact, out of all companies that receive VC financing, only between 10% and 30% exit through a public offering. Out of all VC investments between 1969 and 1985, more than one third resulted in a loss, and only less than 7% returned over ten times the original investment. Therefore VCs typically hope to find one or two highly successful companies that will cover for the losses from other companies and increase overall fund returns." (See Levinthal (2002: 21))

172 As mentioned for every investment made, the VC funds may screen hundreds of possibilities. Some authors explain that "out of these hundreds, perhaps a few dozen will be worthy of detailed attention, and fewer still will merit a preliminary offer." (See Gladstone & Gladstone (2002: 23)). Another author further points out the VC investing process as "preliminary offers are made with a term sheet, which outlines the proposed valuation, type of security, and proposed control rights for the investors. If this term sheet is accepted by the startup company, then the VCs perform extensive due diligence by analyzing every aspect of the company. If the VCs satisfied by this due diligence, then the VC fund and the start-up will negotiate the terms of investing contract. A VC-backed company is set up after the contract has been signed by both parties." (See Metrick (2004: 9)).

173 Perace & Barnes (2006: 23).

174 Bristow, King, and Petillon (2004: 82).

175 Perace & Barnes (2006: 24).

appointment rights,[176] information rights, and staging the investment, to fulfill their management functions in the venture.[177] These legal measures will be explored in Chapter III.

The last phase of the VC fund's life cycle is exit.[178] The VC investors have to earn high returns upon exit.[179] Unlike common investors, the case will never arise in which the VC investors hold the shares of the ventures "perpetually". The goal of VC investors is to reap high profits in a fixed period and then put these profits into new rounds of investments. VC investors exit their ventures through several ways, including IPOs, mergers and acquisitions, liquidations, or stock buybacks.[180]

In both the U.S. and China, IPOs are currently the preferred exit option for VC investors because they guarantee higher returns than other exit measures.[181] The VC investors will design their exit plans carefully, consulting investment bankers, lawyers, and other experts, since a successful exit requires knowledge and skills that extend beyond management experience and investment techniques.[182] After the ventures have been successfully listed on the stock market, the VC firm can sell its shares at a higher price on the public market, following expiration of any blocked period.[183]

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176 Bristow, King, and Petillon (2004: 82). These authors point out that VCs always "sit on the boards of directors of these companies and sometimes have majority voting rights" in the U.S.

177 Berkery (2008: 82).

178 Gilson (2003: 1101).

179 Rosenberg (2001: 385). The scholar says that "equally important, venture capitalists can withhold or provide additional funding to firms, depending on their changing prospects. The venture capitalist's goal for each of its portfolio companies is, of course, a successful exit, either through an IPO, a private sale or a share repurchase by the company."

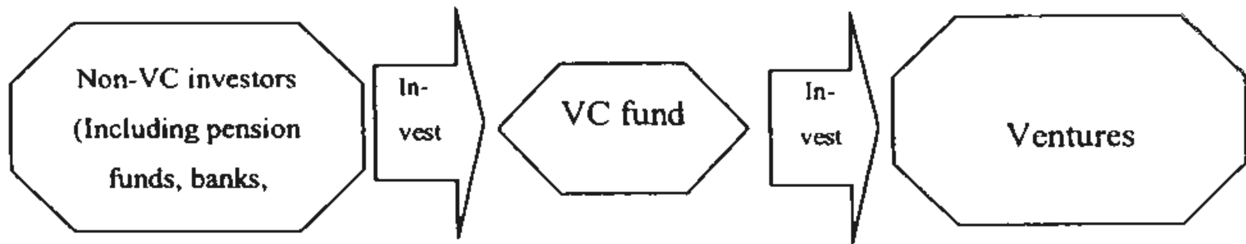
180 Rosenberg (2001: 390).

181 Except the M&A could offer a favorable price, the IPOs will be the best option of VC firms.

182 Metrick (2004: 10). The author says that "a typical IPO underwritten by a top investment bank will sell at least $50 million of new stock and have a total equity value of at least $200 million in the U.S."

183 Sorabella (2000: 18-19).

**Chart 1.3 The Life Cycle of VC Fund**




## 1.6.2 Life Cycle of VC Investments

As mentioned, VC firms will make their investments after they find the suitable start-ups. These start-ups, in which VC firms invest, could be called either "portfolio companies," "VC-backed companies," or "ventures."[184] The term "venture" is used in this study to define these companies. Like the life cycle of VC funds, the VC investment process could also be treated as a life cycle which is separated into several stages.[185] In this dissertation, the life cycle of VC investments is divided into three stages: the early stage, the middle stage, and the late stage.[186] (See Chart 1.4)

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184 Perace & Barnes (2006: 15).

185 Fraser-Sampson (2007: 128-135). See also Osnabrugge & Robinson (2000: 19). In their book, the authors divide the stages into, "1) Seed stage: the entrepreneur has only a concept for a potentially profitable business opportunity that still has to be developed and proven, 2) Start-up stage: the newly formed business is completing product development and initial marketing. It is typically one year old or younger, 3) early stage: the firm is usually expanding, and producing and delivering products or services. Often less than five years old, it may not yet be profitable, 4) Later stage: also called the expansion stage, at this level of development the VC-backed company is mature and profitable, and often still expanding. With a continued high-growth rate, it may go public in a near future." Thompson separates the stages into the early stage, the second stage, the third stage, and the later stage. (See Richard Thompson (2008: 13)). Coyle separates the stages as the early stage, the expansion stage, the leveraged buyouts and buy-ins stage. (See Coyle (2000: 4-8)).

186 See the website of NVCA at http://nvca.org/def.html. Metrick points out that "in the early 1980s of the U.S., the three categories of early-stage and mid-stage were approximately equal, and late-stage was the smallest. That means VCs focused on 'true startup companies' in the 1980s. Gradually, new VCs moved their interest to later stages. By the mid-1990s, Mid-stage investments were larger than Early-stage investments, and Later-stage investments exceeded those in Early-stage. By the late 1990s, angel investors had largely replaced VCs at the Early-stage, and Mid-stage investments comprised more than one-half of all VC investments." (See Metrick (2004: 15)). Another two scholars say that "but in the early 2000s, a much larger percentage of VC investments come back to Early-stage companies, especially high-technology companies." (See Gladstone & Gladstone (2002: 16)).

**Chart 1.4 The Life Cycle of VC Investments**

| Early Stage | Middle Stage | Late Stage |
|---|---|---|
| *High Reward* | *Medium Reward* | *Low Reward* |
| *High Risk* | *Medium Risk* | *Low Risk* |

The early stage means the phase in which the venture has just received investment from the VC firms.[187] In this stage, the ventures might only have some initial ideas about their business, or just operate market studies, set up a management team, and draft a business proposal.[188] These ideas may regard new technology or know-how, or new marketing plans and proposals of new business models.[189] The problem is that the entrepreneurs might possibly have no evidence to show that their ideas will be a success in the future.[190] Therefore, the risks for the ventures at the early stage include acceptance of the markets, feasibility of new products, and good decision-making regarding the business.[191] At this stage, the ventures may have to use a long period to transfer their ideas to a real-life product.[192] But in the real business world, "the ventures may launch the product too soon, before there is market acceptance, or may launch the product too late, after a competitor's launch."[193] The venture may also lack the ability to produce the new products or lack financial support.[194] Thus, the major task of VC investors at this stage is to provide financing and business services to the ventures in order to allow them properly to finish R&D and initial productions.[195]

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187 Lu, Tan, and Chen (2007: 231).

188 NVCA (2005: 113-114).

189 OECD (2003).

190 Coyle (2000: 6).

191 Bygrave (1988: 137).

192 Coyle (2000: 5).

193 Coyle (2000: 6).

194 Ibid.

195 Milhaupt (1997: 866).

The ventures at the middle stage will focus on selling the products in the market rather than on R&D activities.[196] The ventures now are producing and marketing their products, but may not yet gain profits from the business.[197] The key task for the ventures at this stage is to formulate a proper marketing strategy and continue efficient production and adequate supply.[198] Ventures at middle age may demand more funds to finance production than do early stage ventures.[199] The good news for the ventures at this stage is that they may have less risk than at the early stage.[200] As Gompers and Lerner observe, "the stage is an exciting stage in a venture's life and can be likened to adolescent years where the VC firms need to provide good supportive help in order to bring the venture to maturity and enable it to stand on its own feet."[201] This stage could be very profitable and offer big opportunities for a venture's future development if the leaders of the ventures keep making proper business decisions.[202] The VC investors will also change from simply being suppliers of finance to being managers and strategic designers.[203] On the other hand, the VC investors will also begin to design their exit strategies from the investment.[204]

The late stage is also called the expansion stage. That means the venture at this stage is mature and profitable with potential for great expansion.[205] In the U.S., the ventures at this stage are bigger than those at middle stage, and often target further expansion from a domestic market to an international market.[206] At this stage, the ventures focus on promoting product market coverage and refining corporate governance, as well as

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196 Batterson (1986: 88).
197 Thompson (2008: 45).
198 Fiet (1995: 553).
199 Perace & Barnes (2006: 15).
200 Sorabella (2000: 18-19).
201 Gompers & Lerner (2004: 162).
202 Koomagi & Sander (2006: 10).
203 Lu, Tan, and Chen (2007: 231).
204 Osnabrugge & Robinson (2000: 19).
205 Ibid.
206 Zider (1998: 6).

optimizing their financial structure.[207] The VC investors at this stage will accommodate more financial services to the ventures for a stable growth.[208] The details of the VC activities at these stages will be discussed in Chapter III.

## 1.7 Organization of the Dissertation

The dissertation will be grouped into five chapters. The first chapter has defined the concepts of VC and examined the economic function of this instrument, including the life cycle of the VC fund and the VC investments. Chapter I also provides the legal definitions of venture capitalist and venture capital firm, and describes the general legal arrangement of VC investment.

The second chapter gives a comprehensive overview of the current state of laws in China. It will present a brief historical report on the development of China's VC legal system from 1990 to 2009. Based on this background, the chapter then evaluates the existing Chinese VC laws and related laws. Chapter II will explain the causes of the Chinese entry problems, including deficient partnership laws, tax laws, company laws, and the country's exit problems, including the problems of the secondary stock market, which are barriers to China creating a truly mature VC industry.

The third chapter focuses on the theories and practices of the U.S. VC industry. Because the U.S. VC industry and its VC legal system have been considered by many to be the best in the world, the study will examine the U.S. legal system to discover the advantages for China to build up its own framework based on the American model as well as the local impediments to such a transplant. A brief summary of U.S. VC history will be given for better understanding the problems and achievements of VC development in the U.S. Some very important laws and stimulus programs, including the SBIA, limited partnership laws, and the SBIC Program, will then be introduced and analyzed. A detailed analysis of the U.S. stock markets will also be offered following

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207 Schween (1996: 96).

208 NVCA (2005: 113-114).

the statutory review in order to better understand exit possibilities. This chapter proves that the U.S. has a complete and efficient VC mechanism which China could use as an example.

The fourth chapter will compare the U.S. VC legal framework with that in China. The comparison is grouped into four categories, including funding, VC governance in ventures, exits, and stimulus. The comparison shows that without an appropriate economic, legal and social environment an overwhelming success of VC in China is impossible.

The last chapter sets forth the study's summary and offers recommendation on how to improve the VC legal framework in China.

# Chapter II Venture Capital Legal Framework in China

## 2.1 Overview of China's VC Industry and Legal System

Following a period of social and political turmoil in the early 1970s the Chinese government began to focus on economic development to promote stability within the country.[209] While the Chinese government still maintained its dominant role in the economy, it began in the late 1980s to allow the establishment of private enterprises in greater and greater numbers to promote China's economy.[210] In 1978, there were approximately 130,000 individual private businesses and that number passed the one million mark in 2000.[211] While many of these private enterprises were successful, their growth lacked support from the state-run financial system. On the other hand, the government made the first attempt to establish a VC system in support of its goal of promoting a high-tech industry. The first Chinese VC firm, the China New Technology Start-up Investment Company, was founded in 1985 by the State Science and Technology Commission and the Ministry of Finance.[212] Local governments followed suit and began to form government-backed funds to invest in SOEs with a view to increasing their productivity and technologies. Unfortunately, these early VC firms did not perform well as there was often a conflict between the government's aim of investing in high-tech and infrastructure on the one hand and the VCs' desire to invest in the lower risk industries, such as hotels and service industries, on the other hand.[213] Galvanized by Mr. Deng Xiaoping's famous Southern Tour to Shenzhen in 1992, the central and local governments began, again, to form their own VC firms. In the meantime, as a key feature of its reforms, the Chinese government began to open the country to foreign investment by decentralizing the approval authority to central and

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209 Vaughn (2002: 233).

210 Jia & Wang (1988: 6)

211 Ahad (2004).

212 Ahlstrom, Bruton, and Yeh (2007: 250).

213 Ibid.

local government agencies.[214] This decentralization triggered a surge of foreign VC investment into China in the early 1990s.

This study divides the evolution of China's legal framework for VCs into three stages.[215] The first stage is the creation stage, from 1984 to 1999. The second stage is the exploration stage, from 1999 to 2005. The last stage is the development stage, from 2006 to present. China has promulgated a series of laws and regulations in each stage to encourage, guide, or restrict the development of VC industry.

In the creation stage, as will be shown below, China started to explore the VC industry by the promulgation in 1985 of a CCP official document that spells out the idea of promoting the development of high technology through VC vehicles.[216] Indeed, the concept of VC was first introduced into China in 1984 when the National Research Center for Science & Technology Development put forward a proposal for promoting the development of high and new technology by establishing a VC mechanism.[217] In 1985, the Central Committee of the CCP promulgated the 1985 Decision to Reform the Chinese Science and Technical System (DRST). It is the first official document addressing the topic in China.[218] The 1985 DRST states, "VC may be established to support the

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214 Fu (2001: 515).

215 The classification of the present study is based on earlier research conducted by other scholars. One scholar divided China's VC development before 2002 into three stages. (See Feng (2004: 51-117)) The first stage is from 1991 to 1993, which is the first wave of VC investments in China. International VC firms played the main role in China's VC market in the first wave. (See Feng (2004: 51)) The second stage is from 1994 to 1997, which is stage searching of new directions. In the stage, VC-backed private firms raised. The last stage is from 1998 to 2001. The stage is the second wave of VC investment in China. Three other scholars divided the history of China's VC projects into four stages. (See Lu, Tan, and Chen (2007: 238-240)) The first stage is the "incubation stage" from 1985 to 1996. In the stage, Chinese government began to promulgate some VC regulations and policies. (See Lu, Tan, and Chen (2007: 238)) The second one is "thriving stage" from 1997 to 2001 which "was essentially a learning process." (See Lu, Tan, and Chen (2007: 239)) The third stage is "adjustment stage" from 2002 to 2004. During the stage, the government did not promulgate any significant policies related to VC projects. (See Lu, Tan, and Chen (2007: 239)) The last stage is from 2004 to now. The authors point out that "after several years of downturn and adjustment, since 2004 China's VC industry entered into the comprehensive recovery." (See Lu, Tan, and Chen (2007: 240))

216 Ibid.

217 Li (2007: 29).

218 Yu (2000).

development of those rapidly-changing and high-risk technology industries."[219] This statement indicates that Chinese leaders wished to encourage the development of the Chinese high-tech industries by means of, among other things, VC projects.[220] In Beijing that same year, China New Technology Venture Capital Co. Ltd., was jointly invested by STC and MOF, and became the first ever institutional VC firm in Mainland China. The fact that the establishment of the company was approved by the State Council makes it a symbolic event. The company specialized in high-tech VC investment and led the government's formation of similar investment entities in other provinces around China.[221] But all these earlier efforts were halted in 1989 because of the Tiananmen Square incident.[222] China's VC environment withered as a result. Nevertheless, the unpredictable game of VC in China was underway.[223]

In the following several years of the stage, "VC" appeared more frequently in China's economy and legal system. In an attempt to drive the development of high and new technology and to promote the transformation of scientific and technological achievements, the Chinese government started to open up the VC industry by "wading across the stream by felling the stones."[224] In March 1991, the 1991 STC Provision was promulgated by the STC, wherein a provision on the extensions of credit states that "relevant departments may set up VC funds in the high and new technology industry development zones for the development of high-risk, high technology products. VC companies may be established in qualified high and new technology industry

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219 Sec. 2, 1985 DRST.

220 Ibid.

221 Yip (1993: 55).

222 Yu (2000).

223 Ibid.

224 In March 1998, the Proposal of Developing China's VC Cause Swiftly by Using Overseas Experience for Reference was put forward by the Central Committee of China National Democratic Construction Association, a political party in China. The proposal brought forward distinctly for the first time the concept and significance of VC, the problems in China's VC industry and counter-measures. (See Kan (2002: 120)) The proposal also called for the establishment and improvement of Chinese VC legal system. (See Kan (2002: 120)) In 1999, the CPC began to develop the VC industry in China.

development zones when conditions permit."[225] The first wave of VC investment in China then started in 1991.[226] Data offered in the Asian Venture Capital Journal (AVCJ) shows that $16 million was raised for VC investments in 1991.[227] In 1992, the total funds raised jumped to $583 million, a thirty-fold increase compared with the $16 million in 1991.[228]

It is stressed in the Decision of the CPC Central Committee and the State Council on Accelerating the Progress of Science and Technology in May 1995 that "the science and technology VC business should be developed and the science and technology VC mechanism should be established. Capital from both home and abroad should be attracted actively to support science and technology."[229] In May 1996, the Promoting the Transformation of Scientific and Technological Achievements Law was adopted and promulgated, wherein Article 24 states expressly that "the State encourages establishment of funds or risk funds for transformation of scientific and technological achievements." Then, this first wave of China's VC development reached its peak in 1996, with $678 million being invested in the industry.[230] Foreign VC investors still had to face several difficulties investing in China at that time because many of them were unfamiliar with China and did not have sufficient experience or contacts to generate deals on their own.[231] As a result, many international VC funds sought out JV VC funds with Chinese SOEs which they felt could help them overcome these problems.

It took a few more years to realize how unwise it was for international VC firms to invest in Chinese JV VC funds. Many of these JV VC funds ran into difficulties arising from cultural and institutional differences in China as well as from the mismatched

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225 Art. 6(3), 1999 STC Provision.

226 Li (2007: 29).

227 AVCJ (2001).

228 Ibid.

229 Sec. 9(33).

230 AVCJ (2001).

231 Bruton & Ahlstrom (2003: 255).

expectations of the JVs participants and shareholders.[232] The number of JV VC funds decreased from 26 in 1994 to 4 in 1997.[233] The failure of JV VC funds made many foreign investors lose faith in VC investment in China. Such failure caused a new problem for international VC firms: it became difficult for international VC firms that had already raised VC funds in China to raise new VC funds. Raising a second fund is a good standard for non-VC investors to evaluate the VCs' performance because the self-liquidating mechanism of the VC fund is a chance for non-VC investors to know the outcome of previous investments.[234] Since failing to satisfy previous investors in JV VC funds led to failure in raising new VC funds in China,[235] fund-raising of foreign VC investors in China reached a low point with only $96 million raised in 1997, less than 10% of the $1.028 billion raised in 1995.[236] There were 33 international VC firms that raised funds to invest in China between 1991 and 1997; only one firm was able to raise new funds to invest in China after 1997.[237] The total foreign VC investment in China hit bottom the next year in 1998. As Table 2.1 shows, international VC firms accounted for more than 95% of the total fund raised from 1991 to 1997, but this figure then plunged from 1998 to 2000.[238]

Chinese state-owned VC firms rely on government appropriation as their funding source and do not have fund-raising problem like their foreign counterparts. Influenced by the global network economy and guided by national policies encouraging their activity, China's domestic VC firms stepped into a material developing stage after the second half of 1998. (See Table 2.1) A batch of VC firms in the real sense of the word began to come forth. Some pioneers, including Beijing High Technology Venture Capital Co.

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232 Walker (2007: 711).

233 Li, Feng, Wang (2007: 59).

234 Kong (2005: 90).

235 Fenn, Liang and Prowse (1995: 89).

236 AVCJ (2001).

237 This one exception, IDGVC, is a corporate venture fund whose corporate parent contributes a significant portion of its capital. Some venture capital firms, such as Walden International and H&Q Asia, continued to be active in China after 1997. However, they do not raise new China funds because of excessive China risk. They use regional funds to invest in China.

238 Peng (2005: 267).

Ltd., Beijing Venture Capital Co. Ltd., Shanghai Venture Co. Ltd., Shenzhen Capital Group Co. Ltd., remain very active in China's VC market.

**Table 2.1 Distribution of Fund-Raising by Domestic/International Funds**

*The table summarizes the distribution of fund-raising by domestic/international funds by time period.*

| | Domestic | | | | International | | | | Total |
|---|---|---|---|---|---|---|---|---|---|
| Period | Number of Funds | Avg Fund Size | Sum ($ Mil) | % in Total | Number of Funds | Avg Fund Size | Sum ($ Mil) | % in Total | ($ Mil) |
| 1991-1993 | 3 | 14.28 | 42.85 | 4.23 | 20 | 48.45 | 969.05 | 95.77 | 1011.91 |
| **1994-1997** | **1** | **8.78** | **8.78** | **0.35** | **31** | **81.52** | **2527.26** | **99.65** | **2536.04** |
| 1998-2000 | 47 | 35.42 | 1664.61 | 64.14 | 12 | 77.54 | 930.50 | 35.86 | 2595.12 |
| **Sum** | **51** | **33.65** | **1716.25** | **27.94** | **63** | **70.27** | **4426.82** | **72.06** | **6143.06** |

Source: AVCJ's 2002 Guide to VC in Asia

In the 1990s, due to the difficulty of obtaining approval for IPOs from the Chinese government, some VC funds decided to list their ventures outside Mainland China to provide liquidity and high returns to investors.[239] Most of these ventures were listed between 1992 and 1994. After 1998, additional developments promoted a new wave of foreign VC investments in China. Measures were taken by the Chinese authorities to strengthen the Chinese judiciary and to increase the number of accounting professionals. International VC investors, having gained a lot of experience after the first wave of VC investment in China, began to develop new investment strategies that avoided SOEs and focused on private firms. IDG VC firm was the leading VC firm which entered China in 1992 with its IDG Technology VC Investment fund and successful investments in

[239] Hu (2003: 178).

start-ups including Sohu.com, Baidu, and Kingdee.[240] A key aspect of this new wave was the utilization of a "round-trip" model. Under this model, the foreign VC investors would set up an offshore holding company in the Cayman Islands or another favorable place. The VC investors would then offer equity in the offshore company to the domestic company's existing shareholders and managers in exchange for the latter's shares in the domestic company, making these domestic shareholders of the offshore company.[241] There were several advantages to using this structure, including preferential tax treatment, structural flexibility and, most importantly, relatively easy implementation of exit strategy by an overseas listing.[242] This model also had the benefit of potentially bypassing Chinese regulatory hurdles since the private ventures were incorporated overseas. For example, the NASDAQ IPOs of NetEase, Sohu.com, and Sina.com, three Chinese internet portal companies, all involved offshore holding companies as listing vehicles.[243] But the data of AVCJ proves that "round-trip" model did not bring much more returns to VC investors. Table 2.2 presents the performance of four ventures based on AVCJ's data. It shows that in 1998, on average, the share prices of these companies were only 48% of their IPO prices.

**Table 2.2 The Performances of Listed VC Funds**

*This table presents the listed fund price performances for four VC funds in China founded between 1991 and 1994. The data in this table came from AVCJ's monthly fund monitor in each issue from 1995 to 1998. The last four columns stand for the price as of the dates compared with IPO prices.*

240 See the website of IDG at http://www.idgvc.com/about/, (visited on Jan. 12, 2009).

241 Chen & Xing (ed.) (2006: 346).

242 Lu, Tan, and Chen (2007: 252).

243 Chen & Xing (ed.) (2006: 346).

| Fund Name | Launch Date | Exchange Listing | Performance 95/07 relative to IPO, % | Performance 96/07 relative to IPO, % | Performance 97/07 relative to IPO, % | Performance 98/07 relative to IPO, % |
|---|---|---|---|---|---|---|
| **CAM[244]** | **91** | **Hong Kong** | **-65.91** | **-64.16** | **-38.23** | **-77.04** |
| Catha[245] | 92 | Hong Kong | 4.88 | 9.76 | 24.39 | -22.56 |
| **CMEI[246]** | **93** | **Hong Kong** | **-9.04** | **-48.86** | **-23.69** | **-65.81** |
| CNII[247] | 94 | Singapore /Dublin | -4.81 | -55.77 | -66.83 | Delisted |

Source: Annual Directory to Venture Capital in Asia (1998)

From 1999 to 2006, that is, the exploration stage, various rules and regulations were promulgated to address the perceived problems with the Chinese VC industry, such as foreign VC investment control, tax evasion, conflict among different laws, and foreign exchange control. The most outstanding feature of this period is that China issued various restrictive regulations, in particular regulations on mergers and acquisitions, to control the ventures' listing on overseas stock exchanges. As will be shown below, the Chinese government tried to police the VC industry by promulgating a series of regulations and policies that it believed would help to strengthen the VC sector. But it is exactly these restrictions that limited the VC investment and development in China.

The year 1999 is a milestone in the history of China's VC industry. From this year, China's VC industry entered a stage of high speed growth. In August 1999, the CPC Central Committee and the State Council pointed out in the Decision on Strengthening Technical Innovation and Developing High Technologies to Realize Industrialization that:

> The capital markets favorable to the development of high and new technology industry should be fostered. The VC mechanism should be worked up, and VC companies and VC funds should be developed. Exit

244 China Assets Management (Holdings).

245 Cathay Investment Fund Ltd.

246 China Merchants Direct Investment Ltd.

247 China North Industries Investment Ltd.

mechanisms for VC should be established and the support on the growing high-tech enterprises should be intensified. Managerial talents of VC should be introduced and cultivated. The preparation of relevant policies and regulations should be accelerated, and the market behaviors of VC should be standardized. Priority should be given to support the access of qualified high-tech enterprises to domestic and international capital markets. High-tech enterprise sector should be set in existing Shanghai and Shenzhen stock exchanges when appropriate.[248]

In December 1999, based on a series of encouraging and positive VC policies, the State Council promulgated the 1999 State Council Opinion No. 105. The 1999 State Council Opinion No. 105 is the first official document in China tailored specifically for VC. It elaborates the significance and basic principles of establishing VC mechanisms in China. In addition, it brings concrete measures including cultivating the principals of the VC industry,[249] establishing exit mechanisms for VC,[250] and perfecting agency service systems, as well as establishing, perfecting, encouraging and guiding the policy and regulation system of VC.[251] Since then, China's VC market entered a period of high growth.

In the meantime, preferential tax treatments were granted to high-tech enterprises. In 1999, the State Administration of Taxation (SAT) issued 1999 SAT Circular 273, stipulating that technologically advanced enterprises certified by SAT would be entitled to have a favorable tax rate.[252] Many high-tech ventures were accredited as technologically advanced enterprises and they paid the favorable tax rate. In 2000, the State Council promulgated the 2000 State Council Circular No. 18 and decided to reduce or exempt the tax of software enterprises and IC (integrated circuit) companies

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248 Art. 3(9).

249 Art. 2, 1999 State Council Opinion No. 105.

250 Art. 4, Ibid.

251 Art. 5 & Art. 6, Ibid.

252 Art. 1(1), Art. 2(1), and Art. 3(1), 1999 SAT Circular No. 273.

under certain circumstances.[253] The lower tax rates for high-tech enterprises encouraged VC investors and entrepreneurs to start high-tech ventures.

As a consequence of these central government initiatives, a large number of domestic VC firms supported by government funds were established by local governments, and many state-owned funds also entered China's VC market through these VC firms. More importantly, under the guidance of 1999 State Council Opinion No. 105, various provinces and municipalities issued administrative measures to promote the development of their local VC industry (See Table 2.3).

**Table 2.3 Overview of Some Local VC Regulations in 2000-2005**

| No. | Name of the Regulations | Promulgation Date | Promulgating Agency |
|---|---|---|---|
| 1 | Interim Administrative Measures of Nanjing City on High and New Technology VC Funds | Apr. 12, 2000 | Nanjing City Government, Jiangsu Province |
| 2 | Tentative Administrative Measures of Hefei City on High-tech VC Funds | Aug. 29, 2000 | Hefei City Government, Anhui Province |
| 3 | Interim Provisions of Shenzhen City on VC in High and New Technology Industry | Oct. 11, 2000 | Shenzhen City Government, Guangdong Province |
| 4 | Several Opinions of Zhejiang Province on Encouraging the Development of VC | Oct. 20, 2000 | Zhejiang Province Government |
| 5 | Several Provisions of Shanghai City on Promoting the Transformation of High and New Technology Achievements | Nov. 12, 2000 | Shanghai City Government |
| 6 | Several Tentative Provisions of Xiamen City on Promoting the Development of VC | Jan. 2, 2001 | Xiamen City Government, Fujian Province |
| 7 | Administrative Measures on Limited Partnership | Feb. 21, 2001 | Beijing City Government |
| 8 | Several Provisions of Guangzhou City on Promoting the Development of VC Industry | Aug. 9, 2001 | Guangzhou City Government, Guangdong Province |

[253] Art. 5-Art. 9, 2000 State Council Circular No. 18.

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|---|---|---|---|
| 9 | Measures of Beijing City on Supporting and Confirming the Enjoyment of the Special Financial Fund by VC Institutions | Dec. 6, 2001 | Finance Bureau of Beijing City |
| 10 | Interim Provisions of Tianjin City on Promoting the Development of VC Industry | Apr. 6, 2002 | Tianjin City Government |
| 11 | Tentative Administrative Measures of Shanxi Province on VC Enterprises | Nov. 6, 2002 | Shanxi Bureau of Commerce and Industry, Shanxi Family Planning Commission |
| 12 | Interim Provisions of Guangdong Province on Promoting the Development of VC | Feb. 14, 2003 | Guangdong Province Government |
| 13 | Regulations of Shenzhen Special Economic Zone on VC | Feb. 21, 2003 | Shenzhen City People's Congress, Guangdong Province |
| 14 | Interim Provisions of Shanxi Province on Promoting the Development of VC Industry in the Guanzhong High-tech Industry Belt of Shanxi | July 20, 2003 | Shanxi Province Government |
| 15 | Measures of Tianjin City on Implementation of Preferential Taxation Policies by VC Institutions | May 28, 2004 | Tianjin City Science and Technology Commission and the Finance Bureau of Tianjin City |
| 16 | Several Provisions of Autonomous Region on Promoting VC of Science and Technology | June 30, 2004 | Xinjiang Uygur Autonomous Region Government |
| 17 | Tentative measures of Henan Province on Promoting the Development of VC | Nov. 10, 2004 | Henan Province Government |
| 18 | Tentative Administrative measures of Chongqing City on Major High and New Technology VC Funds | Mar. 31, 2005 | Chongqing City Government |

Another important characteristic of this stage was the legislation for the red-chip model. The red-chip model has traditionally been a favorable mode of fundraising and listing abroad and has frequently been adopted by China's private ventures.[254] However, on June 9, 2000, the 2000 CSRC Circular No. 72 was promulgated by the China Securities

[254] Chan (2007: 4).

Regulatory Commission (CSRC). According to the Circular, for any matter concerning domestic ventures' share issuance and listing abroad that is not mentioned in 1997 State Council Circular No. 21, a legal opinion issued by Chinese lawyers must be submitted to the CSRC for reply.[255] A series of amendments to the supervision and control policies of the red-chip model began at that time (see Table 2.4). Red-chip rules exert significant influence on the overseas listing of domestic ventures. Thus less restrictive red-chip rules would encourage overseas listing, while restrictive red-chip policies limit the development of the Chinese VC industry. The details of the red-chip model and related regulations are discussed in the following sections.

Foreign VC investments increased following China's accession to the WTO in 2001.[256] Foreign VC firms, including Doll Capital Management with its investment in 51job.com and domestic VC firms, New Margin Ventures and Legend Capital, enjoyed solid returns.[257] According to one study, the public listings of a dozen firms during the 2003-2005 period, including the Softbank Asia Infrastructure Fund-backed online games maker Shanda Interactive Entertainment on the NASDAQ exchange in 2004, gave their investors a 10-fold rate of return.[258] Since 2004, China's VC market has entered into high growth. The total VC investment amount has arisen from RMB3.715 billion in 2003 to RMB14.36 billion in 2006, a more than 386% growth in three years.[259] In 2005, foreign VC investment was still the largest source of VC financing in China. By the end of 2005 the international VC fund-raising for China's VC investments had reached $4 billion.[260] However, the Chinese government noticed these success stories of foreign VCs and tried to restrict such investments for tax and revenue reasons. In early 2005 the SAFE issued repealed 2005 SAFE Circulars No. 11 and No. 29, which required central government approval for overseas investment activities by

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255 Art. 2, 2000 CSRC Circular No. 72.

256 Chan (2007: 4).

257 Xin & Lu (2007: 89).

258 Chan (2007: 4).

259 Chen (ed.) (2007: 135).

260 Earnest & Young (2006).

Chinese individuals and entities.[261] In practice, SAFE did not grant its approval, and VC activities slowed significantly as a result. In October of 2005, the regulations were revised by 2005 SAFE Circular No. 75 to replace central registration with local registration, which was relatively easier to obtain.[262] These pieces of foreign exchange legislation are discussed in the following sections.

In the development stage starting in 2006, the Chinese government promulgated VC regulations to support VC industry. The limited partnership form, for example, was established in this stage. In particular, the Chinese government recognized that encouraging start-ups and private equity investments are useful measures to reduce the impact of global economic crisis. The government also began to set up some supporting institutions to promote China's VC industry, including governmental VC guiding fund programs, and a secondary board of the stock exchange.

From 2006, the laws of China's VC industry have undergone major reforms. Firstly, the PRC Company Law and the PRC Securities Law were amended in 2006, which improved to a certain extent the legal environment for the establishment, listing and financing of China's enterprises.[263] Secondly, the 2005 DVCM came into effect in 2006, which created a legal framework for promoting the development of China's VC industry. It standardized the operation of VC firms and encouraged VC firms to invest in small and medium-sized enterprises, especially in high-tech enterprises.[264] Finally, the 2006 Ministry of Commerce (MOFCOM) Provisions No. 10 was jointly issued by the six Ministries and Commissions, which on the one hand control the mergers of affiliated companies, and, on the other hand, require the examination and approval by the CSRC on listing of red-chip shares, resulting in a suspension of listing of red-chip shares.[265] The details of 2006 MOFCOM Provision No. 10 are discussed in Section 2.3.3.

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[261] Art. 1, repealed 2005 SAFE Circular No. 11, and Art. 2, repealed 2005 SAFE Circular No. 29.

[262] Art. 2, 2005 SAFE Circular No. 75.

[263] CVCRI & POLYU (2007: 35).

[264] Art. 1, 2005 DVCM.

[265] Art. 40, 2006 MOFCOM Provision No. 10.

In 2007, the 2007 MOF Opinion No. 8 and the 2007 SAT Circular No. 31 were promulgated and carried into execution successively. The two circulars encouraged VC firms to invest in high-tech start-ups with financial support from the government, including governmental investments and tax deduction.[266]

After several years of high growth, the year 2008 was unusual in most countries throughout the world, including China. In this year, the sub-prime mortgage crises in the U.S. evolved into a global financial crisis, which ultimately infiltrated to the whole economy.[267] Economic growth slowed down in major industrial countries, including the U.S., the EU, and Japan, in 2007, 2008 and 2009.[268] The real economy in developed countries has shown signs of a serious recession since mid-October of 2008: consumption and business investment shrank while the unemployment rate surged.[269] At the same time, the financial crisis expanded rapidly to emerging economies, leading to decreased foreign investment, high financing costs, remarkably falling prices of primary products and shrinking export.[270] Since the U.S. real estate bubble went bust and the sub-prime mortgage crisis emerged and evolved into the financial crisis, the world economy has been faced with many challenges, including soaring prices of raw materials, food, energy, increasing inflation risks, coexistence of excess liquidity and credit contraction, and impacts on real economic growth.[271] The world economy has seen a turning point from its boom period and the current economy has entered into a period of adjustment.[272]

China's economy maintained rapid growth during the first half of 2008, but slowed down apparently on the whole in the second half, as the world's economy began to

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266 Art. 4, 2007 MOF Circular No. 8 & Art. 1, 2007 SAT Circular No. 31.

267 Arner, Hsu, Roza, Johnstone, and Lejot (2009: 31).

268 Ibid.

269 Ibid.

270 Ibid.

271 Ibid.

272 See the website of CCTV at http://english.cctv.com/20090819/101472.shtml.

impact on China's economy.[273] As a result, the GDP growth rate slid, deflation rather than inflation risk increased, export growth slowed down, and people were less motivated to consume.[274] Besides the impacts of the global financial crisis, China's economy also faces some serious incidents: a rare snowstorm in South China at the beginning of 2008,[275] a violent earthquake which battered Wenchuan on May 12, 2008,[276] and the Sanlu milk powder scandal in Hebei.[277] With all these kinds of incidents and uncertainties, the Chinese government took active measures and rapidly adjusted its macro-control policies. First, the "Double Prevents" policy (to prevent the economy from slight heating to overheating; to prevent the structural price surge from developing into obvious inflation) enforced at the end of 2007 was replaced with the policy of "One Maintain & One Control" (to maintain stable and relatively rapid economic development; to control excessive commodities price hikes) in July and August in 2008.[278] Then the policy was further replaced again with "Active Fiscal Policy" and "Properly Relaxed Monetary Policy" from late October and early November 2008.[279] These policy changes helped maintain the stable and orderly development of China's overall economy with a slight fall. In October 2008, the 2008 National Development and Reform Commission (NDRC) Opinion No. 10 was promulgated. The Opinion stipulates conditions of use for the guiding funds in detail with respect to such aspects as nature and purpose,[280] establishment and source,[281] principles and mode of operation,[282] management, supervision and instruction, as well as the risk control of the guiding fund, which provides a legal basis for the guiding funds.[283]

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273 Huang (2008: 15).

274 Huang (2008: 15).

275 See the website of Xinhua News Agency at http://www.xinhuanet.com/newscenter/kjbx/index.htm.

276 See the website of Xinhua News Agency at http://www.xinhuanet.com/politics/kzjz/.

277 See the website of Xinhua News Agency at http://news.xinhuanet.com/newscenter/2008-09/11/content_9932071.htm.

278 See the website of PRC Central Government at http://www.gov.cn/jrzg/2008-12/08/content_1171885.htm.

279 Ibid.

280 Art. 1, 2008 NDRC Opinion No. 10.

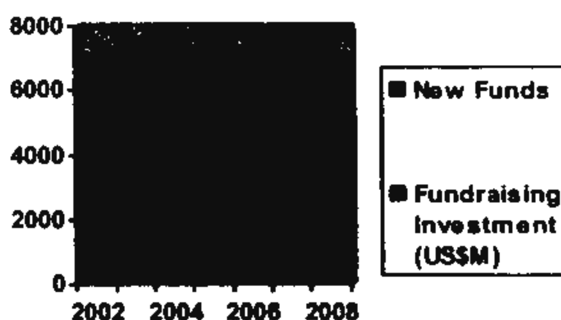
281 Art. 2, Ibid.

282 Art. 3, Ibid.

283 Art. 5-7, Ibid.

During the entire period discussed above, China's VC industry developed rapidly, and fundraising and investment often hit new record highs. In 2002, the amount of fundraising investment was $1,298 million. In 2008, the amount reached to $7,080.81 million. Thirty-four VC funds were funded in 2002. The number changed to 116 in 2008. From 2001 to 2008, the amount VC investment increased from $518 millions to $4, 210.47 million. Meanwhile, the number of the deals rose to 607 in 2008 from 216 in 2001. Chart 2.1 and Chart 2.2 show the change of China's VC investment during the period from 2001 to 2008.

**Chart 2.1 2002-2008 (January-November) Fundraising of VC Funds**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

**Chart 2.2 2001-2008 (January-November) Comparison of Aggregate Investment of China's VC Market**

Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

Although influenced by the financial crisis, the Chinese VC industry has been promoted by the governmental stimulus and incentive policies. In 2008, the VC investment made by foreign VC investors totaled RMB2, 816.66 million, which is 55.7% of the aggregate foreign investment in China.[284] With the development of the Chinese VC industry, foreign VC investors begin to establish RMB VC funds in China. In January 2008, the MOFCOM approved IDGVC to set up a RMB fund with RMB500 million in China, which became the first RMB fund raised by foreign VC investors.[285] Later, another foreign VC firm, DT Capital Partners, also received approval from the Chinese government to raise a RMB VC fund.[286] In 2009, iD Tech Ventures and SAIF Partners established their joint VC funds with Chinese LPs, respectively.[287] More and more foreign VC investors followed the model. In June 2008, Sequoia Capital China, CDH Investments, Hony Capital, and New Horizon Capital began to raise their own RMB funds in China.[288] In 2009, the amount of VC raised totaled $3,766.7 million.[289] (See Chart 2.3)

284 Zero2IPO (2008: 118).

285 http://capital.cyzone.cn/article/46812/.

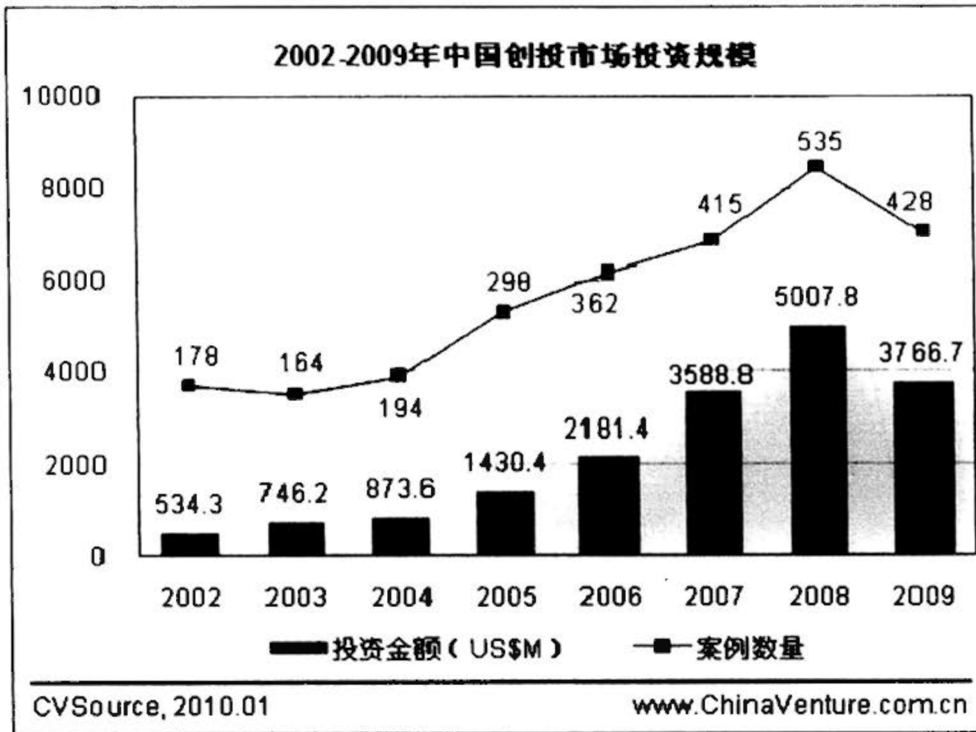
286 http://www.china-cbn.com/s/n/000004/20090812/000000123228.shtml.

287 http://news.chinaventure.com.cn/2/20090716/24909.shtml, and http://tech.163.com/09/0112/13/4VF8F1AJ000915BF.html.

288 http://finance.sina.com.cn/g/20080624/17095018252.shtml.

289 ChinaVenture (2010).

**Chart 2.3 The Size of China's VC Industry from 2002 to 2009**




Source: ChinaVenture (2010), available at http://report.chinaventure.com.cn/r/f/171.aspx

China has encouraged domestic financial institutions to invest in the VC industry since 2008. The expansion of domestic VC sources promotes the rise of VC investment in China. The most important source comes from the social security fund, which received the necessary approval to establish joint VC funds with other VC firms.[290] By the end of 2008, the total VC investments in China reached RMB94.993 billion, 49.38% of which were made by foreign investors, showing a sign of slow down compared with that in 2006 and 2007;[291] 50.62% of which were made by domestic VC firms, which is the first time that domestic VC investments exceeded the foreign VC investments.[292]

After 10 years of discussion, the Administrative Measures for IPOs and Listing on the GEM were promulgated by the CSRC on March 31, 2009. Then, twenty-eight companies were listed on the GEM on October 30th, 2009.[293] The establishment of the

[290] Zhang (2008). See also http://www.caijing.com.cn/2008-06-06/100067916.html.

[291] China Research and Intelligence (2009: 8).

[292] China Research and Intelligence (2009: 9).

[293] See the website of SZSE at http://www.szse.cn/main/chinext/cybdt/39740802.shtml.

GEM, it is believed, would stimulate the development of the Chinese capital market, strengthen Chinese financing ability, and facilitate high growth start-ups and ventures. In particular, the GEM stimulates VC investment and creates a new and easier exit channel for VC investors to obtain high returns.[294] "After years of waiting, the VC firms seem to see their hopes and opportunities materializing."[295] Therefore, the creation of the GEM is a significant favorable legal event for China's VC development.

## 2.2 Current Legal System for China's Venture Capital Projects

### 2.2.1 The Legislative Structure of China's VC industry

China's VC legal system consists of the following laws and regulations: laws for VC investments, laws on the forms of fundraising and the organization of VC firms, laws on the exit of VC investment, laws for the taxation of VC firms and their investments, and the laws on foreign exchange in relation to VC investment. Before analyzing China's legal framework for VCs, the legislative structure in China and some legislative issues related to China's VC industry are discussed below.

There is no uniform VC lawmaker in China. Many governmental agencies, from the national to the provincial level, have promulgated regulations related to the VC industry in accordance with their legislative authorities granted by the Constitution or other laws. This section lists some key laws and regulations governing the Chinese VC industry. It also briefly introduces the functions and authority of major government departments which have legislative authority to promulgate VC related regulations.

The laws governing VCs include the PRC Individual Income Tax Law, which was adopted and promulgated by the National People's Congress (NPC), the PRC Company Law, the PRC Securities Law, and the 2006 PEL, which were all adopted, promulgated, and amended by the NPC's Standing Committee. The NPC is the highest constitutional

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294 Ibid.

295 Chan & Xi (2008: 8).

organ of the PRC.[296] The NPC elects a Standing Committee which exercises the authority of the NPC when the NPC is not in session.[297] The NPC has the power to pass or amend the Constitution and basic statutes.[298] It also can alter or annul decisions of its Standing Committee.[299] The NPC's Standing Committee has the power to supplement or amend NPC statutes, the plan, or the budget when the NPC is not in session, to interpret statutes, to annul administrative rules and regulations, decisions, and orders of the State Council that contravene the Constitution or statutes, and to annul local regulations and decisions where they contravene the Constitution, statutes, or State Council administrative regulations.[300] The State Council is considered an administrative, not a legislative unit.[301] Therefore, its enactments are administrative rules, not laws[302] (only the NPC or its Standing Committee can actually pass laws.[303]). The State Council can pass only administrative regulations, decisions, and orders.[304]

The ministries and commission of the State Council can promulgate departmental rules or other binding official documents. In practice, many VC regulations have been promulgated by these ministries, i.e. the 2005 DVCM and the 2003 FVCP. Because there is no VC "law" adopted by the NPC or its Standing Committee or State Council, these departmental rules or official documents are the "de facto law" of VC projects in China. All participants of China's VC investments shall follow the directive of these rules. The titles of these rules could bear the words measures, provisions, or circulars. As for use of the word "circular" in this study, it should be noted that the Chinese term is usually translated into English "notice". Though the term "notice" is a literal translation of the Chinese words "*tongzhi*", the term "circular" seems to be more

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296 Art. 2 & Art. 57, PRC Constitution.

297 Art. 57 & Art. 58, PRC Constitution.

298 Art. 7, PRC Legislation Law.

299 Ibid.

300 Art. 67, PRC Constitution.

301 Art. 3, PRC Organic Law of the State Council.

302 Art. 56, Ibid.

303 Art. 7, PRC Legislation Law.

304 Art. 89, PRC Constitution.

reflective of the nature of these rules. According to the 2001 HODGP,[305] "notice" and "circular" are both "documents with legal effect and of standard forms formulated in the process of administration and are important instruments for carrying out administration and official activities in accordance with the law."[306] "Notice" shall be used when "approving or forwarding official documents made by sub-branches, forwarding official documents made by the Department at a higher or parallel level, informing sub-branches or other relevant organs matters that should be known and handled thereby, or when announcing personnel appointing or removal".[307] By contrast, "circular" shall be used for "commendation or criticism, or for making public important issues."[308] Thus, "notice" is a type of internal government documents, which only gives instructions to officials or to lower departments of the government. Circulars are, on the other hand, a type of public official documents, which govern the activities of individuals or enterprises. For the purpose of this study, the term "circular" is used to refer to the official documents promulgated by various central government ministries, departments and agencies.[309]

The following six ministries and commissions have promulgated many rules, provisions, measures, and circulars related to VC industry in China: The MOFCOM plays a key role in all matters related to foreign trade, investment, and economic cooperation, including drafting and reviewing the rules, official documents, and policies governing domestic and foreign VC investment, issuing licenses or approvals to every foreign-invested VC firm (FVCF).[310] The 2003 FVCP and the 2006 MOFCOM Provision No. 10 are, for example, promulgated by the MOFCOM. The NDRC is responsible for

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305 The 2001 HODGP has entered into force on January 1, 2001.

306 Art. 2, 2001 HODGP.

307 Art. 9(5), Ibid.

308 Art. 9(6), Ibid.

309 Actually, according to Art. 9 (1) of 2001 HODGP, the term "Order" is the best title for the purposes of these official documents. It is not clear why Chinese ministries like to choose the term "Notice" or "Circular" to promulgate their orders. Maybe the only answer is the Chinese officials should improve their abilities for understanding legal purposes of the laws, rules, and official documents and drafting official documents in the future.

310 See the website of MOFCOM at http://www.mofcom.gov.cn/.

the macro-regulation of the national economy.[311] The mandates of the Commission include formulating and implementing the strategies for national economic and social development, analyzing the fiscal situation and participating in the formation of fiscal and monetary policies, drafting guidelines on equity investments, including VC investments, and approving the key projects related to energy or other resources in relation to foreign investments.[312] The NDRC has been involved in regulating the Chinese VC industry by promulgating the 2005DVCM and the 2008NDRC Opinion 10. The State Administration for Industry and Commence (SAIC) plays a key role administering company registration in China. The department issues licenses to all types of enterprises, including Chinese VC LLCs, VC joint stock companies, foreign-invested VC firms, and VC limited partnerships.[313] The SAFE is an authority under the jurisdiction of the People's Bank of China, and it is mainly responsible for supervising and formulating rules and official documents related to foreign exchange issues.[314] The department promulgated the 2005 SAFE Circulars No. 11, No. 75, and 2007 SAFE Circular No. 106 which regulate the foreign VC investors' activities in China and the ventures' IPOs abroad. The SAT is China's tax authority which drafts and promulgates tax rules and official documents and handles rebate and refund of taxes.[315] The department promulgates some tax incentive documents, including the 2008 SAT Circular No. 985 and the 2009 SAT Circular No. 87, to encourage the development of ventures and VC investors. The CSRC is the key regulatory agency which oversees the securities markets on behalf of the State Council. The CSRC is responsible for drafting relevant rules and official documents for securities markets, developing long-term strategies, delivering guidance and coordinating among central and local governments, conducting supervision and inspection of market activities, supervising securities firms, especially their proprietary trading activities, and listed companies, as well as their offering of securities to the public, and has control over the overseas listing of domestic

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311 See the website of NDRC at http://en.ndrc.gov.cn/.

312 Ibid.

313 See the website of SAIC at http://www.saic.gov.cn/english/index.html.

314 See the website of SAFE at http://www.safe.gov.cn/model_safe_en/index.jsp?id=6.

315 See the website of SAT at http://www.chinatax.gov.cn/n8136506/index.html.

companies.[316] It promulgated the 2000 CSRC Circular No. 72 to govern the IPOs of ventures in domestic stock markets.

The People's Congresses and their Standing Committees at the provincial level have also adopted local VC rules.[317] These rules are valid upon adoption but must be reported to the NPC Standing Committee.[318] Governments at and above the county level can formulate rules related to VC in accordance with national laws and State Council administrative rules and regulations.[319] For instance, Beijing, Hebei, Chongqing, and Zhejiang have all promulgated local governmental VC guiding fund regulations to promote the local VC activities.

### 2.2.2 Funding

As discussed, 2003 FVCP and 2005 DVCM are two main set of regulations governing China's VC firms. Details of establishment, operation and supervision of DVCFs and FVCFs are provided for in the two regulations, which form a legal foundation for the VC firms' formation in China. In his 2005 book, *Investing in China: the Emerging Venture Capital Industry*, Li points out that China will amend its Company Law and the Partnership Law to "provide a more flexible and effective operating environment for the VC industry."[320] He thinks that the legal structure of VC firms in China were "much more rigid, making it more difficult for investors and fund managers to divide profits and risk."[321] In 2005, China did modify the PRC Company Law and the 2006 PEL, which now contain more sophisticated and flexible formation rules on funding VC firms. The section discusses the contents of these laws and regulations.

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316 See the website of CSRC at http://www.csrc.gov.cn/n575458/n4001948/.

317 Art. 7, PRC Organic Law of the Local People's Congress and Local People's Governments.

318 Ibid.

319 Art. 72, PRC Legislation Law.

320 Li (2005: 8).

321 Ibid.

#### 2.2.2.1 Foreign-Invested Venture Capital Firms

##### 2.2.2.1.1 Introduction

Foreign VC investors may set up an FVCF in China as an equity joint venture (EJV) under the EJV law, or a cooperative joint venture (CJV) (with or without legal-person status) under the CJV law, or a wholly foreign-owned enterprise (WFOE) under the WFOEs law, or an FIP.[322] In China, each of these types of enterprise is referred to as a foreign-invested enterprise (FIE). Moreover, a FIE may also incorporate as the foreign-invested company by shares under the PRC Company Law and relevant regulations.[323] The FVCF cannot currently be set up as a limited partnership in China.

The legal definition of "foreign" investment should be provided at this point. The legal treatment of foreign investment differs significantly from that of domestic investment, in terms of establishment procedures,[324] approval standards,[325] and management structures.[326] Therefore, a clear distinction is necessary to ensure that the proper laws are applied.

A current standard generally used by the Chinese governments is to examine the source of investments. If the investment comes from outside the territory of mainland China, it is usually characterized as a "foreign investment." For the purpose of this characterization, investments from Hong Kong, Macao and Taiwan are treated as "foreign investment."[327] One exception to this rule applies to the use of profits from

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[322] The main regulations applicable to EJVs are the PRC Chinese-Foreign EJVs Law. The main regulations applicable to CJVs are the PRC Chinese-Foreign CJVs Law. The main regulations applicable to WFOEs are PRC WFOEs Law. The main regulations applicable to FLPs are the PRC Partnership Enterprise Law and the Administrative Measures for the Establishment of Partnership Enterprises by Foreign Enterprise or Individual in China. The FIE laws themselves are generally very short and skeletal. The laws generally cited and used in practice are the implementing regulations and rules that are much more extensive and practical than the FIE laws.

[323] See the Provisional Regulations on Certain Issues Concerning the Establishment of Companies Limited by Shares with Foreign Investment.

[324] Art.3, Art.5, and Art.6, PRC EJV Law. Art.6 & Art.7, PRC WFOE Law.

[325] Ibid.

[326] See Art.6, PRC EJV Law, Art.12, PRC CJV Law.

[327] Art. 20, Provisions on the Encouragement of Foreign Investment.

existing FIEs operating within China's territory. But if such profits are used for re-investment in China, they are also treated as "foreign investments" so as to enjoy the preferential legal treatments granted to foreign investment.[328] Another exception is that round-trip investment can not be treated as foreign investment because the capital's owners are Chinese nationals or enterprises. The government promulgated the Implementing Opinions on Several Issues Concerning the Application of the Law in the Administration of the Examination, Approval and Registration of Foreign-invested Companies[329] to verify the qualification of "foreign investments." When verifying the qualification, a foreign investor must have his or her identity certificate notarized by a notary of his or her home country in order to prove his or her identity. Such notarization shall then be endorsed by the Chinese embassy (or consulate) stationed in the home country.[330] The round-trip capital's owners cannot receive the notarization of the foreign country because they are Chinese by nationality. Thus, they cannot benefit from the preferential legal treatment granted to foreign investment.

FVCFs should be seen and treated as a special type of FIEs. Unlike EJVs, CJVs, or WFOEs, the business scope of FVCFs is not expressly and explicitly contemplated in the FIE laws. In addition, the FIE laws govern foreign investments in "traditional" industrial sectors in China.[331] Moreover, the FIE laws only recognize one type of foreign investment company, i.e., the FIE Holding Company. According to the Provision on Establishment of Companies with an Investment Nature by Foreign Investors,[332] an FIE Holding Company may engage in direct investments in China.[333] The FIE Holding Company may also provide various support services to its portfolio

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328 In addition, the FIE's may petition for a refund of income tax allocated to the profits used for reinvestment. See Art. 7, PRC EJVs Law; Art. 17, PRC WFOEs Law; Art. 10, PRC Provisions on the Encouragement of Foreign Investment.

329 The Opinion was promulgated on April 24, 2006.

330 Art. 5, PRC FIERO.

331 Art. 3, the Implementation Provision on PRC EJVs Law, Art. 3 & Art. 4, the Implementation Provision on PRC WFOEs Law.

332 The Provision was promulgated by the MOFCOM on Nov. 17.

333 Art. 2, the Provisions on Establishment of Companies with an Investment Nature by Foreign Investors.

companies. The invested company of an FIE Holding Company is not required to be a start-up on which VC firms focus. However, market entry thresholds for the establishment of an FIE Holding Company are rather high. Among other things, the total assets of a foreign investor who sets up an FIE Holding Company shall be at least $400 million and total investment in China must amount to at least $10 million.[334] Or alternatively, the foreign investor must have invested in at least ten companies in China with at least $30 million.[335] The FIE Holding Company itself must also have a registered capital of at least $30 million in China.[336] These requirements may bar foreign VC investors from entering China's VC industry under the FIE Holding Company structure. In contrast, if an FIE is qualified as an FVCF, the applicable market entry thresholds are much lower than those applicable to an FIE Holding Company. Thus, smaller foreign VC investors would presumably avoid entering China's VC industry through the structure of a FIE Holding Company. Moreover, an FVCF can only invest in non-public high-tech start-ups.[337] But there is currently no mechanism for the Chinese government to examine the investment of FVCFs and determine whether it is within the permissible scope.

The 2003 FVCP closes a legal gap with respect to the formation and operation of FVCFs.[338] As mentioned, the 2003 FVCP is the principal piece of legislation that governs FVCFs.[339] A FVCF is also subject to foreign investment restrictions under the FIE laws.[340] Therefore, a FVCF can be considered as a special category of FIEs.[341] The 2003 FVCP classifies FVCFs into legal-person firms and non-legal-person firms.[342] This study summarizes some key points of FVCFs funding as follows.

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334 Art. 3, Ibid.

335 Art. 3, Ibid.

336 Art. 3, Ibid.

337 Art. 3, 2003 FVCP.

338 Art. 2, Ibid.

339 Art. 1, Ibid.

340 Art. 1, Ibid.

341 Art. 10, Ibid.

342 Art.4 and Art. 7, Ibid. As mentioned, under the FIE legal regime, legal-person FIEs include EJVs, legal-person CJV, WFOE, and company limited by shares with foreign investment ("CLS").

#### 2.2.2.1.2 Registered Capital and Requisite Investor

Since foreign VC investors are not allowed to set up limited partnership VC firms in China (all foreign-backed VC firms in China should be corporations or general partnership enterprises), imposing high requirements for registered capital and qualification are one way China can restrict the establishment of foreign VC firms.[343] Only bigger foreign investors that can easily put up the necessary registered capital have chances to enter China's VC industry. The registered capital of a non-legal-person FVCF must be at least $10 million, and it must be at least $5 million for a legal-person FVCF.[344] Legal person means "an organization that has capacity for civil rights and capacity for civil conduct and independently enjoys civil rights and assumes civil obligations in accordance with the law."[345] Except for the RI, which is defined below, each VC investor is bound by a minimum capital commitment of $1 million.[346] Furthermore, in a legal-person FVCF, the RI's stated and paid-in capital must be at least 30% of the total stated and contributed capital amount.[347] In a non-legal-person FVCF, the threshold is 1% for both the stated and contributed capital.[348]

"Requisite Investor" (RI) is the term that the 2003 FVCP adopts to refer to the specific class of investors of an FVCF, and this term is roughly equivalent from a legal perspective to a GP in a U.S. partnership. An FVCF must have at least one RI that

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Non-legal-person FIEs include non-legal-person CJV and partnership, which is still being considered by Chinese government. In a legal-person entity, the shareholders assume limited liabilities for the indebtedness of such entity. Conversely, in a non-legal-person entity, the shareholders assume joint and several liabilities with such entity (i.e. unlimited liabilities) for the entity's indebtedness.

343 Art. 6(2), Ibid.

344 Art. 6(2), Ibid.

345 Art. 36, 1986 PRC General Principles of the Civil Law. The law also stipulates that "a legal person shall have the following qualifications: (1) establishment in accordance with the law; (2) possession of the necessary property or funds; (3) possession of its own name, organization and premises; and (4) ability to independently bear civil liability." (See Art. 37).

346 Art. 6(2), 2003 FVCP.

347 Art. 7(6), Ibid.

348 Art. 7(6), Ibid.

meets certain qualifications provided for in the 2003 FVCP.[349] The principal business of a RI must be VC investment. The amount of capital that a RI manages in the three years prior to the application must be at least $100 million (or RMB100 million for a Chinese RI), of which at least $50 million (or RMB50 million for a Chinese RI) is injected in VC investment projects.[350] A RI must employ at least three professional VC managers to operate the business of the firm.[351] A RI may meet the foregoing qualification requirements through its affiliates, and the RI and his affiliated entities shall not have been prohibited by their own countries from engaging in VC investment.[352]

China is silent on a RI's authorities within the firm. It is uncertain as to whether a RI can have management rights that are comparable to a GP in a limited partnership. In a legal-person FVCF, the board of directors takes charge of day-to-day management.[353] In a non-legal-person FVCF, the authority of managing the firm belongs to the joint management committee.[354] The board and committee have the authority to establish the executive departments, which manage the daily operations of the firm and execute the board or committee's investment decisions.[355] The persons monitoring the executive departments must meet certain criteria.[356] The executive departments must regularly report to the board and the committee.[357] However, the board and the committee may, instead of establishing their own executive departments, delegate daily operational management to another FVCF.[358]

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[349] Art. 6(1), Ibid.

[350] Art. 7(2), Ibid.

[351] Art. 23(2), Ibid..

[352] Art. 7, Ibid..

[353] Art. 17, Ibid.

[354] Art. 17, Ibid.

[355] Art. 18, Ibid.

[356] Art. 19, Ibid.

[357] Art. 20, Ibid.

[358] Art. 21, Ibid.

In a legal-person FVCF, all the shareholders assume limited liability for the debts of the FVCF.[359] In a non-legal-person FVCF, the RI assumes unlimited liability, and she shall undertake joint liability when the assets of the FVCF are insufficient to meet its obligations.[360] Thus, when an FVCF becomes insolvent, its creditors can have recourse to the RI's own personal assets.[361]

#### 2.2.2.1.3 Business Scope and Term of FVCFs

Foreign VC investors are limited in terms of business scope when they conduct business in China. An FVCF may use up to 100% of its paid-in capital for VC investment, including setting up new ventures, investing in existing start-ups, and accepting transfer of other investors' shares of existing start-ups.[362] An FVCF may also provide business start-up advice as well as management consultation services to its ventures.[363] China prohibits an FVCF from engaging in some activities which can be done by their Chinese counterparts. For example, foreign VC investors cannot invest in some Chinese industries which are prohibited to be invested by foreign investors.[364] Foreign VC investors may not trade public shares and corporate bonds. Nor may they own real estate except for their own use.[365] An FVCF cannot provide capital, loans, or securities to other firms.[366] That means an FVCF cannot be a "fund of funds" in China which can be taken by DVCFs.[367]

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[359] Art. 4, Ibid.

[360] Ibid.

[361] Art. 38, PRC FVCP.

[362] Art. 31(1), Ibid.

[363] Art. 31(2), Ibid.

[364] Art. 32, Ibid.

[365] Ibid.

[366] Ibid.

[367] Ibid.

In the contrast with DVCFs, whose term should not be less than seven years,[368] as is discussed in the following section, the term of an FVCF may not exceed twelve years and is renewable subject to the approval of the approval authorities.[369]

#### 2.2.2.1.4 Foreign-Invested Venture Capital Limited Partnership

The 2006 PEL allows foreign enterprises or individuals to establish partnership enterprises in China. The law gives authority to the State Council to make such administrative measures as are necessary to govern foreign-invested partnership enterprises.[370] The State Council finally promulgated the 2009 FIPM on November 25, 2009. The regulation came into force on March 1, 2010.[371] The 2009 FIPM makes some rules affecting VC industry, most of which relax the strict legal requirements on establishing FIP in China. But the regulation fails to give a final answer to foreign VC investors on how to set up FLP VC funds in China. There is no prior approval requirement by MOFCOM for establishing an FIP in China. The most remarkable feature of the 2009 FIPM is that the application process for setting up an FIP is, unlike any other FIE forms in China, which are still required to get governmental approval for establishment, the same as its Chinese counterparts.[372] Some scholars point out that the 2009 FIPM represents an attempt to change the foreign investment approval system which has been applied for over thirty years.[373] Foreign investors could set up a new FIP or acquire an existing domestic partnership via mergers and acquisitions.[374] That means an FIP could be a wholly FIP or a joint partnership, which has both foreign partners and Chinese partners.[375]

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[368] Art. 19, 2005 DVCM.

[369] Art. 37, 2006 FVCP.

[370] Art.108, 2006 PEL.

[371] Art. 16, 2009 FIPM.

[372] Li (2009).

[373] Wang & Chen (Feb. 2010: 15).

[374] Art. 2, 2009 FIPM.

[375] Wang & Chen (Feb. 2010: 15).

The Chinese government removes the restriction that a foreign investor can only contribute its RMB capital in a new domestic investment from limited sources, including dividends or the interests of share transfer.[376] Now any "legally obtained RMB proceeds" of foreign investors are allowed to be invested in an FLP.[377] Further, China offers more flexible mechanisms to foreign VC investors on the ways of making capital contributions. The 2009 FIPM does not require a minimum capital or schedule of contribution for establishing an FIP.[378] Thus, foreign investors enjoy the same freedom on capitalizing LPs as their Chinese counterparts already have. But the bad news is the 2009 FIPM requires that foreign investors only contribute in cash.[379] In contrast, a Chinese investor of the domestic limited partnership VC firm could contribute in cash, intellectual property rights, land use rights, or other assets.[380] It is clear that stricter capital rules are applied to foreign investors.

The promulgation of the 2009 FIPM signals that China is in the process of setting up a legal framework that allows foreign VC investors to establish onshore foreign-invested VC funds through FIPs. However, in the meantime, the provisions of 2009 FIPM also prove that China will not give up its strict control over foreign investment in the near term.[381]

#### 2.2.2.2 Domestic VC Firms

##### 2.2.2.2.1 Introduction

The 2005 DVCM was jointly promulgated by ten ministries and commissions on November 15, 2005 and took effect on March 1, 2006.[382] The material provisions of the 2005 DVCM correspond to the 2003 FVCP. However, the 2005 DVCM mainly governs

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[376] Broad & Bright Law Firm (2009).

[377] Art. 4, 2009 FIPM.

[378] Broad & Bright Law Firm (2009).

[379] Art. 4, 2009 FIPM.

[380] Art. 1, 2005 DVCM, and Art. 27, PRC Company Law.

[381] Wang & Chen (2010: 17).

[382] See PRC NDRC Order No. 39.

the formation and operation of VC firms that involve no foreign investment.[383] But, if the FVCFs could meet the relevant conditions, such firms may "enjoy the relevant policy support granted to startup investment enterprises under these Measures."[384] Unfortunately, up till now, the scope and contents of "the relevant policy support" have not been clarified. The 2005 DVCM reflects a broad governmental policy to cultivate China's VC industry, particularly in the technology sectors.[385] Among other things, the legislation shows that China wishes these VC firms could be established to invest in onshore ventures and that preferential tax policies will be adopted to support these onshore ventures.[386] The legislation represents a positive step forward in the development of China's VC industry.

In China, VC investment is also called "start-up investment."[387] The term "start-up investment" means "any stock right investments that are injected into a start-up enterprise[388] in expectation of capital gains mainly by way of stock right transfer after the invested startup enterprise becomes mature or relatively mature."[389] Correspondingly, domestic VC enterprises are called "startup investment enterprises."[390] This term refers to an "enterprise organization registered and established within the territory of the People's Republic of China for the purpose of mainly engaging in startup investment activities."[391] DVCFs are classified into several types: Chinese LLC, joint stock company, or other business organizations under

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[383] Art. 2, 2005 DVCM.

[384] Art. 5, Ibid.

[385] Art. 1, Ibid.

[386] Art. 23, Ibid.

[387] Art. 2, Ibid.

[388] The term "start-up enterprise" refers to "any growing enterprise registered and established within the territory of the People's Republic of China that is during the course of establishment or re-establishment, excluding those enterprises that have got listed in the open market." See Art. 2, Ibid.

[389] Art. 2, Ibid.

[390] Ibid.

[391] Ibid.

Chinese laws.[392] The 2006 PEL also gives DVCFs an option to be organized in the limited partnership form.

#### 2.2.2.2.2 Legal Forms of DVCFs

**1) Corporation**

As discussed in Section 1.4.3.1, before the 2006 PEL was revised in 2006, all DVCFs had to be organized as Chinese LLCs or joint stock companies[393] under the PRC Company Law.[394] The DVCFs created in these legal forms can enjoy limited liability as the independent enterprise legal person.[395] Today, some big state-owned DVCFs are still organized as Chinese LLC or joint stock company. For example, Beijing High Technology Venture Capital Company,[396] the first VC firm in Beijing, is a big state-owned joint stock company set up by some famous SOEs.[397] Shenzhen High Technology Investment and Guaranty Company[398] is one of the biggest VC firms in China with a Chinese LLC structure.[399] Therefore, understanding the PRC Company Law is a premise to discuss China's VC legal framework. Furthermore, it is generally accepted that PRC Company Law has played an important role in restructuring SOEs and in improving the business environment in China.[400]

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392 Art. 6, PRC DVCM.

393 This type of company is also called as company limited by shares in China. For the purpose of the study, this type of company will be cited as "joint stock company" under discussing PRC laws and the U.S. laws.

394 Art. 2, PRC Company Law.

395 Art. 3, Ibid. In comparison, a Chinese LLC is equivalent to a private company or so-called "closed company" which is popular in the U.S., but is different from an LLC in the U.S. (See Gu (2006: 9)). A Chinese joint stock company is equivalent to a joint stock company in the U.S.

396 The Chinese name is 北京高新技术创业投资股份有限公司

397 The shareholders of the VC firm include Beijing Energy Investment Holding Group (北京能源投资（集团）有限公司), National Development and Investment Company (国投高科技投资有限公司), and other biggest state-owned companies of China. More details are at http://www.bhti.com.cn/aboutus.asp?id=95.

398 The Chinese name is 深圳市高新技术投资担保有限公司.

399 See the website of the company at http://www.szhti.com.cn/c/portal/layout?p_l_id=PUB.1012.2.

400 Gu (2006: Preface).

Chinese law imposes some restrictions on the number of shareholders. A Chinese LLC must be jointly invested in and incorporated by not less than one and not more than fifty shareholders.[401] According to the general rules in China, there are two types of joint stock companies, non-listed joint stock companies and listed companies.[402] A non-listed joint stock company must not have less than two and not more than two hundred shareholders.[403] Non-listed joint stock companies should register with the CSRC and transfer to a listed joint stock company if it issues shares to more than two hundred specified buyers.[404] Chinese VC rules follow the requirements of the PRC Company Law. It is emphasized that the numbers of investors in a Chinese VC LLC must not exceed fifty persons and that the VC joint stock company must have less than two hundred shareholders (there is no listed VC company in China).[405]

The procedure for establishing a Chinese VC LLC is different from that for establishing a VC joint stock company. To be more specific, a Chinese VC LLC can only be established by adopting a "promoter method", which means that the registered capital of this type of company must be wholly contributed by the promoters,[406] whilst VC joint stock companies may be established by either a promoter method or a share offering method.[407] If a DVCF wishes to go to public in the future, the firm should be organized as a VC joint stock company, for it is the only legal form that the PRC Company Law allows to be used for raising capital from the public.[408] The difference makes it complex for investors, including VC investors, to launch their business in China. They have to spend more time and cost on researching different requirements and results on the basis of the different procedures.

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401 Art. 24, PRC Company Law.

402 Art. 79, and Art. 120, Ibid.

403 Art. 79, Ibid.

404 Art. 10, PRC Securities Law.

405 Art. 9, 2005 DVCM.

406 Art.26, PRC Company Law.

407 Art. 78, Ibid.

408 Art. 78 & Art. 145, Ibid.

On the other hand, the requirements for capital contribution for establishing a common Chinese LLC or a joint stock company were amended in 2005. A common Chinese LLC can now be set up with a minimum amount of RMB30,000 registered capital.[409] The minimum capital requirement for a joint stock company is RMB5 million.[410] VC firms must meet other minimum capital requirements the law prescribes for VC firms.[411] For example, the 2005 DVCM increases the requirements for capital contribution of a Chinese VC LLC or a VC joint stock company to no less than RMB30 million, and the down payment of the company's capital contribution shall not be less than RMB10 million.[412] Further, all shareholders of the VC company should promise to pay the "balance of actual capital contribution in a sum of not less than RMB30 million within five years after the registration."[413] The minimum capital contribution of each shareholder of the VC company shall not be less than RMB1 million.[414] The PRC Company Law allows, in general, shareholders to make capital contributions in currency or in kind.[415] But the 2005 DVCM insists that "all investors shall make investments in monetary form."[416] It is clear that Chinese law imposes stricter requirements on these "financial" firms.

2) **Limited Partnership**

Prior to the 2006 PEL, all partners in a partnership enterprise had to be natural persons, and there was no provision for the creation of limited partnerships.[417] Thus there was only one type of partnership enterprise, the general partnership, in China before 2006. One scholar spoke for many by suggesting that China should "legally recognize limited partnership and develop laws that specify the rights and obligations of the general

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409 Art. 26, Ibid.

410 Art. 81, Ibid.

411 Art. 81, PRC Company Law.

412 Art. 9, 2005 DVCM.

413 Ibid.

414 Ibid.

415 Art. 27, PRC Company Law.

416 Art. 9, 2005 DVCM.

417 Art. 30, PRC GPCL, and Art. 5, 1997 PEL.

partners and limited partners" in order to support the development of VC industry.[418] Now, following the most recent amendment of the 2006 PEL, a VC firm can be organized as a limited partnership.[419] The 2006 PEL, adopted by the Standing Committee of the NPC on August 27, 2006, and became effective on June 1, 2007,[420] makes the new limited partnership form accessible for VC investors.

Pursuant to the 2006 PEL, partners in partnership enterprises are generally divided into two groups: GPs and LPs.[421] The classification is very important for VC projects. As mentioned, the LP is a key component of the U.S. VC legal framework. Before the enactment of the 2006 PEL, Chinese VC firms could only be established as either a Chinese LLC or a joint stock company. The incorporated structure might not be flexible enough to attract more non-VC investors to become involved in VC investment because of the tax and capital contribution restrictions. The 2006 amendment provided that natural persons, legal persons, and other organizations may establish limited partnership enterprises.[422] That is to say, legal persons and organizations are allowed to become partners in a limited partnership. However, China still forbids wholly state-owned companies, state-owned enterprises, listed companies, and public service entities or social communities to serve as GPs.[423] This should mean that corporations or individuals may be the GPs in a domestic VC limited partnership. In practice, however, registration offices might refuse to approve applications to set up a limited partnership when a Chinese LLC or joint stock company, rather than an individual, is named as the GP of the partnership. "There is a gap between the law and the practice," Ms. Qiu Dan, the manager of the Shenzhen Green Pine Venture Capital Limited Partnership, has explained, "since the 2006 PEL does not clearly stipulate that corporations can be the

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418 Fu (2001: 527).

419 The legal history of Chinese partnership form can be divided into three stages. The first stage is from 1986 to 1997 before the adoption of PRC Partnership Enterprise Law. The second stage is from 1997 to 2006 when PRC Partnership Enterprise Law ("PEL1997") was promulgated in 1997. The third stage is from 2006 to present with the promulgation of PEL2006.

420 See the Order of the President of the People's Republic of China (No.55, August 27, 2006).

421 Art.2, 2006 PEL.

422 Art.2, Ibid.

423 Art.3, Ibid.

GPs in limited partnerships, the local registration offices prefer to require all applicants of GPs to be individuals, so as to avoid the problem of the 'veil of company'." She added, "The legal culture of China is not people can do everything which is not prohibited by law, but rather people can only do the things which are expressly allowed by law. It is the reason why the GP of our VC firm has to be the individual."

Institutional investors are encouraged to invest in the Chinese VC industry. For instance, the NSSF has been approved to participate in private equity and VC funds up to 10% of the total assets of the funds.[424] Thus, the limited partnership form is the legal structure best suited to meet the needs of such non-VC investors in China. Further, when compared with the general partnership,[425] a limited partnership can be established by at least one GP and one LP.[426] In a limited partnership, the GP's legal liabilities are the same as those of a general partnership, while the liabilities of LPs are limited to the capital to which they contribute the limited partnership.[427] Professional VCs are encouraged to manage the day-to-day business and investment in a VC limited partnership without making a significant capital contribution. Other non-VC investors could only bear limited risks arising from VC investment. In reality, the LPs could set up an advisory board which has "negating" authority to review and veto the decisions of GPs pursuant to terms that could be agreed between the two parties.[428] LPs and advisory bodies cannot, however, take part in management, even "passively," or they will have to bear unlimited liability for these activities. The changes encourage more capital and people to become involved in China's VC industry, but also leave the LPs with the question of how best to protect their investments and fund their 's best interests when the GPs manage several other VC funds at the same time. The LPs typically use non-compete agreements to prevent the GPs management from diverting resources to different VC funds. They will require the GPs to balance the different investment

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424 See the website of NSSF at http://www.ssf.gov.cn/xxgk/zhzw/gzdt/200904/t20090427_881.html.

425 Art.2, 2006 PEL.

426 Art.61, Ibid.

427 Art. 2, Ibid.

428 Han (2006).

opportunities among all funds and forbid them to disclose the relevant fund's confidential information to other funds or other shareholders.[429] Obviously, such agreements cannot fully remove the risks of diversion of opportunities and insider trading. The problem of insider trading is always a risk during the VC investment.

In theory, a VC limited partnership could enjoy preferential taxation. It is provided under 2006 PEL that "for the production and business operation incomes and other incomes of a partnership enterprise, the partners shall pay their respective income tax in accordance with the relevant tax provisions of the state."[430] That means there is no taxation at the partnership enterprise level which should be had at corporation level. All profits generated by the partnership enterprise will be "passed-through" and be attributed to the partners.[431] This privilege encourages VC firms to take the form of the limited partnership rather than that of the corporation in order to avoid additional taxation. The taxation of VC firms is discussed in the following section.

A comparison of VC company and VC limited partnership is as follows:

| | **VC Company** | | **VC Limited Partnership** |
|---|---|---|---|
| | **Chinese LLC** | **Joint Stock Company** | |
| **Number of Initiators** | **Less than 50** | **Less than 200** | **2-50** |
| **Requirements on Capital** | Paid-in capital ≥ RMB30 M<br>Individual investment ≥ RMB100 M contribution in currency | | Paid-in capital ≥ RMB30 M<br>Individual investment ≥ RMB100 M contribution in currency |
| **Assumption of Risks** | **Limited liability within the amount of contribution** | | **GP: unlimited liability**<br>**LP: limited liability** |
| **Stipulation on Management** | Equal rights for equal shares.<br>Entrusted administration by agreements | | GP has more power in management and decision making |
| **Distribution of Profits** | **According to the ratio of contribution or to the cost (by agreement)** | | **Proportion as agreed** |
| **Tax Burdens** | Enterprise income tax | | Levying income tax on the partners' |

429 Ibid.

430 Art. 6, Ibid.

431 Han (2006).

| | Individual income tax | income only |
|---|---|---|
| **Applicable Laws** | **PRC Company Law, DVCM, FVCFP** | **PEC2006, DVCM, FVCFP** |

**2.2.2.2.3 Management, Investment, and Governmental Support**

When managing the DVCFs, the GP must have at least three sophisticated senior managers[432] who have two or more years experience selecting investments for a VC firm, to take charge of the VC investment and management.[433] If the GP entrusts another DVCF or a domestic VC consulting firm as a management consultant to undertake its VC investment and management, this consultant shall also have at least three sophisticated senior managers who have two or more years investing experience of a VC firm to undertake the VC investment and management.[434] A DVCF could set up other VC firms, including establishing a new firm or investing in an existing firm through share participation,[435] or conduct business as a VC consulting agency for other VC firms,[436] i.e. the form of "fund of funds" therefore does exist in China.

A DVCF faces less legal restrictions than those facing an FVCF. A DVCF cannot conduct any guaranty business or real estate business except for self-use purposes.[437] Though a DVCF may make investments with all its capital, such investments must be limited to non-listed corporations.[438] That means a DVCF can not trade stocks on stock exchanges. Further, the investments made by a DVCF into a single enterprise must not exceed 20% of the total capital of this DVCF.[439] The reason of the limitation is to reduce the risk of VC investment in a single firm. Moreover, whereas an FVCF cannot

432 The Art. 9 of the 2005 DVCM defines the "sophisticated senior manager" as "the managerial personnel who hold the position of deputy manager or higher positions or equivalent positions in the VC firm."

433 Art. 9(5), 2005 DVCM.

434 Art.9, Ibid.

435 Art. 6 and Art. 14, Ibid.

436 Art. 12, Ibid.

437 Art.13, Ibid.

438 Art.14, Ibid.

439 Art.16, Ibid.

make investment with other people's money[440] and is not allowed to borrow money from other institutions or individual in China, a DVCF could advance its capital by credit financing.[441] This situation widens the fundraising channels of the DVCFs.

The local governments can support VC development through governmental VC guiding fund programs. China encourages central and local governments to establish governmental VC guiding funds to support the development of VC firms and start-ups by the means of share participation and providing financing guaranty.[442] The 2008 NDRC Opinion No. 10 has set up governmental guiding funds to support start-ups and encourage private VC funds to invest in high-tech start-ups.[443] With governmental guiding funds, the governments may increase the supply of VC projects and encourage more and more private VC firms to invest in early stage start-ups.

### 2.2.3 Restrictions on Foreign-Funded Venture Capital

#### 2.2.3.1 Restrictions on Investment

##### 2.2.3.1.1 General

As mentioned, for nearly thirty years following the founding of PRC in 1949, China eschewed all foreign direct investment in its development. It was not until 1979 when China started to implement an "open-door" policy and promulgated laws to allow and encourage foreign capital to flow into China.[444] However, China implements its open-door policy on a selective basis. In other words, China has retained various restrictions on foreign investment.[445] China's accession to the WTO since the end of

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440 Art.32, 2003 FVCP.

441 Art.20, PRC DVCM.

442 Art. 22, Ibid.

443 Art. 1, 2008 NDRC Opinion No. 10.

444 Voss, Bucley, and Cross (2008: 1)

445 See the Opinions on Further Encouraging Foreign Investment at the Present Period, the Circular on Enlarging the Local Approval Power of Foreign Investment Projects in the Encouraged Category Requiring no National Comprehensive Balancing, the Interim Measures for the Administration of Examining and Approving Foreign Investment Projects (2004), and the Catalogue for the Guidance of Foreign Investment Industries (2007)

2001 has resulted in the increasing opening up of economic sectors to foreign investment, though certain sectors remain closed to foreign investments.[446]

It has been commonplace that two parallel legal regimes, with one for domestic enterprises and the other for FIEs, co-exist in China. As for the industries in which VCs are allowed to invest there is, in theory, almost no limitation for DVCFs. The only exception in the 2005 DVCM is that "the VC enterprises shall not engage in guaranty business and realty business, except for purchasing real estate for self-use."[447] But FVCFs face a series of limitations on VC investment in China's industries. The FVCFs should follow the guidance of both the 2002 Provisions on Guiding the Orientation of Foreign Investment (PGOFI) and the 2007 Industry Catalogue to conduct their investment.[448]

China promulgated the Interim Regulation on the Guidance of Foreign Investment Direction,[449] which was repealed and replaced by the 2002 PGOFI in 2002, and by the 1995 Industry Catalogue in 1995.[450] These rules present a clearer picture of the Chinese government's policies as to foreign investors' involvement in various industries. Subsequently, the 1995 Industry Catalogue was amended, respectively, in 1998,[451] 2002,[452] 2005,[453] and 2007,[454] reflecting China's seeking of balance between pursuing high economic growth backed by foreign investment, including VC investment, on the

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446 See the Industries Catalogue (2007).

447 Art. 13, 2005 DVCM.

448 Art. 39, 2003 FVCP.

449 The regulation was promulgated by the State Council on June 7, 1995.

450 The Industry Catalogue was promulgated by Decree No.5 of the State Planning Commission, the State Economic and Trade Commission and the Ministry of Foreign Trade and Economic Cooperation on June 20, 1995.

451 The 1998 Amendment was approved by the State Council on Dec.29, 1997, and for trial implementation since Jan.1, 1998.

452 The 2002 Amendment was promulgated by Decree [2002] No.346 of the State Council and entered into force on April 1, 2002.

453 The 2005 Amendment was promulgated by the State Development and Reform Commission, the Ministry of Commerce on Nov. 30, 2004.

454 The 2007 Amendment was promulgated by Decree [2007] No. 57 of the State Development and Reform Commission, the Ministry of Commerce of the PRC and came into force as of December 1st, 2007. The Catalogue as promulgated by the former State Development Planning Commission and the Ministry of Commerce on March 30, 2004 shall be annulled at the same time.

one hand, and the concerns of national economic security on the other hand. The current version of the 2007 Industry Catalogue became effective as of December 1, 2007. It retains the classification methodology and organizational structure used in the previous versions without significant changes.[455]

The 2002 PGOFI provides for a general description and differentiation in the treatment of different categories.[456] The 2002 PGOFI and the 2007 Industry Catalogue are the primary legislation governing foreign investments in different economic sectors in China.[457] To be more specific, the 2002 PGOFI and the 2007 Industry Catalogue divide foreign investments into four categories: encouraged category,[458] permitted category, restricted category,[459] and prohibited category.[460] These regulations should be reviewed carefully by foreign VC investors before making any investment decision. VC investors must ensure that proposed projects do not fall within the "prohibited" category.[461] Furthermore, specific classification of foreign investment projects under the 2007 Industry Catalogue is one of the major criteria for determining whether such projects will benefit from any customs duty and related tax exemption.

There are various incentives and preferential treatments for "encouraged" projects, mainly tax exemptions and rebates.[462] Most foreign VC projects in the "encouraged" sector are allowed to take the form of WFOE.[463] Encouraged industries include agriculture, energy, transportation and important raw material industries. Sectors not listed in the 2002 PGOFI belong to the "permitted" category.[464] Like those in the

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455 See the Industries Catalogue (2007).

456 Art. 1, 2002 PGOFI.

457 Art. 3, Ibid.

458 Art. 5, Ibid.

459 Art. 6, Ibid.

460 Art. 4, Ibid.

461 Art. 2, Ibid.

462 Art. 9, Ibid.

463 Art. 8, Ibid, the 2007 Industries Catalogue, and the Catalogue of Encouraged Foreign Investment Industries.

464 Art. 4, 2002 PGOFI.

"encouraged" sector, foreign VC projects in the "permitted" sector are allowed to take the form of WFOE.[465] However, they are generally not eligible for extra incentives and preferential treatments except in the case that they will be investing in the mid-west territory of China.[466] There are stricter approvals or filing requirements for "restricted" projects.[467] Furthermore, foreign VC projects in the "restricted" sectors may be required to take the form of JV.[468] Foreign VC investors may only hold a minority interest in the investment projects.[469] Foreign investment, including VC investment, is not allowed in the sectors falling into the prohibited category.[470] These sectors include, "a) those that jeopardize national security or harm the public interest, b) those that cause pollution damage to the environment, destroy natural resources or damage human health, c) those that occupy large tracts of cultivated land or are disadvantageous to the protection and development of land resources, d) those that jeopardize the security or efficient use of military installations, e) those that, in the production of products, apply techniques or technologies that are unique to China, or f) those that are otherwise provided for in laws and administrative regulations of the State."[471]

While access to many industries remains heavily restricted, the changes in the 2007 Industry Catalogue as a whole are positive and encouraging. Manufacturing of railway transportation equipments and operation of electricity grids, with carve-outs, are now open to foreign investment. Although the 2007 Industry Catalogue provides no major changes other than those required to give effect to China's commitments to the WTO protocol, the 2007 Industry Catalogue has been made substantial amendments to the 2002 Industry Catalogue and has liberalized many sectors.

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465 Art. 8, Ibid.

466 Art. 9 and Art. 11, Ibid.

467 Art. 10 and Art. 12, Ibid.

468 Art. 8, Ibid, the 2007 Industry Catalogue, and the Catalogue of Restricted Foreign Investment Industries.

469 Art. 8, 2002 PGOFI.

470 Art. 7, Ibid, the 2007 Industry Catalogue, and the Catalogue of Prohibited Foreign Investment Industries.

471 Art. 7, 2002 PGOFI.

#### 2.2.3.1.2 Restricted Industries for Foreign Venture Capital Investment

Some of the "restricted" industries and sectors that are potentially attractive to and favored by foreign VC investors[472] are described in greater detail below.

Although participation by foreign investors is limited to EJVs and CJVs only, the operation of institutions of higher education falls within the "encouraged" category.[473] The operation of high school level educational institutions falls within the "restricted" category and participation by foreign investors is also limited to the EJVs and the CJVs only.[474] The operation of basic or compulsory educational institutions falls within the "prohibited" category and participation by foreign investors remains prohibited.[475] The specific governing authority of this sector is the Ministry of Education of China.[476]

Foreign-invested wholesale enterprises must not engage in the distribution of tobacco.[477] Also, foreign-invested wholesalers may not engage in the distribution of salt.[478] Furthermore, unlike domestic enterprises, foreign-invested wholesale or retail enterprises are generally required to have a limited operational term of thirty years, but it may be extended to forty years if they are set up in the central and western regions.[479] The specific governing authority of this sector is MOFCOM.[480]

The permitted investment vehicle in the telecom industry for foreign investment is the EJV.[481] The restricted services that can be offered by an EJV include basic telecom services and value-added services.[482] In respect of basic telecom services, a

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472 Lexsina (2006: 4).

473 The 2007 Industry Catalogue, and X.1, the Catalogue of Encouraged Foreign Investment Industries.

474 Ibid, and XII, the Catalogue of Restricted Foreign Investment Industries.

475 Ibid, and IX.1, Ibid.

476 See the website of the Ministry of Education at www.moe.gov.cn.

477 Art. 17, the Measures for the Administration of Foreign Investment in the PRC Commercial Sector.

478 Ibid.

479 Art. 7, Ibid.

480 Art. 5, Ibid.

481 Art. 2, the Administration Provisions of Foreign-funded Telecommunications Enterprises.

482 Art. 4, Ibid.

provincial-level foreign-invested telecom enterprise is required to have a minimum registered capital of RMB2 billion,[483] whereas the minimum for a municipal-level foreign-invested telecom enterprise is RMB200 million.[484] In respect of value-added services, the minimum registered capital of RMB10 million is required for a provincial-level foreign-invested enterprise[485] and the minimum of RMB1 million is required for a municipal-level foreign-invested enterprise.[486] Internet activities fall into the scope of value-added telecom services.[487] The restrictions described above, as far as they relate to value-added telecom services, are applicable to the internet sector. The specific governing authorities of this sector are the Ministry of Information Industry of China and the Ministry of Culture of China.[488]

The advertising industry is also a restricted industry for foreign VC investors. In the advertising industry,[489] foreign-invested advertising enterprises could be organized as EJVs, CJVs, or WOFEs.[490] However, the establishment of a foreign-owned advertising company is subject to more stringent and restrictive approval procedures.[491] The specific governing authority of this sector is the SAIC.[492]

Foreign investment in real estate also falls within the "restricted" category.[493] In an effort to restrict the inflow of foreign "hot money" into the Chinese real estate sector

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[483] Art. 5, Ibid.

[484] Ibid.

[485] Ibid.

[486] Ibid.

[487] Art. 1, the Circular on Intensifying the Administration of Foreign Investment in Value-added Telecommunications Services.

[488] Art. 5, the Administration Provisions of Foreign-funded Telecommunications Enterprises.

[489] The Administration of Foreign-invested Advertising Enterprise was promulgated by the State Administration for Industry and Commerce and the Ministry of Commerce on March 2, 2004 and effective as of date of promulgation.

[490] Art. 2, the Administration of Foreign-invested Advertising Enterprise.

[491] The conclusion can be made by comparing Art. 6 and Art. 7 of the Administration of Foreign-invested Advertising Enterprise.

[492] Art. 4, the Administration of Foreign-invested Advertising Enterprise.

[493] See the 2007 Industries Catalogue, and Sec. VIII, the Catalogue of Restricted Foreign Investment Industries.

and prevent property speculation, the Chinese government has introduced various substantive and procedural restrictions.[494] Such restrictions include the requirement of "commercial presence" of a foreign-invested real estate enterprise in China before it can make acquisition of any real property, a higher debt to equity ratio than for investments in other sectors, and tightened approval and registration procedures.[495] In particular, "development of houses for residence" was removed from the "encouraged" category to the "restricted" category whilst the "second-hand transaction and real estate intermediary or agent company" was added to the "restricted" category in the 2007 Industry Catalogue.[496] The specific governing authority of this sector is the Ministry of Land and Resources of China.[497]

#### 2.2.3.1.3 Examination and Approval of Foreign Venture Capital Investment

China sets up the examination and approval procedures to monitor and control foreign VC investors' investment. The FVCFs must, when investing in any start-ups falling within an encouraged or permitted category, go through examination and approval procedures for record with the local authorities.[498] The local authorities must, within fifteen days after receiving the forgoing materials for record, finish the examination and approval procedure, and must issue a certificate of approval to the FVCFs.[499] If a VC firm determines to invest in a start-up of restricted category, it must apply to the relevant local authorities at the provincial level by providing a series of materials, including a statement of sufficient investment fund, certificate of approval for VC firms, business license, contract on the start-up to be invested, signed by the VC firms (and other investors of the start-up), and the articles of association.[500] The authorities should, within forty five days of receiving such application, communicate their approval or

494 Art. 1(4), the Opinions Concerning Regulating the Access to and Administration of Foreign Investment in the Real Estate Market.

495 Art. 3(10), Ibid.

496 See the 2007 Industries Catalogue, and Sec. VIII, the Catalogue of Restricted Foreign Investment Industries.

497 See the website of MLR at http://www.mlr.gov.cn/mlrenglish/about/mission/.

498 Art. 40, 2003 FVCP.

499 Art. 40, Ibid.

500 Art. 41, Ibid.

disapproval in written form.[501] If the application is approved, a certificate of approval for foreign-invested enterprises must be issued to the FVCF.[502] The start-up must apply for the registration with the reply for approval and the certificate of approval for foreign-invested enterprises.[503] The registration authorities will determine to accept or refuse such application. If the application is approved, a business license for foreign-invested ventures will be issued.[504]

As to the examining requirement, it depends on the amount of capital and the investment categories. Firstly, foreign VC investors should obtain approval from the NDRC if they wish to invest in the encouraged category or permitted category with a total investment of $100 million or more. The same department will also review the foreign VC investments if such investors will invest in the restricted category with a total investment of $50 million or more.[505] The State Council will examine the application if the amount increases to $500 million and $100 million respectively.[506] Secondly, the examination authority moves to the local governments if the amount of such investment is less than $100 million or $50 million respectively.[507]

**2.2.3.1.4 Mergers and Acquisitions for Foreign Venture Capital Investment**

In addition to setting up their own ventures, foreign VC investors also seek various alternate possibilities, such as taking over existing domestic start-ups through M&A. Though rather new in China, M&A transactions have recorded explosive growth since 1995.[508] There is no regulatory hurdle for domestic VC investors to take over a domestic enterprise. But with the increase of M&A transactions in China, more and

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501 Ibid.

502 Ibid.

503 Ibid.

504 Ibid.

505 Art. 3, the Interim Administration Measures on Examining and Approving Foreign-invested Projects.

506 Ibid.

507 Ibid.

508 Wolff (2008: 1).

more rules regulating foreign VC investor's M&A activities have been promulgated in recent years.

The early legal framework for foreign-backed M&A structure was established by the PRC FIE laws.[509] In 1994, a new M&A legal system was created by the PRC Company Law.[510] In recent years, the Chinese government has passed a series of specific measures governing foreign VC investors M&A transactions which can be classified as follows.

The M&A transactions in China may be consummated through an equity purchase or an asset acquisition. The various transactions involving different types of target entities may incur different concerns and be governed by different rules.[511] The acquisition method will depend on various considerations such as the financial conditions of the target companies, the required governmental approvals, the transaction time, and the tax consequences of the structure.[512]

**1) Equity Interests Transactions**

In an equity interest M&A transaction, the VC investor may acquire equity interests in a target venture from existing shareholders.[513] Equity interests M&A transactions provide a good establishment for VC investors, as they entail an existing operation vehicle, business, asset and skilled staff.[514] Investors can enter into the market in an easier and quicker manner with this structure. Furthermore, in many cases, the reputation of the target venture will have a fundamental value for the VC investors, including trade name, sales network, client base, and market share.[515] The easiest way to buy an existing venture is to purchase part or all of its equity interests, and thus, all existing business

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509 See FIE laws.

510 See the repealed 1994 PRC Company Law.

511 Wolff (2008: 12-14).

512 Wolff (2008: 23).

513 Zhang (2007: 2-3).

514 Horn (2001: 5).

515 Stamdford Law Corporation (2006: 34).

and contracts are automatically continued and inherited if not restructured.[516] However, risks and negative aspects of equity interests should also be considered by VC investors when choosing the method since the proposed foreign-invested venture to be converted from the target will normally inherit all of the liabilities and responsibilities of the target.[517]

**2) Assets Deal**

The M&A transaction may also be structured as an asset acquisition for VC investors. In this case, the acquirer may purchase selected assets and liabilities, excluding the trade name, sales network, client base, and market share of the target enterprise.[518] The most essential advantage of an asset deal is that it enables the investors to select the most viable assets from the whole bulk, without taking over the accumulated debts and liabilities.[519] However, although an asset transaction may enable the foreign VC investor to get rid of unwanted assets and liabilities, if this is to happen, agreements with the relevant creditors of the target venture are required as the precondition.[520] Another issue is about tax efficiency.[521] Transfer of assets is subject to business tax depending on the type of assets.[522] Thus, an asset deal may be more costly than a share acquisition due to the additional tax burden.[523]

**3) Targets of M&A**

Based on the 2006 MOFCOM Provision No. 10, only Chinese companies organized in the form of a Chinese LLC or joint stock company are directly qualified to be the target of an equity interest M&A transaction involving foreign investment.[524] Other entities

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[516] Wolff (2008: 57).

[517] Zhang (2007: 5).

[518] Bristol (1998: E1.3).

[519] Tan (2003: 2)

[520] Wolff (2008: 57).

[521] Ibid.

[522] Ibid.

[523] Ibid.

[524] Art. 72 and Art. 138, PRC Company Law.

such as "wholly people-owned enterprises" or "collectively-owned enterprises" are not yet adequate for directly introducing foreign VC investors into an equity interest acquisition.[525] However, there is no restriction on what type of target an asset transaction can accommodate.[526] In other words a Chinese venture that is not organized in the form of a Chinese LLC may also act as the vendor of the target asset in an asset transaction.

If the foreign VC investor wants to take over an SOE, the proposed M&A deal must first be approved by the relevant authorities.[527] Generally, the 1998 PARSOEUFI promulgated in 1998 provides that projects involving large SOEs or existing plants of "extra-large" scale have to be approved by MOFCOM and the department in charge of the domestic enterprise.[528] Projects above $100 million have to be approved by the State Council while those below $30 million may be approved locally.[529] The local approvals must be sent to MOFCOM for record.[530] For projects with a capital amount of between $30 million and $100 million, approval must be obtained from the local authorities.[531] After such approvals are obtained, MOFCOM and its local agencies will then approve the joint venture contract and articles of association.[532]

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525 Art. 2, the Administration of Transfer of State-owned Property Rights of Enterprises Tentative Procedures,

526 Art. 2, the Tentative Provisions on Asset Reorganization by State-owned Enterprise Using Foreign Investment & Art. 3, the Tentative Provisions on Using Foreign Investment to Reorganize State-owned Enterprise.

527 Art. 5, Ibid, also see Art. 5, the Circular on the Transfer of State-owned Shares and Legal Person Shares in Listed Companies to Foreign Investors, Art.5, and Art. 8, the Tentative Procedures of Transfer of State-owned Property Rights of Enterprises.

528 The Tentative Provision was promulgated by the State Economic and Trade Commission ( the Commission has been mergered into MOFCOM) on, and effective as of, Sept. 14, 1998. Art. 5, 1998 PARSOEUFI.

529 Art. 5(1), 1998 PARSOEUFI.

530 Art. 5(2), Ibid.

531 Art. 5(3), Ibid.

532 Art. 3, PRC EJVs Law.

According to the 1997 PCEIFIE and the 2001 MDFIEP (Revised),[533] which should firstly apply to the M&A transactions of FIEs, a direct equity interest acquisition in an FIE requires the approval of the government that has originally approved the establishment of such FIE.[534] Furthermore, the consent of other shareholders of the target FIE must first be obtained and these shareholders will have statutory pre-emptive rights to acquire the target equity interests of the transferring shareholders on the same conditions as the bidder.[535]

**4) Compliance with the Industry Catalogue**

An acquisition of a FIE should comply with the 2007 Industry Catalogue.[536] It cannot take place if the original investors have either not made their capital contribution in full or provided their co-operation conditions in full in accordance with the contract and the articles of association, or if such a company has not commenced production or business.[537] The foreign VC investor should purchase at least 25% shares in the target venture.[538]

**5) Domestic Companies**

The 2006 MOFCOM Provision No. 10 was promulgated on August 8, 2006 and became effective on September 8, 2006. The 2006 MOFCOM Provision No. 10 sets up a restrictive system for foreign purchasers to acquire domestic companies. Four key features of the restrictions are as follows:

Firstly, the foreign acquirers should meet the basic approval requirements. Acquisitions of equity of domestic enterprises in China and assets of Chinese enterprises by foreign

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533 The 1997 PCEIFIE was promulgated by the Ministry of Foreign Trade and Economic Co-operation (the Ministry has been mergered into MOFCOM) and SAIC on, and effective as of, May 28, 1997. The 2001 MDFIEP (Revised) was promulgated by the Ministry of Foreign Trade and Economic Co-operation and SAIC in 1999, and was revised on Nov. 22, 2001.

534 Art. 3, 1997 PCEIFIE.

535 Art. 2, Ibid.

536 Art. 4, Ibid.

537 Art. 9, 2001 MDFIEP.

538 Art. 12, Ibid.

acquirers must be approved by MOFCOM.[539] The acquisition value must be appraised by an independent Chinese appraisal organization.[540] Secondly, the Chinese government tries to control the process of such private business. MOFCOM is now given broad authority to unwind transactions resulting in foreign "control" of a company in a "key industry," an industry that affects economic security or a company owning a well-known trademark or established Chinese brand.[541] Transactions that may result in such control must be reported to MOFCOM.[542] However, a definition of "control" is not included, and the concepts and procedures for the exercise of such "control" by foreign VC investors remain very unclear. Thirdly, it is impossible for Chinese entrepreneurs and their foreign VC investors to exit by launching an IPO abroad through a round-trip investment structure.[543] Round-trip investment structure which allows Chinese investors to hold shares in domestic companies through offshore vehicles becomes subject to new disclosure requirements.[544] Transactions under round-trip structure that avoid investment or foreign exchange controls are explicitly prohibited.[545] Further, there is no preferential treatment for round-trip investment anymore. When offshore companies with Chinese shareholders carry out acquisitions in China, the target company qualifies for the benefits of foreign-invested enterprises only if non-PRC shareholders make new capital contribution equal to at least 25% of the enlarged capital of the target company.[546] Fourthly, acquisitions through share swaps between the foreign acquirer and the domestic target are permitted.[547] However, the foreign acquirer must be a listed company or a SPV established by Chinese shareholders for the purpose of listing domestic assets.[548] A share swap must be completed within

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539 Art. 6 and Art. 10, 2006 MOFCOM Provisions No. 10.

540 Art. 14, Ibid.

541 Art.11and Art. 12, Ibid.

542 Ibid.

543 The definition and details of round-trip investment is discussed in Section 2.2.3.2.2.

544 Art. 9, 2006 MOFCOM Provisions No. 10.

545 Art. 11, Ibid.

546 Art. 9, Ibid.

547 Art. 27, Ibid.

548 Art. 28 and Art. 39, Ibid.

six months after MOFCOM approval if the foreign party is a listed company.[549] If the foreign party is an SPV, it must complete the share swap and its overseas listing within one year after approval.[550] If the deadline is not met, the MOFCOM approval becomes void.[551] Moreover, the offshore listing of the SPVs involved in the share swap must be approved by the CSRC.[552]

#### 2.2.3.2 Restrictions on Foreign Exchange

##### 2.2.3.2.1 General

Foreign VC investment into China through offshore holding companies experienced a slump during 2005. This is largely due to Chinese foreign exchange regulation before 2005 which set forth strict approval requirements. After China changed its strict foreign exchange policies after 2005, offshore financing was poised to re-commence at a faster pace in the 2006.

Foreign VC investors traditionally rely on the use of offshore holding companies as their Chinese investment vehicles. These are typically located in tax efficient jurisdictions such as Bermuda, the Cayman Islands, or the British Virgin Islands. As mentioned, rather than investing in a Chinese start-up directly, these VC investors commonly take their investment into the offshore holding companies and then use the companies to establish a foreign-invested venture in China to move ownership or control of domestic assets to the offshore holding companies and then go for offshore listing.

The year 2005 was a turning point in the legal environment for foreign VC investments in China. On January 24, 2005, SAFE promulgated the repealed 2005 SAFE Circular No.11, under which the establishment of offshore companies by Chinese entrepreneurs and the transfer of domestic equity for exchange of equity in offshore companies was

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[549] Art. 33, Ibid.

[550] Art. 45, Ibid.

[551] Art. 45, Ibid.

[552] Art. 40, Ibid.

made subject to mandatory approval and registration.[553] At the time, the repealed 2005 SAFE Circular No.11 was generally understood as the Chinese government's attempt to restrict the practice of "round-trip investment" by some Chinese who would transfer their capital to the offshore company, and then invest in China as foreign investment to enjoy the favorable tax treatments for FIEs.[554] It was not viewed as an attempt to regulate other purposes of using offshore holding structures for VC investors.

However, on April 21, 2005, SAFE promulgated the repealed 2005 SAFE Circular No. 29. This Circular set forth additional clarifications and rules for the implementation of the repealed 2005 SAFE Circular No. 11.[555] The repealed 2005 SAFE Circular No. 29, SAFE emphasized that if the offshore companies controlled by Chinese do not register with SAFE, SAFE will refuse to approve any foreign exchange business applications of the companies.[556] SAFE's intent was to protect state-owned assets and tax revenue. But another consequence is that the foreign-backed ventures could not be listed on overseas stock markets if their applications for setting up offshore companies through the red-chip model were refused by the SAFE. Many IPOs of domestic ventures on offshore stock exchanges were caught and put on hold because of the rejection of SAFE. These Circulars restricted and controlled foreign VC investment in China.

Since many VC firms complained of these rules, officials from SAFE soon met with representatives from VC and private equity funds, investment banks, and law firms, to discuss the impact of the above circulars.[557] The representatives suggested that SAFE could limit the application of the two Circulars to certain transactions, or could turn the approval requirement into a notice-based regulatory scheme.[558]

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553 Art. 2, repealed 2005 SAFE Circular No. 11.

554 Shen & Xin ed. (2006: 71).

555 Art. 4, 2005 SAFE Circular No. 29.

556 Art. 1 and Art. 6, Ibid.

557 http://biz.163.com/05/1020/14/20H13QLA00020QEV.html

558 Ibid.

After a few months of dialogue with these professionals, SAFE issued a new circular, the 2005 SAFE Circular No. 75 in October 2005. The new regulation removed some of the most stringent rules of the repealed 2005 SAFE Circulars No. 11 and No. 29 and laid down a revised set of guidelines regarding SAFE approval for "round-trip investment" transactions.[559] In 2007, SAFE added further detail to 2005 SAFE Circular No. 75 by a new official document, the 2007 SAFE Circular No. 106. This Circular provides for various procedures related to the establishment and registration of SPVs and round-trip investments by such SPVs.[560] The 2007 SAFE Circular No. 106 also provides for a retroactive registration mechanism to amend failures by Chinese persons to comply with the 2005 SAFE Circular No. 75.[561] It remains to be seen whether these detailed operating guidelines will meet SAFE's expectation to provide further guidance to foreign VC investors and their Chinese entrepreneurs.[562]

On August 29, 2008, SAFE issued the 2008 SAFE Circular No. 142, which further regulates the process of foreign capital used by ventures in China.[563] The 2008 SAFE Circular No. 142 is significant for foreign VC investors because of its potential impact on VC investment in China conducted through ventures. The Circular aims to further restrict the settlement of foreign exchange to RMB.[564] For example, a FVCF may not exchange its registered capital from a registered foreign currency into RMB to make a VC investment with RMB in China.[565] The restriction currently limits the activities of foreign VC investment in China.

In conclusion, the purposes of these official documents issued by the Chinese government are to monitor and restrict foreign VC investors and their Chinese partners'

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559 Art. 2 and Art. 13, 2005 SAFE Circular No. 75.

560 Schedules, 2007 SAFE Circular No. 106.

561 Schedule IV, Ibid.

562 Roberts & Zhang (2009: 1-2).

563 Art. 1 and Art. 3, 2008 SAFE Circular No. 142.

564 Art. 3, Ibid.

565 Akin Gump Strauss Hauer & Feld (2008: 1).

offshore investments by means of foreign exchange control.[566] The People's Bank of China also confirmed in 2007 that China would strengthen the control of foreign capital flowing into China as well as improve the management system of cross-border capital flows in the future.[567]

#### 2.2.3.2.2 SPVs and Round-trip Investment

Under Chinese law, SPVs are offshore companies established or controlled by Chinese for the capital financing, including public offerings, VC financing, or other private equity financing, of its operations as a vehicle for cross-border capital flow and share swaps.[568] SPVs include offshore companies newly formed or acquired by Chinese. The procedures applicable to different types of SPVs are determined by their methods of formation.[569] Depending on the types of SPVs involved, China also sets forth certain operating history requirements as a precondition for their investment activities in China.[570]

Under Chinese law, "round-trip investment" is defined to include, "without limitation, purchasing or swapping for the equity of a Chinese owner or a domestic enterprise, establishing an FIE in China and using it to purchase or control domestic assets, purchasing domestic assets and using them to establish an FIE, or increasing the capital of a domestic enterprise."[571] The SPV will wholly own the venture in China. The majority or all of the venture's business activities and assets are in China. The primary reason for employing round-trip investment is that it facilities exit by foreign VC investors, either through M&A or IPOs. It is very challenging to take a "pure" Chinese company public in an offshore market.[572] Obtaining the approval from the CSRS is

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566 McKinnon (2005).

567 The People's Bank of China (2007: 148).

568 Schedule I, 2007 SAFE Circular No. 106.

569 Schedule V & Schedule VI, Ibid.

570 Schedule III, Ibid.

571 Art. 1, 2005 SAFE Circular No. 75.

572 Art. 3 & Art. 5, 1996 CSRC Circular 1996/6/17.

another main challenge.[573] Another reason is because of the restrictions in PRC Company Law. VC investors rely normally on preferred stock or convertible preferred stock to secure a preferential return. But only one class of common stock is allowed under the Chinese corporate legal system.[574] Through SPVs and round-trip investment, Chinese ventures and foreign VC investors would possibly arrange preferred stock structure and get the returns offshore.[575] (See Chart 2.4)

The round-trip investment involves two investment models, the red-chip model and the captive model. Under the red-chip model, the owners of the Chinese company will first set up an SPV with their foreign VC partners in the Cayman Islands or the British Virgin Islands.[576] Once the SPV has been established, it will purchase all shares of the Chinese company and will make the Chinese company its wholly owned subsidiary.[577] When the acquisition is done, the SPV will be listed on an overseas stock exchange by Chinese owners and their foreign VC partners.[578] (See Chart. 2.4) VC investors choose the red-chip model when they invest in the permitted industries of China. Today, China Mobile Communications Corporation (listed on Oct. 23, 1997), Bank of China (listed on July 25, 2002), China Unicom (listed on June 22, 2000), and China Netcom Group Corporation (listed on Nov. 17, 2004) are all listed on the SEHK under red-chip model.[579] Another example of the red-chip model is the listing of Home Inns & Hotel management, Inc. ("Home Inns"). Home Inns is a Chinese leading hotel based in Shanghai listed on the NASDAQ exchange.[580] In preparation for its IPO, the shareholders of the Home Inns, including Chinese shareholders and foreign VC investor (the Sequoia VC firm of the U.S.), set up a company in Hong Kong, namely Home Inns

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573 Chan (2007:1).

574 Art. 127, PRC Company Law.

575 Gmbh (2006: 2)

576 Chan (2008: 503).

577 Wolff (2008: 172).

578 Ibid.

579 Brown, Hempel, and Lu (2007).

580 See the website of the Home Inns at http://www.homeinns.com/resvhomeinns/About/intro.aspx?tm=194813.

(HK).[581] Then the same shareholders established a new company in the Cayman Islands, namely Home Inns (Cayman).[582] The Home Inns (Cayman) held 100% shares of the Home Inns (HK).[583] The Home Inns (HK) held 100% shares of Home Inns.[584] Then the shareholders of the Home Inns listed the Home Inns (Cayman) on the U.S. stock market in October, 2006.[585] The Home Inns (Cayman) could meet the requirements of the NASDAQ exchange based on its control of the Home Inns through the holding of the Home Inns (HK). In this way, Home Inns could raise money from the international markets through its financial vehicle on the NASDAQ exchange.

Foreign VC investors employ the "captive" model to undertake investment and launch IPOs in restricted industries. (See Chart 2.5) The captive model allows foreign VC investors to control a domestic venture by a series of contracts rather than by shareholdings, thus avoiding restrictions against operating businesses classified as restricted industries.[586] In practice, a foreign VC firm will firstly create an offshore company with some domestic partners. Then this offshore company will set up an onshore company, usually a WFOE in China. The WFOE will further establish some subsidiaries in China. These subsidiaries cannot conduct restricted business because of their foreign-invested background. But they will enter into contractual relationships with Chinese companies that are not limited by the Chinese foreign investment restrictions. Although neither the foreign VC firm nor the offshore company directly controls the subsidiaries and their domestic partners, the foreign VC investors can maintain indirect control over the business of the WFOE: they control the subsidiaries via shareholding, and control the domestic partners via contractual commitments. These contracts between the WFOE and its domestic partners allows the WFOE to share interest and business sources with its domestic partners who hold the restricted sector

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581 Li (Feb. 2007).

582 Ibid.

583 Chan (2007: 505).

584 Chan (2007: 506).

585 See the website of the Home Inns at http://www.homeinns.com/resvhomeinns/About/intro.aspx?tm=194813.

586 A. T. Kearney (2007: 11).

business licenses that allow them to operate in the applicable restricted sector.[587] These contracts will transfer "a substantial portion of the revenues generated by the domestic partners to the WFOE, and will give the WFOE an exclusive option to purchase all or part of the equity interests and assets of the domestic partners when and to the extent permitted by PRC laws."[588] Finally the foreign VC investors and these domestic partners will list the offshore company on a foreign stock market to obtain returns. The Captive model offers two advantages as an investment structure. First, it offers "a better savings rate because the company does not have to pay a profit margin to a third party."[589] Second, the model gives the company indirect management over the ventures while avoiding policy limitations in China.

Sina.com was the first Chinese Internet company listed on the Nasdaq in 2000 through the captive model.[590] That is the reason why in China the captive model also is called the "Sina model." In 2000, the foreign-invested companies still could not directly "hold Internet content provision (ICP) licenses."[591] Thus, foreign VC investors and the entrepreneurs of Sina.com created a captive structure through an offshore holding company which set up a WFOE in China. "The WFOE in turn contracts with a Chinese company that actually holds the ICP license. The model has been used by every Chinese Internet-related company that has listed on the Nasdaq since Sina."[592]

The IPO of the Focus Media Company also shows the operating process of this model. The Focus Media Company is a leading advertising company in China.[593] It is very hard for this type of company to go conduct an IPO on a foreign market or otherwise obtain foreign investment, due to Chinese industries restrictions.[594] So the company's

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587 Chan (2008: 728).

588 Ibid.

589 A. T. Kearney (2007: 11).

590 Red Herring (2006).

591 Ibid.

592 Ibid.

593 See the website of Focus Media at http://www.focusmedia.cn/en/aboutus/milestones.htm.

594 Chan (2007: 233).

chief executive, Mr. Jiang Nanchun, set up an offshore company in Cayman Islands, namely Focus Media Holding (Cayman), with a prominent foreign VC firm, Softbank Group, in 2003.[595] Focus Media Holding (Cayman) then established Focus Media (HK) in Hong Kong, and the latter invested in China and set up a WFOE, namely Focus Media (Shanghai) in Shanghai.[596] Focus Media (Shanghai) then entered into contractual relationships with a number of domestic companies, including Focus Media Advertisement and Focus Media Advertisement Agency.[597] The contracts in this transaction included a loan agreement,[598] an equity pledge agreement,[599] a call option agreement,[600] a voting rights proxy agreement,[601] a business cooperation agreement,[602] a technology license and service agreement,[603] and a trademark license agreement.[604] It is clear that these domestic companies were all controlled by Mr. Jiang, the controlling shareholder of the Focus Media Holding (Cayman), through the above contracts.[605] In

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595 See the website of Focus Media at http://www.focusmedia.cn/en/aboutus/milestones.htm.

596 Ibid.

597 Chan (2008: 234).

598 In the agreement, the Focus Media Holding (Cayman) lent money to Mr. Jiang. Mr. Jiang used the money to set up a Chinese LLC for applying restricted license of advertising services in China. (See Chan (2008: 726))

599 In the agreement, Mr. Jiang pledged his shares of the Chinese LLC to the Focus Media (Shanghai) as security against his performance of the loan agreement. (See Chan (2008: 726))

600 The agreement addresses the transfer of shares to the Focus Media (Shanghai). Under this agreement, Mr. Jiang will transfer his shares in the Chinese LLC to the Focus Media (Shanghai). The agreement also allows the Focus Media (Shanghai) to purchase all assets of the Chinese LLC. The Focus Media Holding (Cayman) then indirect controls the Chinese LLC through the Focus Media (Shanghai). (See Chan (2008: 726-727))

601 The agreement allows the Focus Media (Shanghai) to vote in the board of the Chinese LLC. (See Chan (2008: 727))

602 The agreement provides cooperation among the Focus Media (Shanghai), the Chinese LLC, and other domestic partners for developing media and advertising business together. (See Chan (2008: 727))

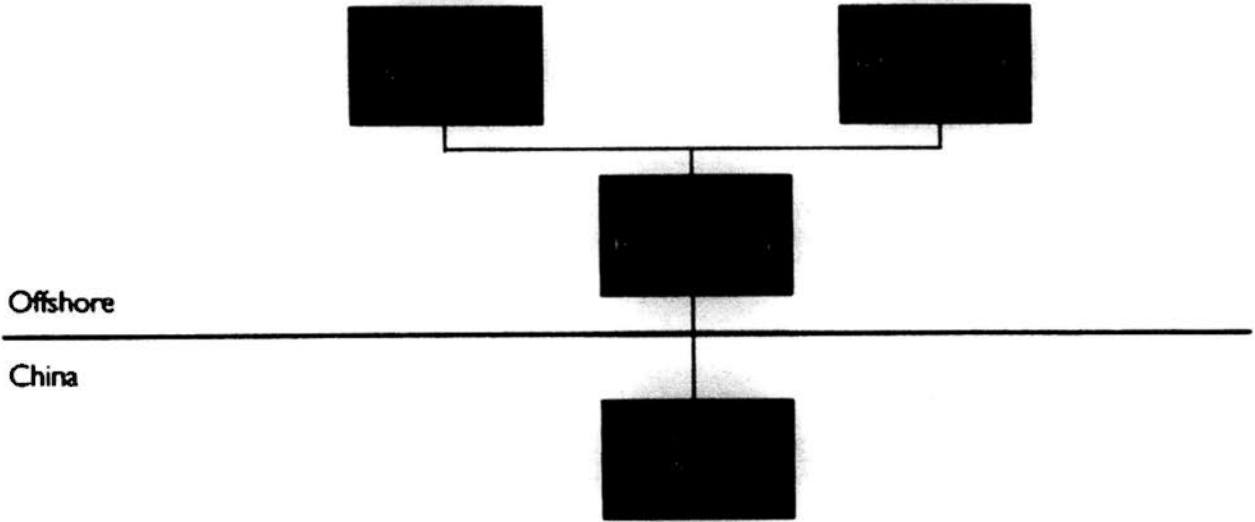
603 The agreement allows other domestic partners to give authority to the Chinese LLC to operate their advertising business. That means the Focus Media (Shanghai) can indirect use these partners' licenses through the Chinese LLC. (See Chan (2008: 728))

604 The agreement allows other domestic partners to give their trademarks to the Chinese LLC. That means the Focus Media (Shanghai) can indirect use these trademarks through the Chinese LLC. (See Chan (2008: 728)).

605 See the website of Focus Media at http://www.focusmedia.cn/en/aboutus/milestones.htm.

the end, Mr. Jiang and his foreign VC partners listed the Focus Media Holding (Cayman) on the NASDAQ exchange in July 2005.[606] This is so called the captive model.

**Chart 2.4 Investment Through Red-Chip Model**




Source: Chao & Xu (2008: 3)

**Chart 2.5 Investment Through Captive Model**

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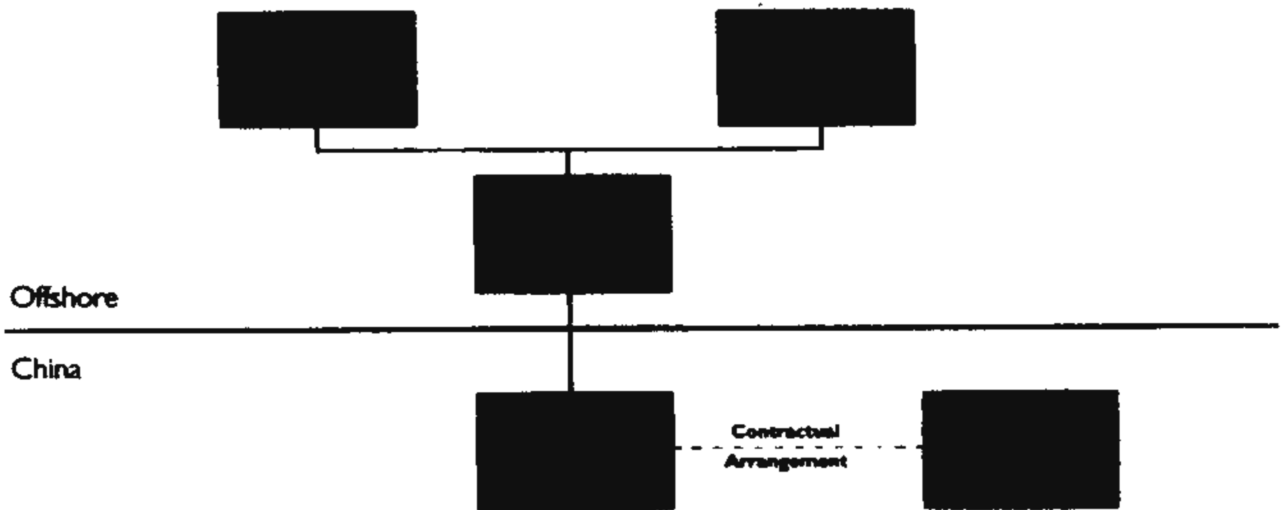
606 See the website of Focus Media at http://www.focusmedia.cn/en/aboutus/milestones.htm.




Source: Chao & Xu (2008: 3)

The most important development under 2005 SAFE Circular No.75 is the absence of approval requirements for Chinese to engage in offshore financing through SPVs. However, the 2005 SAFE Circular No.75 established a set of strict registration procedures and reporting obligations. When an SPV conducts a round-trip investment, its Chinese shareholders or the ventures should hold the five approvals, reporting or registration procedures when the SPV invests in China.[607] Mr. Liu, a venture capitalist and shareholder of a VC company in Shenzhen, set up an SPV in Cayman three years ago. He now holds shares of a state-owned company through this SPV. He has affirmed that he could buy shares of domestic companies through the SPV only if he had fulfilled all requirements of SAFE.

The first approval is the foreign exchange registration for offshore investment.[608] Before a Chinese establishes an offshore SPV or transfers an existing offshore company to an SPV, the Chinese must submit a set of complex documents to the local SAFE office to report the event, including an application letter, identity documents, an offshore financing proposal, the verification certificate of offshore capital for offshore investment and the approval for offshore investment (in general, the certificate will be

607 Art. 1, 2005 SAFE Circular No. 75.

608 Art. 2, Ibid, and Schedule I, II, 2007 SAFE Circular No. 106.

issued by SAFE, and the approval will be issued by MOFCOM, sometimes by NDRC as well), as well as the foreign exchange registration certificate for offshore investment.[609] This reporting requirement means Chinese (companies and individuals) are permitted to establish SPVs to engage in equity financing in international capital markets.

According to the process and the structure of the round-trip investment, two types of follow-up registrations (the second registration) are required. One is the follow-up registration following the establishment of contractual control over the domestic venture,[610] and the other is the follow-up registration following the effectiveness of the acquisition of the domestic venture through a share swap.[611] The purpose of these registrations is to monitor the increase in the assets of the SPV. In this process, VC investors and their Chinese partners submit a written application, a foreign exchange registration certificate for offshore investment, the approval of SPV's round-trip investment, and the registration documents of the SPV.[612]

The third required approval is the post-incorporation foreign exchange registration of the venture.[613] After foreign VC investors set up a venture with their Chinese entrepreneurs, each venture must register with SAFE before operating its business, even after having received its license from the government.[614] The venture cannot open its foreign exchange capital and current accounts without such registration. This registration creates a tracking system to monitor the cash flow, capital transformation of the ventures. Thus, any investing activities made by foreign VC investors can be noted by the Chinese government. After the registration, the venture may also distribute funds

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609 Art. 2 and Art. 3, 2005 SAFE Circular No. 75.

610 Art. 3, Ibid.

611 Schedule IV, 2007 SAFE Circular No. 106.

612 Art. 3, 2005 SAFE Circular No. 75.

613 Art. 5, Ibid.

614 Art. 5, Ibid.

to SPVs or foreign VC investors through various means, including dividends, liquidation, equity transfers, and capital decreases.[615]

The fourth procedure is the amendment registration of asset changes in SPVs.[616] The venture should update its registration with SAFE within thirty days if there is any big change to the company's assets or business, including share transfer and equity financing.[617] The purpose of this registration is to require VC investors and the ventures to disclose the important events to the Chinese government from time to time.

The last procedure is the registration of foreign debts. The venture should register with SAFE if it borrows from its offshore SPV.[618]

### 2.2.3.3 Conclusion

Thus, although Chinese are imposed with strict registration and reporting obligations as listed above, the Chinese government officially permits foreign VC investments through offshore holding companies for the first time, which will definitely encourage more foreign VC investment to help Chinese entrepreneurs to seek offshore financing.[619] However, the government also restricts ventures from using RMB converted from foreign capital for investments outside their business scope.[620] Although the intended target of this rule is to control the flow of "hot money" into China, it might have a negative impact on the legal structure of cross-border transactions and foreign VC investment. Additional time and expenses, as well as uncertainties, arising from the new regulation will also increase difficulties for foreign VC investors to invest in China.

In conclusion, the official documents show that Chinese government's purpose is to strictly monitor foreign capital inflow, including foreign VC investment. The

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615 Art. 6, Ibid.

616 Schedule III, 2007 SAFE Circular No. 106.

617 Art. 7, 2005 SAFE Circular No. 75, and Schedule V, 2007 SAFE Circular No. 106.

618 Art. 7, 2005 SAFE Circular No. 75.

619 Han (2006).

620 Art. 3, 2008 SAFE Circular No. 142.

government mainly employs two means to control foreign VC investment and other types of foreign investments: one is control of cross-border capital transactions (including control over the transaction objects and control over transaction activities) implemented mainly by state planning departments and competent industrial authorities; and the second is the control of cross-border capital transactions in foreign exchange, implemented mainly by SAFE.[621]

**2.2.4 Exit**

**2.2.4.1 Introduction**

As mentioned, the last phase of the life cycle of aVC investment is the exit process.[622] VC investors cannot earn healthy returns without timely and efficient exit.[623] Exit is also very important to the operation of the VC industry.[624] There are two frequently-used options for VC investors to exit from their ventures in China's VC industry, i.e., IPOs and trade sales. This section focuses on IPO issues.

There are two steps for VC investors in IPO exit. First, the venture is listed. Then, the VC investors, at their own discretion, can sell their shares in the listed venture on the stock markets at an appropriate time and price, following any lock-up period.[625] The second step involves only the provisions of the lock-up period. The required lock-up period at present in the A share market in China is twelve months (unless the shareholders are willing to extend such a period). The lock-up period for the controlling shareholders is thirty six months. In oversea markets, however, lock-up periods are usually range from six months to twelve months.[626] The listing of ventures in the first step includes domestic listing and overseas listing, including red-chip model.

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621 Han (2006).

622 Gilson (2003: 1101)

623 Rosenberg (2001: 385). The scholar says that "equally important, venture capitalists can withhold or provide additional funding to firms, depending on their changing prospects. The venture capitalist's goal for each of its portfolio companies is, of course, a successful exit, either through an IPO, a private sale or a share repurchase by the company." (See Rosenberg (2001: 385)).

624 Lu, Tan, and Chen (2007: 251).

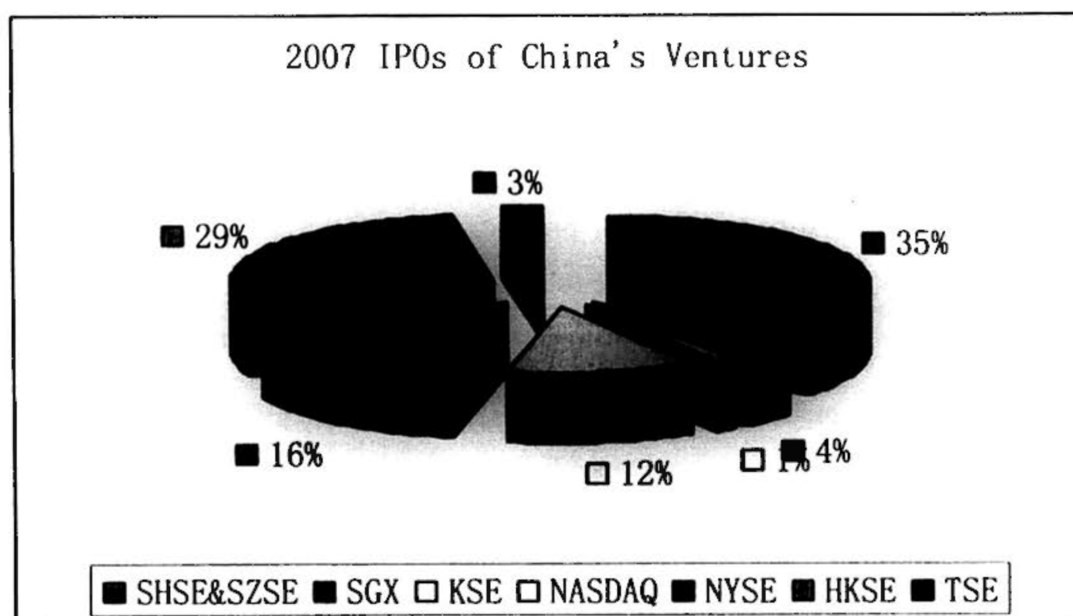
625 Peng (2005: 245).

626 Ibid.

### 2.2.4.2 Offshore Stock Markets

Although Hong Kong and Singapore host the majority of mainland-based offerings, Western exchanges have become increasingly attractive to Chinese issuers. The Nasdaq Stock Market (Nasdaq) and the NYSE have become particularly appealing to Chinese high-tech ventures.[627] In September 2007, Nasdaq was home to thirty-eight Chinese companies with a market capitalization of approximately $30 billion.[628] (See Chart 2.6)

**Chart 2.6 2007 IPOs of China's Ventures**




Source: CVCRI & POLYU (2008: 110).

As discussed, MOFCOM and other related authorities promulgated the 2006 MOFCOM Provisions No. 10 on August 8, 2006. This set of rules has put a question mark on the viability of the red-chip model.[629] It is generally believed that the Chinese government tries to limit the ability of foreign VC or PE investors to engage in hostile takeovers against Chinese companies.[630] There has been much media of deals such as Carlyle's acquisition of Xugong Heavy Machinery and Schaeffler Group's takeover of Luoyuang

627 The Main Wire (2007).

628 CVCRI & POLYU (2008: 109-110).

629 Zero2IPO (2007: 81).

630 Zhang (2007: 17).

Bearing Corporation.[631] The Chinese government became concerned about the safety of China's economy.[632] It is not the first time Chinese companies face this situation. In 2000, the CSRC required Chinese lawyers to submit a legal opinion for CSRC's approval before any offshore IPO could be made via red-chip model.[633] The CSRC had dropped this requirement in 2003 and had stopped regulating red-chip offerings.[634] But the 2006 MOFCOM Provisions No. 10 have now brought these issues back into the review of the CSRC.[635] Table 2.4 shows the laws and regulations of China on the red-chip model.

Now domestic companies should obtain the approval of MOFCOM before establishing an SPV.[636] But it is currently unclear whether Chinese individuals need to receive this approval before setting up an SPV offshore. An SPV also needs to get an approval before it swaps its shares with a domestic company.[637] If MOFCOM approves the swap applications, it would issue an approval letter on the basis of which the domestic company would submit a listing application to CSRC.[638] CSRC has twenty business days to review the letter and the application to decide whether to approve the application.[639] The domestic company will finally receive an approval certificate with the annotation "equity held by an offshore SPV, valid for one year from the date of issuance of the business license" from MOFCOM if CSRC approves the application.[640]

Within thirty days of the issuance of the certificate, the domestic company must apply for the amendment of registered information with SAIC and SAFE, which would issue to the domestic company an FIE business license and foreign exchange registration

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631 Chan (2008: 5)

632 Zero2IPO (2007: 104).

633 Art. 2, 2000 CSRC Circular No. 72.

634 Art. 1 and Appendix 26, 2003 CSRC Circular 2003/4/1.

635 Art. 40, 2006 MOFCOM Provisions No. 10.

636 Art. 42, Ibid.

637 Art. 44, Ibid.

638 Art. 45, Ibid.

639 Ibid.

640 Ibid.

certificate respectively, with the annotation "valid for fourteen months from the date of issue."[641] Then, the domestic company must report the status of the offshore listing and submit the financing proceeds repatriation plan to MOFCOM within thirty days to apply for replacement of a non-annotated FIE approval certificate.[642] Also, it must report the status of the offshore listing and provide the relevant record filings to CSRC.[643]

**Table 2.4 Variation of Red-chip Policies**

| | |
|---|---|
| **Name** | **Circular on Issues Concerning the Overseas Issuance and Listing of Shares by Overseas Companies with Interests in Mainland (CSRC Circular No. 72)** |
| **Key Points** | Requiring to "check and approve the legal opinions issued by Chinese lawyers on issuance and listing of shares by overseas companies with interests in Mainland China" |
| **Promulgated by** | CSRC |
| **Promulgation Date** | 2000 |
| **Validity Status** | Invalid |

| | |
|---|---|
| **Name** | **Circular on Abolishing Supervisor Modes of the Second Batch of Items under Administrative Examination and Approval** |
| **Key Points** | Cancelling the requirements of "check and approval the legal opinions issued by Chinese lawyers on issuance and listing of shares by overseas companies with interests in Mainland China." |
| **Promulgated by** | CSRC |
| **Promulgation Date** | 2003 |
| **Validity Status** | Valid |

| | |
|---|---|
| **Name** | **Circular on Issues of Improving Foreign Exchange Administration for Mergers and Acquisitions with Foreign Investment (2005SAFE Circular No. 11)** |
| **Key Points** | Transfer of assets and shares within Mainland China by any domestic residents for share certificates and other property rights from overseas companies must |

641 Art. 46, PRC MOFCOM Provisions No. 10.

642 Art. 47, Ibid.

643 Ibid.

| | |
|---|---|
| | obtain approval from relevant foreign exchange control departments. No domestic residents may obtain shares and other property rights of overseas companies with his assets or shares with Mainland China without approval. |
| **Promulgated by** | SAFE |
| **Promulgation Date** | 2005 |
| **Validity Status** | Invalid |

| | |
|---|---|
| **Name** | **Circular on Relevant Issues of Registration of Overseas Investment Contributed by Domestic Individual Residents and Foreign Exchange Registration of Mergers and Acquisition with Foreign Investment (SAFE Circular No. 29)** |
| **Key Points** | If any domestic individual residents invest any assets or shares within Mainland China in any overseas enterprise and directly or indirectly hold such enterprise's shares, the resident in question must, in the form as required in the Appendix, go through procedures for registration of overseas foreign exchange investment with the foreign exchange bureau of the place where the merged enterprise is located. |
| **Promulgated by** | SAFE |
| **Promulgation Date** | 2005 |
| **Validity Status** | Invalid |

| | |
|---|---|
| **Name** | **Circular on Relevant issues Concerning Foreign Exchange Administration for Domestic Residents to Engage in Financing and in Return Investment via Overseas Special Purpose Companies (2005 SAFE Circular No. 75)** |
| **Key Points** | Domestic residents must, before establishing or controlling an overseas special purpose companies, go through procedures for registration of overseas foreign exchange investment with relevant local branch offices of foreign exchange and departments of foreign exchange control. |
| **Promulgated by** | SAFE |
| **Promulgation Date** | 2005 |
| **Validity Status** | Valid |

| | |
|---|---|
| **Name** | **Provisions on Mergers of Domestic Enterprises by Foreign Investors (No. 10)** |
| **Key Points** | First, the mergers of any domestic affiliated companies by any domestic companies, enterprises, or legal entities in the name of any of their overseas companies duly incorporated or controlled by them must be reported to the |

| | |
|---|---|
| | **Ministry of Commerce for examination and approval. No one may evade the foregoing requirements by investment in Mainland China with foreign-funded enterprises or by other methods. Second, overseas listing of special purpose companies must be approved by the securities supervisory authorities of the State Council.** |
| **Promulgated by** | Six Ministries and Commissions |
| **Promulgation Date** | 2006 |
| **Validity Status** | Valid |

| | |
|---|---|
| **Name** | **PRC Securities Law** |
| **Key Points** | **Direct or indirect overseas issuance or listing of securities by domestic companies must be approved by the securities supervisory authorities of the State Council in accordance with relevant provisions of the State Council.** |
| **Promulgated by** | NPC |
| **Promulgation Date** | 2006 |
| **Validity Status** | Valid |

### 2.2.4.3 Domestic Stock Markets

The Stock Market in China has long been dominated by the exchanges in Shanghai and Shenzhen ("A-Share Markets") without much diversification.[644] The stringent listing requirements on size, profitability and industry focus exclude many companies.[645] This limits the financing options of Chinese companies and reduces the range of risk-return profiles available to investors. In order to expand the market, the SZSE began to explore the possibility of building a growth enterprise market in 2001 and set up the SME Board in May 2005. By the end of 2007, two hundred SMEs have been listed on the board.[646]

There were two principal hurdles to a listing in the A-share markets in China. The first was a quota system that restricted non-state owned and less-connected businesses from listing on the Mainland exchanges.[647] This hurdle has essentially been removed by a

644 CSRC (2008: 25).

645 CSRC (2008: 178).

646 Ibid.

647 CSRC (2008: 96-98).

new rule which now allows businesses to simply join a queue.[648] The second hurdle to A-share markets was a rule that controlling stakes were not tradable. This obstacle was removed in 2005.[649] While this does not offer the same flexibility as most foreign stock markets, it is significantly more attractive to VC investors than the old rule.

China has taken other steps to increase the attractiveness of its domestic exchanges as well. For one thing, it has lowered the level of registered capital the companies need to list in China. As discussed above, the PRC Company Law reduced the threshold to establish a Chinese LLC. Further, the Securities Law was amended to lower the required level from RMB50 million to RMB30 million.[650] In 2006, the Chinese government then promulgated the 2006 Administrative Measures of Initial Public Offerings and Listing of Shares, which strengthened the independence of IPO issuers by lifting financial benchmarks and reducing the government's obligation to protect investors, including VC investors.[651]

China has also reduced the burdens of auditing. On May 9, 2006, the 2006 Measures of Issuing and Auditing Committee for Securities Supervision and Management Commission of China became effective. The regulation has made the auditing process both more transparent and more efficient. It has also contributed to speedier listings on domestic exchanges. Therefore, it now only takes three to four months to consummate an IPO on the Shenzhen SME Board.[652]

Since these changes were taken in conjunction with the new difficulties in offshore listing created by the 2006 MOFCOM Provisions No. 10, it is no surprise that A-shares listings may become increasingly attractive to foreign VC investors. But, on the other hand, while this alternative may be attractive, it is not without challenge. The Chinese

648 CSRC (2008: 95).
649 Yam (2007: 12).
650 Art. 50(2), PRC Securities Law.
651 CSRC (2008: 66).
652 Zero2IPO (2007: 112).

stock markets are significantly less sophisticated than the NYSE and the Nasdaq Stock Market. First, foreign VC investors are less familiar with the Chinese stock markets. Further, even after their IPOs, listed companies in China may find themselves facing tight regulatory approvals for share placements and rights issues.[653] In China, if the VC investors want to exit on the domestic stock exchanges, the listed venture must go through an approval process in connection with the trading of "legal person shares" held by such VC investors.[654]

There are some basic requirements that a VC investor must meet before its shares in the venture can be publicly traded. One of these requirements is that, as a necessary step for a Chinese LLC going public, the company must first be restructured as a Chinese company limited by shares and restructure its capital into equal units of shares that have a par value.[655] The restructuring requires a 2/3 majority approval of the shareholders.[656] Furthermore, as mentioned before, there may be dual transfer restrictions or lock-up requirements applicable to the shares held by a foreign VC investor.[657] As a general requirement, if such foreign VC investor is a promoter of foreign-invested venture limited by shares, it must not transfer its shares within three years of the establishment of the entity.[658] Furthermore, a public offering of the shares of the company will lock up such shares for another year.[659] In the event of public trading of the foreign-invested shares held by the VC investor, these shares must have been owned by the investor for at least one year after the public offering.[660]

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653 Yam (2007: 12).

654 Art. 4, 2002 CSRC Circular 2002/11/1.

655 Art. 121 and Art. 126, PRC Company Law.

656 Art. 38 and Art. 100, PRC Company Law.

657 Art. 142, PRC Company Law.

658 Art. 5.1.5, Trading Rules of Shanghai Stock Exchange, and Art. 5.1.5, Trading Rules of Shenzhen Stock Exchange.

659 Art. 142, PRC Company Law.

660 Art. 3(5), and (6), Public Trading Notice.

Moreover, revenue thresholds imposed by CSRC are unattainable for many high-tech start-ups. This is often referred to as the "four, five, and six" requirements.[661] In order to apply for an offshore listing, the net asset value of the domestic enterprise must reach RMB400 million.[662] Its profit in the past year must reach RMB60 million,[663] and its listing proceeds be at least $50 million.[664] On the other hand, the SME board is currently a duplication of the main boards in terms of substantive listing requirements. These requirements include, for example, that an applicant must have been in business for more than three years and profitable over the last three consecutive years.[665] Compliance with these listing rules would be unrealistic for most start-ups for their weak business incomes and short company history records.

Compared with overseas IPOs, Chinese government encourages foreign VC investors and their domestic ventures to list on domestic stock exchanges. Generally, there are no policy barriers for FIEs to be listed in China. However, during the process of listing joint venture FIEs, due to the different applicable laws for JV FIEs, there are some conflicts of laws that must be resolved when these ventures try to transform from a "closed company" to a public company.[666] For instance, the legal form of JV FIEs is a Chinese LLC, while in PRC Company Law, a listed company must be a joint stock company. The conflict was finally resolved by an Administrative rule, the 1995 Interim Provisions on Establishing Foreign-invested joint stock companies in 1995.[667]

Further, the regulators gave the green light to JV FIEs to list on the domestic stock exchanges. Take Lianhua Fiber (600617.SH) (the earliest listed JV) for instance, its foreign promoter, Hong Kong Good Speed Group, held 30% of its shares when Lianhua

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661 See the Circular on the Qualification, Procedure, and Documents of recommending Proposed Companies Listing Offshore (CSRC Circular 1996/6/17).

662 Art. 3 and Art. 5, Ibid.

663 Ibid.

664 Ibid.

665 Art. 3(1), the Procedure of Listing on SME.

666 Peng (2005: 245).

667 Art. 2, 1995 MFTC Order No. 1.

Fiber went public in October 1992.[668] In addition, there was also a leading card for foreign VC firms to exit Shanghai Stock Exchange. In September 2003, Sanyuan Food (600429.SH) went public.[669] It was one of the few JV FIEs which was under absolute control of foreign capital to be listed on the A-shares market. Shares held by foreign investors accounted for 73% of Sanyuan Food before listing and 55.76% after listing.[670] It means that Sanyuan Food is an enterprise under absolute control by foreign capital according to PRC Company Law.[671] Although there had been nearly one hundred listed joint venture FIEs in China's A-share markets at that time, the share proportion of foreign capital was often between 10% and 40%, and there were few listed companies controlled by foreign capital.[672] Listing of WFOEs and overseas enterprises in A-share markets is still under discussion.

The GEM and the A-share markets of China, the important parts of the Chinese capital market, have differences in issue standards, system design, and risk control based on their different service purposes. (See Chart 2.7) The A-share markets offer services to large companies with stable business operation and strong track records. The GEM offers a financing channel to small size companies which are still in the growth stage, especially high-tech ventures. The following Charts compare the key requirements of the A-share markets with those of the GEM and prove that the listing requirements of GEM are lower than those of the A-share markets. The GEM evaluates the value of ventures through the market to encourage more VC investors to support the development of start-ups and high technology. This exit channel ensures the benefits of VC investors as well as reduces the investment risks of VC firms.

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668 See the website of Lianhua Fiber at http://www.600617.com.cn/.

669 See the website of Shanghai Stock Exchange at http://www.sse.com.cn/sseportal/webapp/datapresent/SSEQueryListCmpAct?reportName=QueryListCmpRpt&COMPANY_CODE=600429&REPORTTYPE=GSZC&PRODUCTID=600429.

670 Zero2IPO (2009: 402)

671 Art. 217(2), PRC Company Law.

672 Zero2IPO (2009: 402)

**Chart 2.7 Comparison of the Listing Requirements of Chinese A-share markets and the GEM**

**Subject Qualification**

| *A-share Markets* | *GEM* |
| --- | --- |
| Chinese joint stock companies.[673] | |

**Operation Year**

| *A-share Markets* | *GEM* |
| --- | --- |
| The continuous operation period should be over three years.[674] | |

**Requirement on Profitability**

| *A-share Markets* | *GEM* |
| --- | --- |
| Firstly, the net profits of the recent three years are all positive and the amount exceeds RMB30 million.[675] | The net profits of recent two years are positive and the amount is not less than RMB10 million, or |
| Secondly, the net cash flow from business operation in the last three years must exceed RMB50 million; or the business revenue in the last three years must exceed RMB 300 million.[676] | The net profit in the last two years is positive and the amount is not less than RMB5 million. The operating revenue growth rates in the last two years are no less than 30%.[677] |

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673 Art. 121, PRC Company Law.

674 Art. 5.1.1 (4), PRC SZEXR. Art. Art. 5.1.1 (5), PRC GEMR.

675 Art. 33 (1), PRC IPOM.

676 Ibid.

677 Art. 10 (2), PRC GEMIPOM.

**Requirement on Assets**

| *A-share Markets* | *GEM* |
|---|---|
| The intangible assets at the end of the last reporting period must not account for more than 20% of the net assets.[678] | The net assets at the end of the last reporting period must not less than RMB20 million.[679] |

**Requirement on Stock Offering**

| *A-share Markets* | *GEM* |
|---|---|
| The total stock amount before the public issue must not be less than RMB30 million.[680] | The total stock amount after the public issue must not be less than RMB30 million.[681] |

**Requirement on Major Business**

| *A-share Markets* | *GEM* |
|---|---|
| There are no significant changes in major business in the last three years.[682] | The listed companies should focus on the major business.[683] Raised capital could only be used for developing major business.[684] |

**Director of the Board and Senior Manager**

| *A-share Markets* | *GEM* |
|---|---|
| There are no significant changes of the directors of the board and the senior managers in the last three years.[685] | There are no significant changes of the directors of the board and the senior managers in the last two years.[686] |

678 Art. 33 (4), PRC IPOM.
679 Art. 10 (3), PRC GEMIPOM.
680 Art. 33 (3), PRC IPOM.
681 Art. 10 (4), PRC GEMIPOM.
682 Art. 12, PRC IPOM.
683 Art. 12, PRC GEMIPOM.
684 Art. 27, Ibid.
685 Art. 12, PRC IPOM.

***De facto* Controller**

| *A-share Markets* | *GEM* |
|---|---|
| There are no significant changes of the *de facto* controllers in the last three years.[687] | There are no significant changes of the *de facto* controllers in the last two years.[688] |

**Non-Competition**

| *A-share Markets* | *GEM* |
|---|---|
| There is no competition between the issuer and the controlling shareholder, *de facto* controlling person and other enterprises controlled by them.[689] | |

**Connected Transaction**

| *A-share Markets* | *GEM* |
|---|---|
| There is no significant unfair connected transaction. Profits cannot be controlled through the connected transactions.[690] | There is no connected transaction affecting the independency of the listed companies.[691] |

**Growth Features and Innovation Capacity**

| *A-share Markets* | *GEM* |
|---|---|
| No requirement. | Issuers have growth features and certain independent innovation capacity.[692] |

686 Art. 13, PRC GEMIPOM.

687 Art. 12, PRC IPOM.

688 Art. 13, PRC GEMIPOM.

689 Art. 19, PRC IPOM. Art. 18, PRC GEMIPOM.

690 Art. 19, PRC IPOM.

691 Art. 18, PRC GEMIPOM.

692 Art. 1 and Art. 32, PRC GEMIPOM.

**Applications of Raised Capital**

| *A-share Markets* | *GEM* |
|---|---|
| There must be a clear direction in the application of the raised capital which, in principle, will be applied towards the major business.[693] | The raised capital must be used mainly for its major business.[694] |

**Seeking Comments in the First Examination**

| *A-share Markets* | *GEM* |
|---|---|
| The CSRC will seek comments of the government at the provincial level of the place of registration of the issuer on whether it consents to the issuer's share offering, and seek the comments of the NDRC on whether the projects in which the offer proceeds of the issuer are invested comply with the industrial policy of China.[695] | No requirement. |

The Third Sino-US Strategic Economic Dialogue was held in December 2007, and a joint statement was released after the meeting.[696] The two countries agreed in the statement that they would strengthen cooperation in the financial services industry. In accordance with the principle of prudence, China allowed eligible foreign-invested companies (including banks) to issue stocks denominated in RMB, allowed eligible listed companies to issue corporate bonds denominated in RMB, and allowed eligible foreign corporative banks to issue bank debentures denominated in RMB.[697] In the

693 Art. 38, PRC IPOM.

694 Art. 27, PRC GEMIPOM.

695 Art. 49, PRC IPOM.

696 See the website of Xinhua News Agency at http://news.xinhuanet.com/fortune/2007-12/13/content_7235537.htm.

697 Ibid.

Fourth Sino-US Strategic Economic Dialogue held in June 2008, in accordance with the principle of prudence in supervision and control, China agreed to allow eligible overseas companies to go public in China's stock exchanges through both stock issuance and depositary receipts.[698] The foreign-controlled enterprises, including foreign VC invested-ventures would then get more support in domestic listing.

### 2.2.5 Stimulus

#### 2.2.5.1 Taxation Stimulus for Venture Capital Corporation

At present, different VC firms assume different tax liabilities. In general, the VC firms assume a relatively heavy tax burden and lack strong support in tax preference policies. According to the PRC Tax Law, a corporation should bear double taxation, i.e., the corporate income tax and the income tax of the shareholders.[699] That means as the taxpayer, the start-ups and the VC companies must pay corporate income tax once profits occur. Whether the after-tax profits are transferred to paid-in capital or distributed to the shareholders, the shareholders must pay income tax for that once again. That is, when the proceeds (the tax of which has been paid by the ventures) are distributed to the VC companies, the investor must once again pay the individual income tax[700] (if the investor is an individual) or corporate income tax[701] (if the investor is a firm).

The recently amended PRC EIT Law has changed the situation. A VC firm engaging in VC projects "that call for special support and encouragement from the central government" are eligible for certain deductions from their taxable income.[702] The deductions correspond to the amounts of VC investment in the ventures.[703] Presumably, the VC projects must be those high-tech ventures that are fundamental to the Chinese

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698 Ibid.

699 Art. 6, PRC EIT Law, Art. 2, PRC IIT Law.

700 Art. 2, PRC IIT Law.

701 Art. 6, PRC EIT Law.

702 Art. 31, Ibid.

703 Art. 31, Ibid.

economy.[704] As mentioned, 2007 SAT Circular No. 31, promulgated on February 15, 2007, stipulated that if the domestic VC firms have invested in high-tech start-ups for more than two years, 70% of the amount invested by the VC firms may be deducted from their taxable income.[705] If the deductible amount fails to be deducted in full from the taxable income in the current year, the remaining amount thereof may be deducted on a year-on-year basis from the taxable income of the following taxable years.[706]

To qualify for this deduction, the ventures invested by VC corporations must have incurred R&D expenses equal to at least 5% of their revenues.[707] Moreover, revenues generated from R&D and high-tech business must account for at least 60% of such companies' total revenues.[708] But the Circular indicates that the VC firms enjoying tax preference must be a "Chinese VC LLC" or a "VC joint stock company."[709] That means limited partnership VC firms cannot apply for the deduction according to this official document. The current tax rules also do not point out whether foreign VC corporations can enjoy the deduction until 2009.

Further, a new circular promulgated on December 2, 2008 clarified the details of the deductions. According to the 2008 SAT Circular No. 985, firstly, Chinese tax authorities must apply EIT pre-payment procedures for high-tech ventures (based on the 15% EIT rate) if the enterprises have been certified with "High-and New-technology Enterprises" status.[710] Secondly, ventures certified as the status that prepaid their 2008 EIT based on the 25% rate will be eligible to deduct the difference from their 2009

704 Art. 30(1), Ibid.

705 Art. 1, 2007 SAT Circular No. 31.

706 Art. 2, Ibid.

707 Art. 1(4), Ibid.

708 Ibid.

709 Art. 1(1), 2007 SAT Circular No. 31.

710 Art. 1, 2008 SAT Circular No. 985.

pre-payments in December 2008.[711] In 2009, foreign VC corporations can also enjoy the deduction. [712]

### 2.2.5.2 Taxation Stimulus for Limited Partnership Venture Capital Firm

There are no definite detailed tax preference rules for limited partnership VC firms. The partners are required to pay their respective income tax with the production and business operation incomes and other incomes of the enterprise.[713] The 2008 SAT Circular No. 159,[714] further clarifies the principle of "allocate first, then tax" (i.e. the "pass-through" treatment) will be applied to the income derived from production and business operations and other income of partnership enterprises.[715] Each partner of a partnership enterprise must be a taxpayer.[716] Where the partners of the partnership enterprises are legal persons or other organizations, they should pay enterprise income tax.[717] Where the partners of the partnerships are individuals, they should pay individual income tax and be taxed at five-level progressive rates ranging from 5% to 35% referring to taxable item of "income derived from production and business operation of individual industrial and commercial households".[718]

According to the survey of CVCA, Table 2.5 shows that 79.5% and 61.5% of respondents considered the major tax problems include unclear tax treatment of partners in a limited partnership VC firm and absence of preferential taxation policies for partners in a limited partnership VC firm.[719]

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[711] Art. 2, Ibid.

[712] Art. 1, 2009 SAT Circular No. 87.

[713] Art. 4, the Measures on Individual and Partnership Income Taxation.

[714] The Circular was promulgated by the MOFCOM and the SAT on December 23, 2008.

[715] Art. 3, 2008 SAT Circular No. 159.

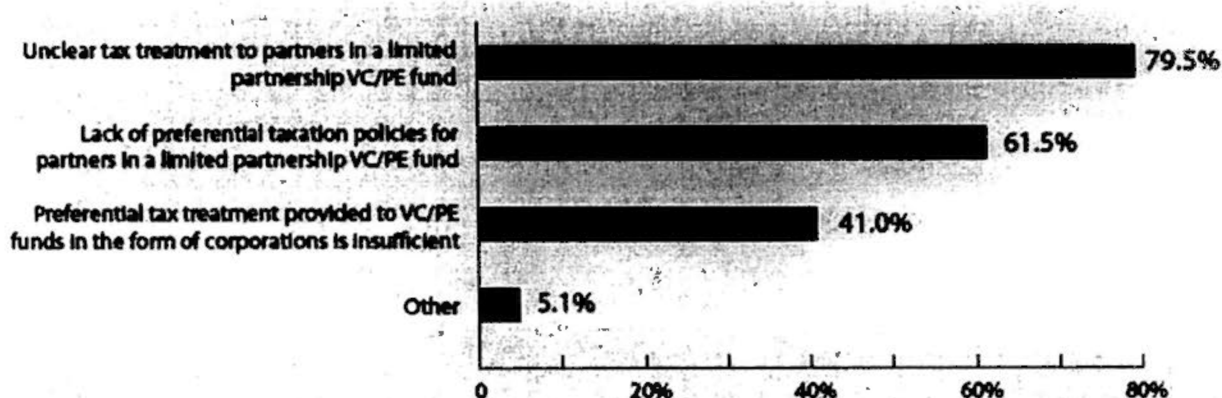
[716] Art. 2, Ibid.

[717] Ibid.

[718] Art. 3, 2008 SAT Circular No. 159.

[719] CVCA (2009:20).

**Table 2.5 Main Policy Problems Concerning Taxation**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

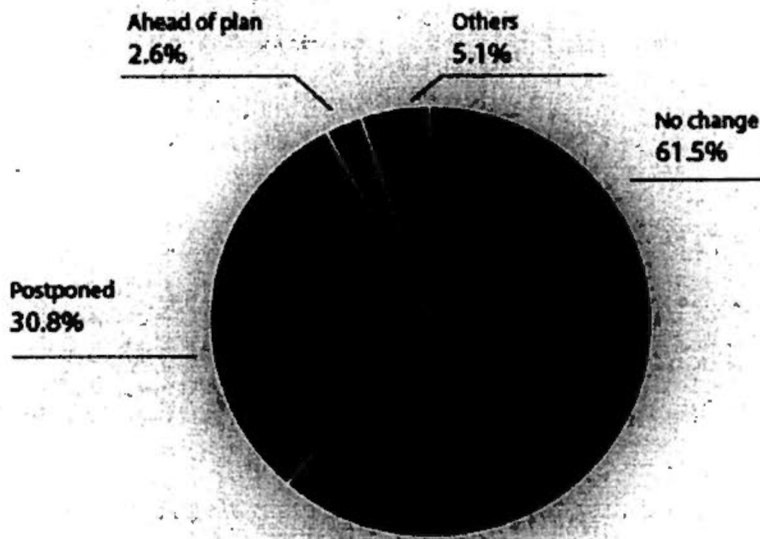
## 2.3 Summary

Since the real economy of China has faced serious challenges since the global financial crisis that began in 2008, it has also become more difficult for VC firms to raise funds.[720] The first problem of China's VC firms is funding. Table 2.6 shows that 30.8% of respondents postponed new fundraising, 17.9% cut the size of fundraising, and 30.8% expanded their target LP lists, which indicate that fund raising became more difficult. Because of the financial crisis and economic slowdown, the VC fund duration has to be extended. VC firms have had to slow down their investment pace and delay exit plans given the high risks under current circumstance. As a result, foreign LPs' assets shrunk and they became more conservative in terms of the investment strategy, which resulted in even fewer capital sources for VC funds.

[720] The CVCA conducted a survey in the first quarter of 2009 with 39 international VC firms for revealing the impact of the global financial crisis and China's economic slowdown on the VC industry and assessing the regulatory environment of the industry. (See CVCA (2009: 1)). See also CVCA (2009: 6).

**Table 2.6 Time of Launch of New Fundraising**

**Time of launch of new fundraising**

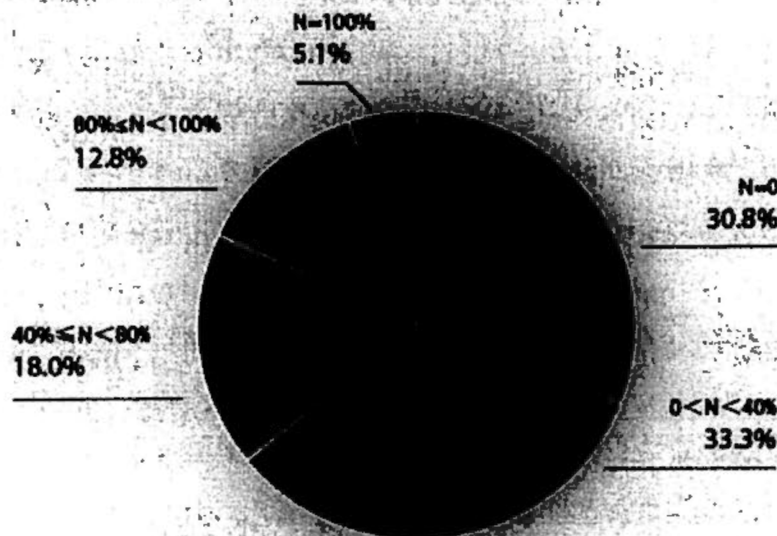



Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

Another problem for China's VC industry is that the IPO exit channels have been blocked because the capital markets were weak following October 2008. Many VC firms were forced to cancel or postpone IPO plans of their ventures. (See Table 2.7)

**Table 2.7 Proportion of Ventures that Delayed or Canceled IPO Plans**

**Proportion of portfolios that delayed or canceled IPO plans**

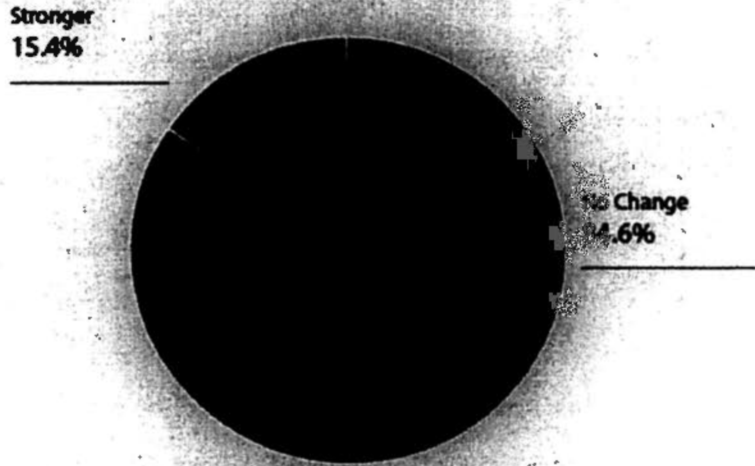



Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

Although there are some problems of VC investments in China, international VC firms continue to be confident about the long-term development of China's VC industry. (See Table 2.8)

**Table 2.8 Foreign VC Firms' Long-term Investment Confidence in China**

**Your Firm's Long-term Investment Confidence in China**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

The main reason why international VC firms are still optimistic about the long-term development of China's VC industry is because they have faith in the long-term prospects of the Chinese economy, legal support by China's governments, and the development of Chinese start-ups.[721] In addition, they are confident that China's current economic situation will offer the VC industry good opportunities for high growth. For example, lower investment costs, more rational investment mentalities of VC practitioners, an increasing emphasis on the value-added service for ventures, and the surface of high-quality deals will have a positive impact on the long-term development of China's VC industry.[722] (See Table 2.9)

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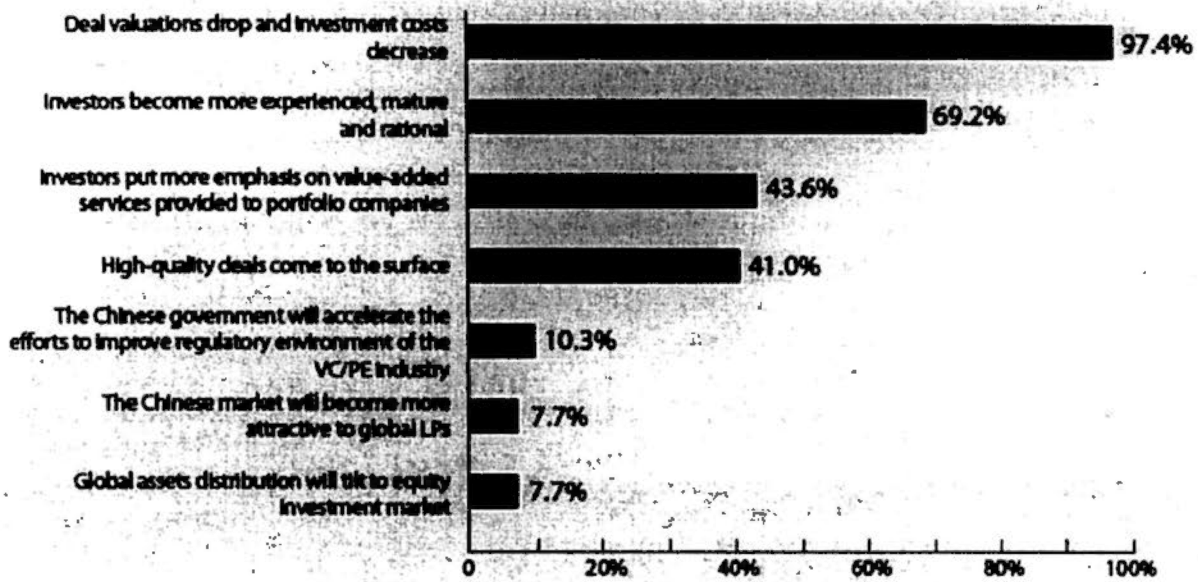
[721] CVCA (2009: 6-7).

[722] CVCA (2009: 7).

**Table 2.9 Major Opportunities Faced by China's VC Sector**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

As discussed above, since China recognizes that VC projects can play a meaningful role in promoting China's economy, the central government has paid increasingly more attention to VC projects, which is reflected by a series of policies such as the implementation of the 2008 State Council Opinion No. 126[723] and formulation of the Measures on the Administration of Private Equity Funds (Draft)[724] led by the NDRC.

With the implementation of the amended 2006 PEL in 2006, the 2003 FVCP and the 2005 DVCM, the basic VC legal framework has now been put in place. Recently, there has been significant progress: a series of implementation rules for partnership businesses were issued by the central and local fiscal and taxation authorities, which gave clear guidelines for the formation of limited partnership VC funds,[725] the NSSF successfully invested in four PE funds,[726] and trials of equity investment by insurance

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723 Art. 5(19), 2008 State Council Opinion No. 126.

724 See the Wall Street Journal (Chinese Version) at http://chinese.wsj.com/gb/20090818/bch092852.asp.

725 CVCRI & POLYU (2008: 83).

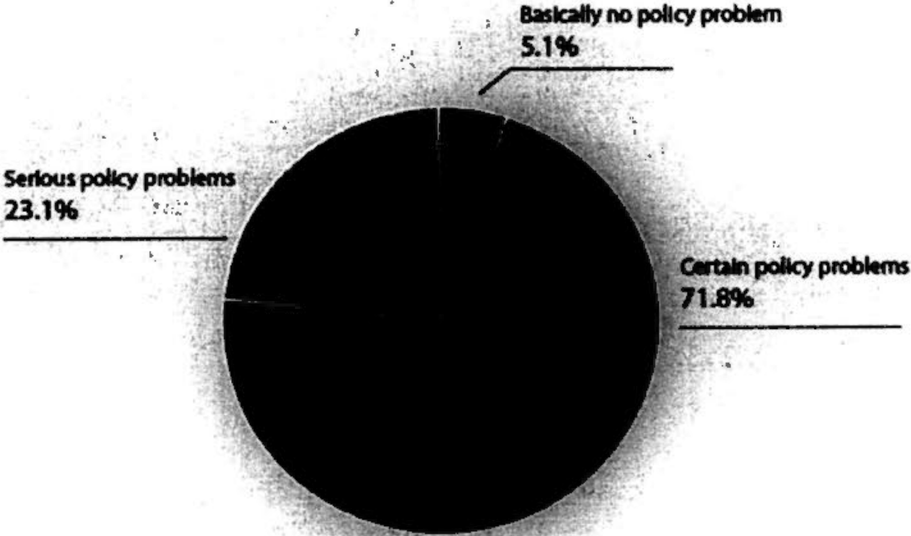
726 See the website of NSSF at http://www.ssf.gov.cn/xxgk/zhzw/gzdt/200904/t20090427_881.html.

companies have been initiated.[727] It is believed that as more institutional investors are approved to invest in VC funds, VC investments are expected to become a major force in China in the future. Local governments have set up a number of government-guided VC funds which facilitate the pooling of VC, entrepreneurs and deals.[728] The GEM was launched in 2009, which is a milestone of the Chinese capital markets, and further facilitates the development of China's VC industry.[729]

In conclusion, a primary legal system for China's VC projects has been established. The enactment and implementation of these VC policies have promoted the development of China's VC industry and have laid a solid foundation for its further development. However, since China's VC industry is still in its infancy, the regulatory environment is far from perfect and needs to be improved step by step. Many VC investors believed that there are some certain serious policy problems in the Chinese VC projects.[730] (See Table 2.10)

**Table 2.10 Overall Regulatory Environment of the VC Industry**

**Overall regulatory environment of the VC/PE industry**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

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[727] Ibid.

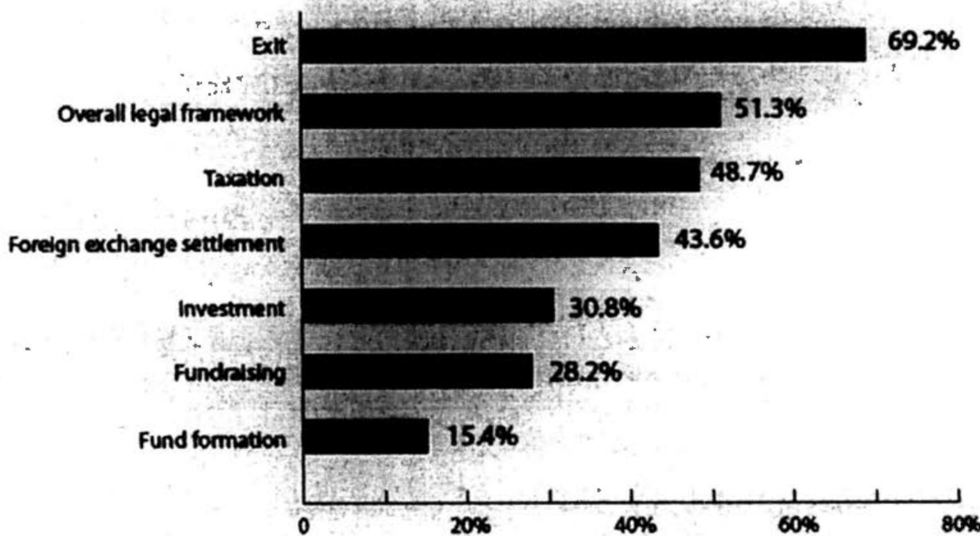
[728] CVCRI & POLYU (2008: 90-136).

[729] Chan & Xi (2008: 8).

[730] CVCA (2009: 21).

The policy problems mainly exist in China's VC industry, including the problems of funding, governance techniques in ventures, exits, governmental stimulus, taxation, and foreign exchange settlement.[731] (See Table 2.11) For example, the international VC firms would like the Chinese government to promulgate regulations for foreign-invested VC limited partnerships as soon as possible, and also to improve other VC laws related to foreign VC investments.[732] (Table 2.12 shows the response of the international VC firms and their suggestions on China's VC legal system.) In terms of further improvement of the overall VC legal framework, China's government should increase enforceability of the existing VC laws and ensure the consistency of these laws, and it especially should study the VC legal framework of the U.S., which will be introduced in the following chapter.

**Table 2.11 Which Areas do the Policy Problems Mainly Exist In?**



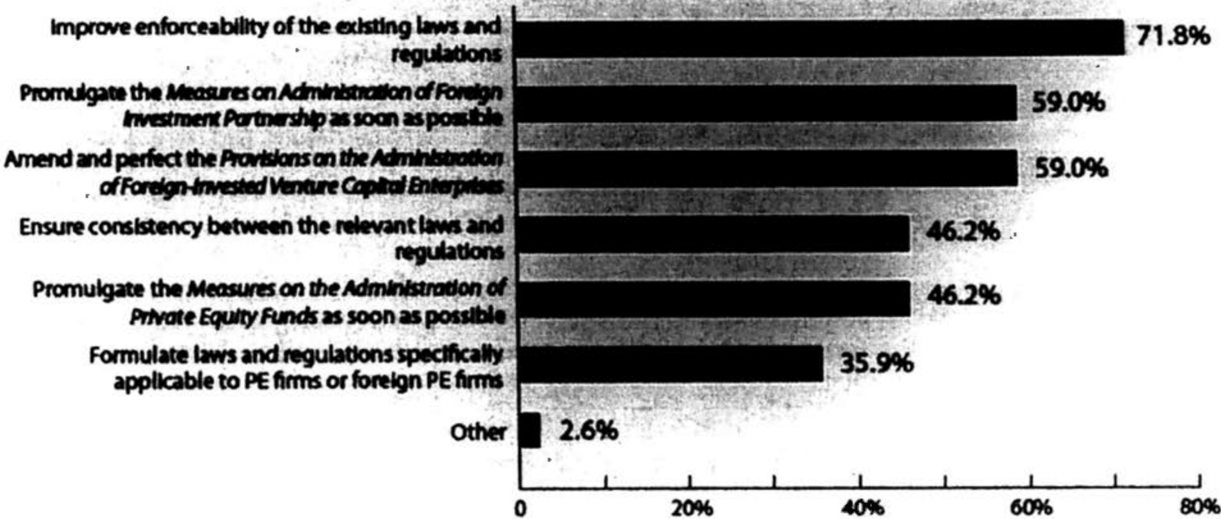

Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

[731] Ibid.

[732] CVCA (2009: 22).

## Table 2.12 VC Firms' Recommendations on the Overall Legal Framework

**Your firm's recommendations on the overall legal framework**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

# Chapter III. A Successful Venture Capital Legal Framework in the U.S.

## 3.1 Overview

The VC industry in the U.S. grew dramatically during the twenty years before the 2008 financial crisis.[733] The data of the NVCA show that the annual VC investment increased from $7, 406.77 million in 1995 to $17, 680.25 million in 2009.[734] The annual VC deals also increased from 1838 in 1995 to 2795 in 2009 (see Table 3.1).[735] Due to the financial crisis, the VC deals and investment amount showed a sharp year on year decline in 2009, which decline could well be temporary: "The venture capital industry had no choice but to slow the investment pace in 2009," said Mark Heesen, president of the NVCA, but "now that the economy has begun to show signs of improvement, we expect to see dollars flow more freely back into those sectors that offered the most promise before the recession began—clean technology, life sciences and IT."[736]

The long term growth of U.S. VC activity and the dimension of this activity in absolute terms have led investors, scholars, lawmakers, and other professionals to conduct considerable research and discussion on the development of the VC industry in the U.S.[737] How can the U.S. VC industry be so successful? Does a proper legal framework play a significant role in it? What can China learn from the legal experience of the U.S. VC industry? As a step in answering these questions, this chapter introduces the legal system and legal elements of the U.S. VC industry.

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733 Gilson (2003: 1069).

734 NVCA (2009: 1-3).

735 Ibid.

736 NVCA (2010: 1).

737 Feng (2004: 8-28).

**Table 3.1 Total U.S. VC Investments by Year 1995 to 2009**

| Year | Count of All Venture Capital Deals | $M Average Amount of All VC Deals | Total VC Investment $M |
|---|---|---|---|
| 1995 | 1,838 | 4.36 | 7, 406.77 |
| 1996 | 2,573 | 4.38 | 11,265.38 |
| 1997 | 3,157 | 4.71 | 14,870.89 |
| 1998 | 3,648 | 5.78 | 21,081.77 |
| 1999 | 5,504 | 9.82 | 54,052.77 |
| 2000 | 7,906 | 13.28 | 105,009.01 |
| 2001 | 4,484 | 9.05 | 40,563.36 |
| 2002 | 3,099 | 7.10 | 21,994.80 |
| 2003 | 2,937 | 6.73 | 19,764.92 |
| 2004 | 3,085 | 7.27 | 22,432.14 |
| 2005 | 3,153 | 7.33 | 23,106.74 |
| 2006 | 3,654 | 7.29 | 26,634.00 |
| 2007 | 3,920 | 7.82 | 30,665.42 |
| 2008 | 3,985 | 7.02 | 27,992.30 |
| 2009 | 2,795 | 7.33 | 17,680.25 |

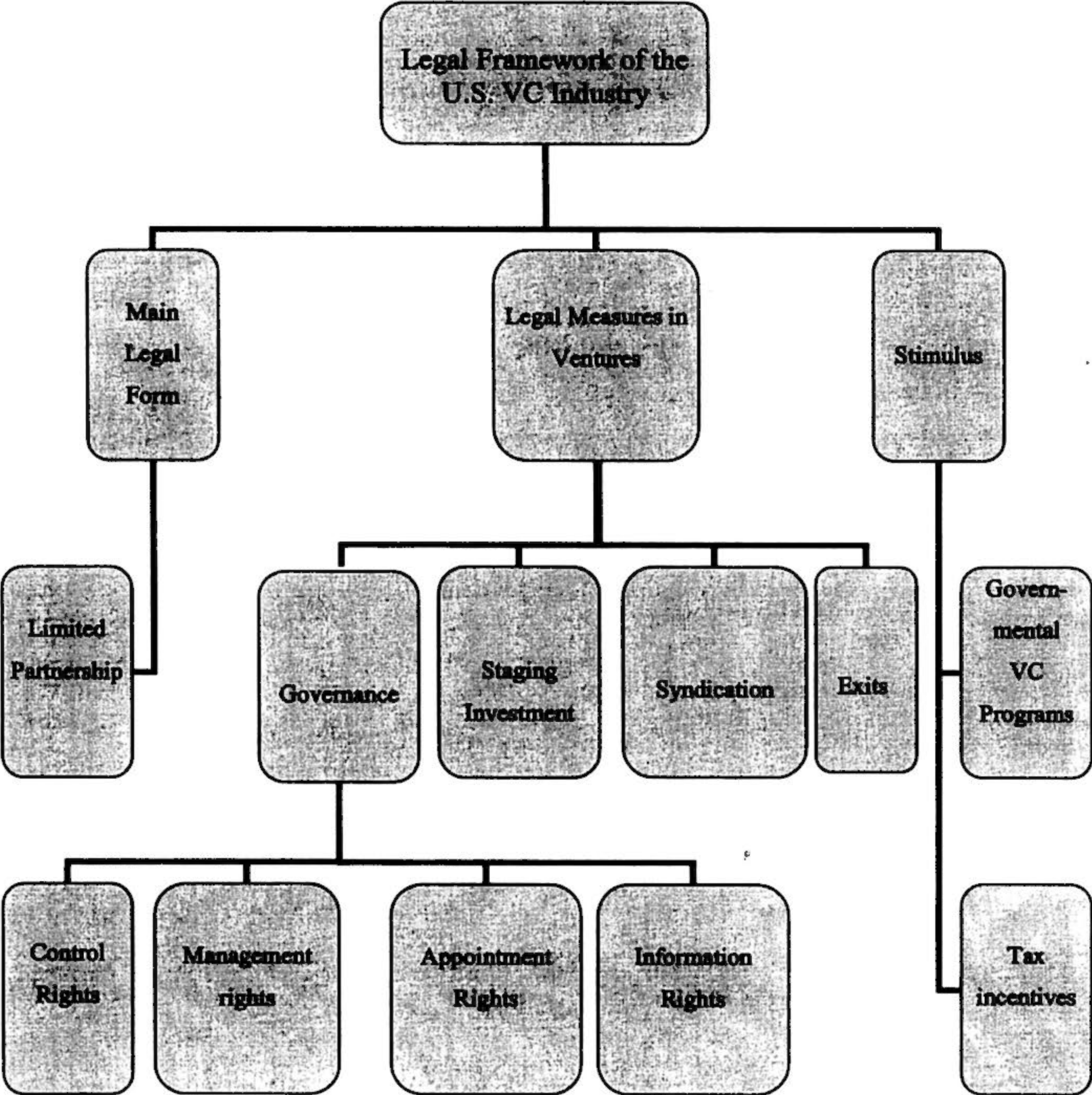
Source: PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report, Data: Thomson Reuters, available at www.nvca.org

This chapter is divided into three sections. The first section summarizes the key points and structure of the U.S. VC legal framework. The second discusses the milestones of the U.S. VC industry. The third discusses the theories and practice of the U.S. VC investments, including measures of VC governance, exits of VC, and U.S. governmental stimulus programs.

In detail, Section 3.2 introduces the background and several key events during the development of the U.S. VC industry from 1939, including the establishment of the first VC firm in the U.S., the promulgation of the SBIA, the interpretation of "Prudent Man" in the 1974 ERISA in 1978, and the limited partnership laws. The section shows the outcomes of each event and proves that legislation and government stimulus programs encourage the development of the U.S. VC industry.

Section 3.3 lists and analyses three elements of the U.S. VC legal framework, including the legal form of the VC firm, the governance of VC investment, and governmental stimulus. Since the limited partnership is the mainstream VC form in the U.S, Section 3.3.1 introduces the formation processes and management structure of the form, and the reasons why VCs choose the form. One central question animates this chapter: how do VCs reduce risks in their investments? Section 3.3.2 lists three agency problems: adverse selection, hold-up, and moral hazard in ventures. These problems create agency risk and business risk in VC investments. VCs use diversified governance measures to solve the problems in ventures during three VC phases of selecting investments, monitoring investments, and exiting investments. Section 3.3.2.2 explores these measures in VC investment. These measures include the use of control rights, management rights, appointment rights, and information rights. VCs monitor, bond, and advise the ventures through these legal rights to protect their interests and steer toward high returns. VCs will also use other measures, including staging investments, syndication, and exits to fulfill their investment goals, which are discussed in Section 3.3.2.2.6, Section 3.3.2.2.7, and Section 3.3.3 respectively. Section 3.3.4 explores the stimulus programs which are set up by the U.S. government to promote the VC industry. The U.S. VC industry would not have been so successful without the support from the government. The section briefly discusses the SBIC and other programs, as well as tax incentives.

**Chart 3.1 Structure of the Legal Framework of U.S. VC Industry**



## 3.2. Milestones of Venture Capital Development in the U.S.

### 3.2.1 Introduction

In the U.S. before World War II, the term "venture capital" was not treated as a particular financial sector but as a traditional investment industry which allowed some wealthy individuals to invest in start-ups.[738] For example, Mr. Andrew William Mellon is identified as one of the most successful "venture capitalists" in Pittsburgh in 1882.[739] He took charge of his family private bank and funds. These VCs invested in American industrial areas without underwriting or syndicating security issues to the public. This type of VC was far more personal than institutional.[740] The first formal institutional VC firm, which is discussed in Section 3.2.3, is the ARD formed in 1946.[741] This section briefly introduces the background of personal VC investments before 1946, and then presents in more detail the legal milestones of the VC industry of the U.S. after the establishment of ARD, including the SBIA program, the SBIC program, the 1974 ERISA, and limited partnership legislation. This section then argues that that a proper legal framework is the cornerstone of the U.S. VC industry and that legislation and governmental stimulus programs will encourage the development of the VC industry.

### 3.2.2 Wealthy Individuals as Informal Venture Capitalists

Before World War II, start-up investment was the field of wealthy individuals and families.[742] Whitneys, Rockefellers, and Warburgs were the famous investors in start-ups in the first half of the 20th century.[743] As early as the 1920s, these wealthy

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738 Thompson (2008: 5).

739 Chandler (1990: 80).

740 Gupta (2000: 2).

741 Bygrave & Timmons (1992: 1-2).

742 Gupta (2000: 2).

743 Lerner, Hardymon, and Leamon (2005: 1-2).

individuals and families set up personal funds to invest in start-ups, a kind of informal VCs.[744] But high tax rates discouraged them to invest in new industries in the 1930s.[745] A large rate increase came with the Revenue Act of 1932.[746] The Revenue Act of 1937 separated individuals' short-term and long-term capital gains and taxed their short-term capital gains as ordinary income.[747] VC investment became less attractive to wealthy individuals as tax rates grew heavier and more progressive.[748]

Another problem of VC investment at that time was that it was very hard for start-ups to raise capital from traditional investment firms. In 1938, a U.S. venture capitalist, Joseph Nicholson, noted, it was necessary to improve small businesses' access to capital.[749] However, institutional obstacles were great. He concluded that neither banks, investment firms, nor the government could properly supply long-term or permanent capital for small business.[750] He then called for a new institution to infuse capital into these start-ups.[751]

Under this circumstance, the U.S. securities laws tended to give some "privileges" to VC investment in the 1940s.[752] The 1940 Act contains two exemptions for so-called private investment companies which do not make a public offering of their shares. The one is related to VC projects, and exempts companies which only sell their shares to a small number of investors.[753] More specifically, the rule excludes a company from registration if its securities are owned by one hundred or fewer persons and it will not make a public offering of the securities.[754] The reason why the U.S. Congress created

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744 Gupta (2000: 3-6).

745 Reiner (1989: 6).

746 Reiner (1989: 12).

747 Paul (1937: 59).

748 Reiner (1989: 7).

749 Nicholson (1938: 34), see Reiner (1989: 40).

750 Ibid.

751 Ibid.

752 Reiner (1989: 40).

753 Money Manager's Compliance Guide (2000: Tab 300-55).

754 Sec. 3(c)(1), 1940 Act.

this exemption is that at the time it was believed such small, private investment companies would involve the kind of face-to-face negotiations and sales traditionally protected by contract and tort law, and that companies engaging only in such sales should not have to fulfill the complex registration obligations under the federal securities regulations to trigger standardized disclosure and remedies.[755] Individual VC firms, including formal VC firms after World War II, can commonly rely on this exemption to avoid the comprehensive requirements of the 1940 Act.[756] Such exemption did encourage investors to enter into VC projects. This legislative tendency also helped to set up an independent VC industry from traditional investment fields.

### 3.2.3 American Research and Development Corporation

As mentioned, it was very difficult for start-ups to borrow money from traditional financial institutions, such as commercial banks, from the 1920s to the 1940s in the U.S. because bank rules emphasized that the entrepreneurs should offer enough assets or business reputation to guarantee repayment prior to the lending. Most start-ups, however, could not meet these requirements and it was also very hard for entrepreneurs who did not have wealthy friends to fund their start-ups.[757] To resolve the "deadlock," the ARD was set up in order to meet large needs for VC.[758] The ARD was established in 1946 by MIT President Karl Compton, a professor at Harvard Business School, General Georges F. Doriot, and local business leaders from the Boston area; ARD was the first institutional modern VC firm in the U.S.[759] It was formed as a public corporation.[760] But the legal features of public corporation bring some disadvantages to VCs because VC investment is usually long-term investment, which does not suit the needs of many investors. For example, if sixty-year old investors buy the shares of a public VC corporation, they would likely prefer a high current income as soon as possible rather than long-term capital gains. Conflict between the shareholders and VCs

755 Money Manager's Compliance Guide (2000: Tab 300-56).

756 Ibid.

757 Thompson (2008: 6-7).

758 McCahery & Renneboog ed. (2003: 35).

759 Allen & Song (2002).

760 Lerner, Hardymon, and Leamon (2005: 2).

in a public VC corporation would hurt the business, reputation, and the future of the company. Therefore, one disadvantage of a public VC corporation is that the company or the existing shareholders cannot choose the potential shareholders.

The ARD was the first institutional VC firm, supplementing the investing of wealthy families or informal VCs.[761] It was also the first VC firm to use capital from other institutional investors, including insurance companies, investment companies, and universities.[762] The first significant story of VC investment was written by the ARD when it invested $70,000 in Digital Equipment Corporation in 1957 and exited the venture with over $355 million after the company's IPO in 1968.[763] The ARD did not stop its VC investment until 1971 with Doriot's retirement. In 1972, Doriot merged the ARD with Textron after having invested in over one hundred and fifty companies.[764]

### 3.2.4 Small Business Investment Companies Act of 1958

The ARD could not alone solve all the problems in the VC industry. To solve these problems faced by start-ups, the U.S. government began its VC efforts in 1958. One of the steps toward a professional VC industry supported by the government was the 1958 SBIA.[765] The 1958 SBIA allowed the SBA to license and regulate private SBICs to invest in start-ups in the U.S. This governmental VC operation is called the SBIC program, in which an SBIC can be organized as a corporation, a limited partnership, or an LLC.[766] Private investors could set up SBICs to finance start-ups by long-term loans or debentures.[767] However, SBICs could not buy stocks from the public markets until the amendments of 1958 SBIA in June 1960.[768] Private investors needed $300,000 in capital to be licensed as an SBIC. In 2003, the amount was increased to $5 million.[769]

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761 Chew (2001: 10).

762 Chew (2001: 11-12).

763 Fuerst & Geiger (2003: 201-202).

764 http://www.pbs.org/wgbh/theymadeamerica/whomade/doriot_hi.html_

765 Sec.101, 1958 SBIA.

766 Allen & Song (2002).

767 Gupta (2000:7-8).

768 Bartlett (1994: 590-593).

769 Sec. 302(a)(1)(A), SBIA1958.

Initially, the SBA could expand its investment in an SBIC by purchasing subordinated debentures of the SBIC if the private investors would contribute at least $150,000.[770] Amendments in 1961 and 1963 raised to $700,000 the amount of subordinated debentures that the SBA could buy from an SBIC to match its private investors' contributions.[771] The SBA could also make loans to SBICs for as much as half of their capital, up to $4 million.[772] Thus, investors could leverage their own capital two for one in VC investments by organizing SBICs.[773] Another main advantage of the SBIC program is that private VC investors can obtain low-cost loans from the SBA. The debentures have "a term of 10 years and provide for semi-annual interest payments and a lump sum principal payment at maturity."[774] But it is not simple for an SBIC to get the funds from the government. It faces strict financial reporting requirements and other examinations by the SBA.[775] The SBICs are also required to have qualified management teams, some successful VC investment experience, and a good business plan for future investments.[776] Nevertheless, scholars have criticized that many managers in SBICs do not have enough VC investment skills.[777]

The SBIC program also encouraged institutional investors to join. The program allows banks, which were previously prohibited from doing so, to engage in VC investments. Thus, some bank-backed SBICs appeared and became the major VC financing sources after 1958.[778] For example, Bank of America organized an SBIC in 1959 named the Small Business Enterprises Corporation.[779] This firm was the first of the "orthodox

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770 Sec. 303(b)(2)(A), Ibid.

771 Bartlett (1994: 601).

772 Sec. 306(a), 1958 SBIA.

773 Reiner (1989: 279).

774 See the website of Small Business Notes at http://www.smallbusinessnotes.com/financing/sbic.html.

775 Sec. 308(g)(1), 1958 SBIA.

776 Sec. 301(c)(3)(A)(ii), 1958 SBIA.

777 Gupta (2000: 7).

778 Reiner (1989: 316).

779 Ibid.

institutions on the West Coast to get involved" in VC investments.[780] Fourteen banks launched their VC investments between 1958 and 1965 through the SBIC program.[781]

Although private limited partnership VC firms have played the major roles in the VC industry since the 1970s, the SBICs were the dominant VC vehicles in the 1960s.[782] Hence, the SBIC program created a chance for training many professional VCs for the U.S. and for the coming prosperity of the VC industry in the 1970s. The SBIC program still exists today and shares many sources and experiences with VC investors and entrepreneurs. However, the complicated legal restrictions of the program keep it from becoming the major VC financing for start-ups in the U.S.[783]

### 3.2.5 Employee Retirement Income Security Act

In the late 1970s, there was an important regulatory interpretation which pushed the U.S. VC industry towards drastic growth. It was the Labor Department's interpretation of the "prudent man" provision of the 1974 ERISA.[784] The 1974 ERISA regulates the administration, investment, and risk management policies of private pension funds in the U.S.[785] These pension funds were traditionally prohibited from conducting VC investments before 1979.

In 1974, the Congress passed the 1974 ERISA as comprehensive regulation of the private fund industry, and a prudence requirement it placed on fund managers worked to restrict pension fund managers from investing in high-risk industries.[786] The 1974 ERISA's ambiguous definition of the fiduciary duties of fund managers made these managers worry about their personal liability if they failed in the VC investments.[787]

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780 Ibid.

781 Reiner (1989: 317).

782 Reiner (1989: 281).

783 Gompers & Lerner (1997).

784 Fuerst & Geiger (2003: 201-202).

785 Purcell & Staman (2008: 7).

786 Gompers & Lerner (1996).

787 Allen & Song (2002).

Because of both the large funding needs of the VC industry and the quality of many investments in start-up enterprises, the U.S. Department of Labor loosened the restrictions by the reinterpretation in 1979 of the definition of the "prudent man", allowing VC investments of pension funds' managers.[788] The most important aspect of the reinterpretation is that the managers of pension funds will not automatically incur fiduciary liability for decisions to make VC investments.[789] The ERISA stipulates that a person is a fiduciary with respect to an investment plan to the extent that such a person does any of the following: "1) Exercises any discretionary authority or control over the management of a plan, or over the management or disposition of plan assets; 2) Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan; or 3) Has any discretionary authority or discretionary responsibility in the administration of such plan."[790] Thus, the ERISA defines "fiduciary" not in terms of "formal title but rather in functional terms of control and authority over the plan."[791] Further, according to the law, a fiduciary must give "appropriate consideration to the facts and circumstances that the fiduciary knows or should know are relevant to the particular investment, including the role that the investment plays in the plan's investment portfolio; fiduciary must act in accordance with the conclusions that were reached after the appropriate consideration."[792]

To clarify its position on the nature of a proper investment for a fiduciary, the U.S. Department stated, "Clearly, we believe the stocks of smaller companies have a place in investment portfolios ...when prudently selected to include adequate diversification, these stocks can offer above average potential and will significantly add to the overall diversification and return on pension assets."[793] Beyond the federal context, today 35 states in the U.S. have adopted the modern prudent investor rule for repealing the old

[788] Purcell & Staman (2008: 3).

[789] Ibid.

[790] Sec. 3(21)(A), 1979 ERISA.

[791] Jones, Ziga, and Chong (2004: 1).

[792] Sec. 2550, 404a-1(b)(1), 29 C.F.R.

[793] Reiner (1989: 386-387).

prudent man rule.[794] The new rule provides that the "trustee's investment and management decisions respecting individual assets are evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[795]

After the revision at the federal level, the U.S. pension funds started to invest in start-ups and VC firms. According to the current rule, investments should be managed "with the care, skill, prudence and diligence under the circumstances then prevailing, that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[796] During the late 1970s and early 1980s, most of pension funds invested in VC firms.[797] In 1988, 47% of the new capital raised by VC firms came from pension funds.[798]

A VC fund will be governed under the 1974 ERISA if it admits a pension fund to be the LP.[799] The VC fund's capital and assets will be treated as property of the pension fund under the 1974 ERISA if the pension fund invests in the VC fund.[800] The regulation defines the property as "plan assets," which are strictly monitored by the U.S. authorities.[801] But the VC fund could get an exemption from the law if it can meet the following standards:

(1) the fund is a U.S. registered investment company under the 1940 Act; or

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794 Schanzenbach & Sitkoff (2010: 316).

795 Sec. 2, 1994 Uniform Prudent Investor Act.

796 29 C.F.R., § 2550, 404a-1(2009).

797 Gompers & Lerner (1996: 468).

798 Gompers & Lerner (1996: 389).

799 Sec. 80a-3(b)(3), 15 U.S.C.

800 Chan (2008: 456-457).

801 Helm & Babikian (2006: 821-822).

(2) the securities of the fund are publicly offered in the U.S., that is, the securities are widely held, freely transferable and either (i) part of a class of securities registered under 12(b) or 12(g) of the 1934 Act; or (ii) sold as part of an offering of securities to the public pursuant to an effective registration statement under the 1933 Act and the securities are part of a class registered under the 1934 Act within 120 days after the end of the fiscal year of the issuer during which the offering to the public occurred; or

(3) employee benefit plan investors (U.S. or foreign, including government pension plans) hold 25% or more of any class of equity interest of the fund; or

(4) the fund is a "VC operating" company. To maintain the status of a VC operating company, the VC fund should invest more than 50% of its capital in VC investments and at least manage one program of the investments; or

(5) the fund is either a "venture capital operating company" or a "real estate operating company" as defined for ERISA purposes.[802]

### 3.2.6 Laws of the Limited Partnership

In 1822, New York State passed the first limited partnership act in the U.S.[803] Other states soon followed this legislation. In 1868, a common law court stated that the purpose of limited partnership legislation is to "encourage trade by authorizing and permitting a capitalist to put his money into a partnership with general partners possessed of skill and business character only, without becoming a general partner, or hazarding anything in the business except the capital originally subscribed."[804] Today,

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802 Chan (2008: 456–457).

803 Kessler (2003: 530).

804 Clapp v. Lacey, 35 Conn. 463, 463 (1868)

all U.S. states except Louisiana have approved the Uniform Limited Partnership Act.[805] The first Uniform Limited Partnership Act was adopted in 1916 by the NCCUSL.[806] Then the act was replaced by the 1976 ULPA,[807] which gave way to 1985 RULPA,[808] and eventually to 1996 ULPA. In 2001, a new limited partnership act, the 2001 ULPA, was adopted by NCCUSL.[809] The 2001 ULPA is a "stand alone" act, "de-linked" from both the original UPA and the 1985 RULPA.[810] That means the 2001 ULPA is intended to provide "the entire operative organizational law for limited partnerships in a single act."[811] But up till now, only seven states have adopted this act.[812] Thus, most limited partnerships in the U.S. are still governed by the 1985 RULPA.

The first limited partnership VC firm, Draper, Gaither and Anderson LP., was formed in 1958.[813] But prior to the 1980s only a few VC firms were structured as limited partnerships.[814] During the 1980s and 1990s, however, over 80% of the VC money was invested in limited partnership VC firms.[815]

The provision of the 1916 ULPA about limited partners' liability and participation in management is very simple; it stipulates that an LP has no personal liability to creditors unless the LP "takes part in the control of the business" without defining the meaning of

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805 See the list at http://www.law.cornell.edu/uniform/vol7.html#limpart.

806 Kleinberger (2004: 583).

807 Kessler (2003: 542).

808 Ibid.

809 Kessler (2003: 543).

810 See the Prefatory Note, 2001 ULPA.

811 Geu & Nekritz (2002: 47).

812 Those states are Florida, Hawaii, Illinois, Iowa, Minnesota, and North Dakota. See Florida Revised Uniform Limited Partnership Act of 2005, Fla. Stat. § 620.1101 to 2205 (2006); Uniform Limited Partnership Act (Revised), Haw. Rev. Stat. § 425E-101 to -1205 (2006); Uniform Limited Partnership Act, Idaho Code Ann. § 53-2-101 to -1205 (Supp. 2006); Uniform Limited Partnership Act, 805 Ill. Comp. Stat. §215/0.01 to / 1402 (Supp. 2006); Uniform Limited Partnership Act, Iowa Code § 488.101 to .1207 (2007); Uniform Limited Partnership Act of 2001, Minn. Stat. § 321.0101 to .1208 (2006); Uniform Limited Partnership Act (2001), N.D. Cent. Code §§ 45-10.2-01 to -117 (Supp. 2005). See also Stephens (2007: 527).

813 Gompers & Lerner (2004).

814 Gompers & Lerner (1997).

815 Allen & Song (2002).

"control." [816] The 1976 ULPA and 1985 RULPA then try to reduce the uncertainty of the definition of "control." The 1985 RULPA created a "safe harbor" for LPs. Unless the LP "participates in the control of the business" and people "transact business with the limited partnership reasonably believing...that the limited partner is a general partner,"[817] the actions of the LPs listed in the "safe harbor," including consulting with a GP about the firm's business, hosting or joining a partners' meeting, and voting on any business issues which need to get an approval of the LPs according to the partnership agreements will not be treated as participation in the control of the limited partnership firm.[818] The 2001 ULPA sharply modified the relevant rule, providing that the LPs will not be treated as GPs "even if the limited partner participates in the management and control of the limited partnership."[819] As stated, the 2001 ULPA has not been widely adopted, thus in most states, in order to keep the protection of limited liability, the LPs should not conduct day-to-day management of the firm and make decisions on VC investments as GPs, unless GPs allow them to do that with a prior agreement.[820]

The limited partnership form has a number of advantages for VC projects. One of them is VC investors can enjoy pass-through taxation, which would not be possible by using the corporation structure. That means the limited partnership VC firms do not need to pay capital gains taxes, as gains are taxed only at the level of the partners.[821] Today, the limited partnership VC firms may choose whether they want to be taxed as a partnership or as an LLC of the U.S.[822] The arrangement makes it possible, when choosing a firm's

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816 Sec. 7, 1916 ULPA.

817 Sec. 303(a), 1985 RULPA.

818 Sec. 303(b), Ibid.

819 Sec. 303, 2001 ULPA.

820 Gulinello (2006: 290-278).

821 Gompers & Lerner (1997).

822 The LLC is a legal entity created by the U.S. laws (see the Revised Uniform Limited Liability Company Act (2006) ("2006 RULLCA"), § 102, § 201) which is defined as having legal characteristics of both a corporation and a partnership (see Peng (2005: 105)). An LLC's owners are waived from personal liability as a corporation and can enjoy pass-through taxation as a partnership (see 2006 RULLCA, § 304 and the Comment to Section 304; see also the Treasury Regulation of the U.S., § 301.7701-3). This is a fundamental characteristic of the LLC legal structure. An LLC can be

structure, for VC investors to have various options to suit their business purposes. One advantage of the limited partnership structure for VC investors investing in ventures is that the partners would not be taxed when they distribute shares of the ventures to other buyers until these securities have been sold.[823] Of course, the partners could not enjoy this advantage unless they can meet some requirements. First, the transfer of the partnership' units is restricted, which makes it difficult to buy or sell the units.[824] It is also difficult for partners to quit the firm before the termination of the partnership.[825]

### 3.2.7 New Markets Venture Capital Program

Most VC firms in the U.S. would not like to invest in low-income areas because of poor returns.[826] The U.S. government had to launch the NMVC program in 2001 to encourage VC investments in low-income communities of the U.S. to create more job opportunities and new start-ups in these places.[827] The goal of the program is to promote the business in low-income areas and to offer more jobs and higher salary to local people through VC investments, particularly in high technology, more start-ups, and talents.[828] The program accommodates guaranteed debenture financing to VC funds which invest in these places and gives other financial supports to the local ventures.[829] The details of the operation of the program are discussed in Section 3.3.7.2.

Generally, VC investments seek "rich" areas in the U.S. From 1991 to 2000, for instance, 65.2% of all VC investments were in start-ups established in only five states,

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treated as a partnership to avoid double tax charge (see the Treasury Regulation of the U.S., § 301.7701-1 and 7701-3). Therefore, the LLC is a hybrid structure which consists of the tax treatments of a partnership and the limited liability protections of a corporation in the U.S.(see Shu (2005: 1014); see also 2006 RULLCA, § 304 and the Treasury Regulation of the U.S., § 301.7701-3). However, some states of the U.S., California for example, prohibit the use of LLC to operate professional services, such as banking, trust company, or insurance (see Shu (2005:1015)).

823 Gulinello (2006: 290-291).

824 Callison & Vestal (2004: 731).

825 Callison & Vestal (2004: 732).

826 The Community Development Venture Capital Alliance (2006).

827 Sec. 108.10, NMVC program.

828 Sec. 108.10, and Sec. 108.130, Ibid.

829 Sec. 108.1200, Ibid.

Massachusetts, California, Texas, New York, and Colorado.[830] In the first three months of 2006, three regions, Silicon Valley, New England, and Orange County attracted 59% of all VC investments and 49% of all VC transactions.[831] The NMVC program wants to change this situation by encouraging VC investors to look for new opportunities in low-income areas.[832] Currently, there are seven NMVC-backed funds, and these NMVC companies have raised $48 million from private investors, including commercial banks, wealthy individuals, and insurance companies, and have invested the money in low-income areas in the U.S.[833]

## 3.3 Theories and Practice of Venture Capital Investments in the U.S.

### 3.3.1 Limited Partnership: Main Legal Form of Venture Capital

#### 3.3.1.1 General

The legal forms of VC firms in the U.S. VC industry are thus the limited partnership, the limited liability partnership, the LLC, and the corporation.[834] One scholar classifies VC firms in four basic categories. The first type is the SBICs. As discussed, these companies are "federally chartered corporations" established under the 1958 SBIA.[835] Some researchers call these firms "incubator funds" because the SBA will take care of

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[830] Carlson & Chakrabarti (2007).

[831] Ibid.

[832] Kerry (2006).

[833] The NMVC companies are: the Southwest Development Fund, LLC (Arizona), the Murex Investments, I, L.P. (New Jersey, Pennsylvania & Delaware), the Pennsylvania Rural Opportunities Fund (Pennsylvania), the CEI Community Ventures Fun, LLC (Main, New Hampshire & Vermont), the Adena Ventures, L.P. (Ohio, West Virginia, Maryland & Kentucky), the Dingman Center for Entrepreneurship (Maryland & Washington DC), and the Southern Appalachian Fund, L.P. (Tennessee, Kentucky, Alabama & Georgia), see Banner & SmallBiZ.com, Inc. (2001).

[834] See NVCA (2009)., Venture Capital Industry Overview. In the article, the legal forms of US VC firm are identified as four types, 1) limited partnership, 2) corporation, 3) limited liability partnership (LLP), and 4) LLC.

[835] In Sec. 301 (a) of the 1958 SBIA, "a small business investment company shall be an incorporated body, a limited liability company, or a limited partnership organized and chartered or otherwise existing under State law solely for the purpose of performing the functions and conducting the activities contemplated under this title, which, if incorporated, has succession for a period of not less than thirty years unless sooner dissolved by its shareholders, and if a limited partnership, has succession for a period of not less than ten years, and possesses the powers reasonably necessary to perform such functions and conduct such activities." See also Megginson (2002: 8).

these companies by providing management directions and financial supports.[836] The second type is financial VC firms, which are the subsidiaries of some financial institutions, including commercial banks or insurance companies.[837] The third type is corporate VC firms, which are the subsidiaries set up by non-financial corporations, including some big international companies or high-tech companies.[838] The last type is limited partnership VC firms. They are the firms created by private VCs, which act as GPs to set up, invest in, manage, and finally liquidate the firms.[839] The capital of these firms comes from their LPs.[840]

Partly, but not completely, overlapping with the above, VC firms could also be classified into five types.[841] The first type is the private VC firms funded by pension funds or wealthy individuals.[842] The second type is the corporate industrial VC firms, wholly owned by corporations.[843] The third type is the corporate financial firm, which is wholly owned by financial institutions.[844] All these three types of VC firms are classified as "private firms." The forth type is the government or the public VC firms, which are VC corporations owned and run by the governments.[845] The fifth type of firm is the hybrid firm, which is formed under a governmental incentive program.[846]

Although the corporation structure is a very popular VC form in China, it is not the mainstream VC form in the U.S.[847] The mainstream VC form of the U.S. is the limited

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836 Gladstons (2002: 10).

837 Megginson (2002: 7).

838 Megginson (2002: 8).

839 Ibid. NVCA calls the VC limited partnership as "private independent firms" and the financial VC firms or corporate VC firms as "corporate venture investors." See the website of NVCA, available at www.nvca.org/def.html.

840 Megginson (2002: 8).

841 Cumming & Macintosh (2002: 80).

842 Ibid.

843 Ibid.

844 Ibid.

845 Ibid.

846 Ibid.

847 Peng (2005: 106).

partnership. In 2007 and 2009, China has also modified its partnership regulations twice to establish a limited partnership structure for domestic and foreign VC investors.[848] The legislation indicates that China is trying to set up a limited partnership structure for its VC industry based on the experience of the U.S. For the purpose of this study, the discussion will be based on the legal classification of this form, which is helpful for understanding how to set up a proper legal framework for China's VC industry.[849] The aspects of definition, formation, management, and control of the limited partnership VC form will be introduced and examined in the following sections. Further, as mentioned before, the U.S. VC legal framework is treated as the standard framework in this study. Hence, all legal issues about limited partnership are discussed under the U.S. laws.

### 3.3.1.2 Limited Partner and General Partner

Although other legal forms are permitted,[850] the U.S. VC firms prefer to set up limited partnerships as it provides a good mix for taxation, management and liability.[851] The limited partnership form is also beginning to be a mainstream VC form now in China because of its advantages.[852] A limited partnership has one or more GPs, who manage the business and bear the firm's legal debts and obligations, and one or more LPs, who are liable only to the extent of their investments for the partnership obligations under the limited partnership laws of the U.S. or China.[853] In the Delaware Limited Partnerships Act, the limited partnership means "a partnership formed under the laws of the State of Delaware consisting of two or more persons and having one or more general partners and one or more limited partners."[854] The 2001 ULPA defines the limited

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848 See Chapter III.

849 Another reason is stated by a scholar. He points out that all business organization forms have three fundamental characteristics, "(1) each form has control attributes, which concern the firm's patterns of decision-making authority and agency power, (2) each form has risk attributes, which concern the manner in which the firm's loss risks are allocated among the participants, (3) each form has reward attributes, which concern the allocation of the firm's profits and value among the participants." See Callsion (2000: 101).

850 Gompers & Lerner (2000: 95).

851 Black & Gilson (1998: 252).

852 Gladstons (2002: 15).

853 Sec. 402 (a), 2001 ULPA. Art. 77 & Art. 83, 2006 PEL.

854 Sec. 17-101(9), DRULPA.

partnership as "an entity, having one or more general partners and one or more limited partners, which is formed under this Act by two or more persons..."[855] Thus, the limited partnership is an entity distinct from its partners.[856]

Furthermore, the limited partnership VC firm has the following features under current U.S. law.[857] Unlike a corporate form, a limited partnership VC firm has a finite lifespan.[858] The LPs of the VC firm are passive investors and do not have authority on firm's management and decision-making for VC investments.[859] But they have rights to monitor the operation of the firm.[860] The GPs have full power to manage the firm's day-to-day business.[861] A U.S. limited partnership VC firm enjoys pass-through taxation status as discussed above. The VC firm cannot enjoy such treatment if it organizes as a corporation.[862] These features raise another question: what are the legal relationships between GPs and LPs in the limited partnership? The following discussions of rights and obligations of GPs and LPs will answer the question.

An LP does not have the power to manage the limited partnership[863] unless the partnership agreement gives her such power.[864] Except the authority of managing the limited partnership, an LP has full rights in the partnership. These rights include the rights to vote on approval of admission of a new LP,[865] if LP shares are made subject to transfer restrictions, of admission of GPs,[866] of revising the partnership agreement,[867]

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855 Comment to Sec. 102 (11), 2001 ULPA.
856 Sec. 104 (a), Ibid.
857 Ribstein (2001: 819).
858 Fenn et al. (1995: 34).
859 Gulinello (2006: 268).
860 Levin (2001: §1001.1).
861 Gulinello (2006: 282).
862 Levin (2001: §1001.1).
863 Sec. 302, 2001 ULPA.
864 Comment to Sec. 302, Ibid.
865 Sec. 301 (3), Ibid.
866 Sec. 401 (4), Ibid.
867 Sec. 406 (b) (1), Ibid.

of making a contribution, of returning an improper distribution,[868] and a right to review business information of the limited partnership.[869] A very important difference between LPs and GPs is that the LPs, unlike GPs, do not have any fiduciary duties to the limited partnership.[870] The fiduciary duties are duties of loyalty "to account to the limited partnership and hold as trustee for it any property, profit, or benefit derived by the GPs in the conduct and winding up of the limited partnership's activities or derived from a use by the GPs of the limited partnership property, to refrain from dealing with the limited partnership in the conduct the limited partnership's activities as or on behalf of a party having an interest adverse to the limited partnership, and to refrain from competing with the limited partnership in the conduct of the limited partnership's activities."[871] A person who has significant power to conduct business on behalf of other persons should bear such fiduciary duties.[872] The LPs do not need to fulfill any fiduciary duties to the partnership or other partners due to their very limited power in the firm.[873]

A GP is an agent of the limited partnership based on her activities and power in the partnership.[874] Each GP has equal rights to manage the firm and to conduct the VC investments of the firm.[875] Generally, all issues relating to daily operation of the limited partnership should be solely decided by the GPs.[876]

The LPs are capital contributors to the limited partnership. In the U.S., these LPs could be institutional investors, i.e. pension funds, corporations, banks, or individuals. GPs are the VCs, who will set up the VC fund and operate the investments without contributing

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868 Sec. 502 (c), Ibid.

869 Sec. 304 (a), Ibid.

870 Sec. 305 (a), Ibid.

871 Sec. 408 (b), Ibid.

872 Comment to Sec. 305 (a), Ibid.

873 Comment to Sec. 305 (a), Ibid.

874 Sec. 402 (a), Ibid.

875 Sec. 406 (a), Ibid.

876 Sec. 406 (a), Ibid. Such activities should be decided by a majority of the GPs if there is more than one GP in the limited partnership. See Also the section.

to the fund.[877] The legal relationships between the LPs and GPs are determined by a series of contracts and the limited partnership agreement which generally include three types of covenants, the covenants relating to the management of the VC firm (e.g., the size of the investment in one start-up, the distribution of debt, syndication, and reinvestment of gains), the covenants relating to the activities of the GPs (e.g., sale of partnership assets, fundraising, and the admission of other GPs or investment managers), and the covenants relating to other financial operations (e.g., investments in other VC firms, buying public securities, foreign securities or other properties).[878]

### 3.3.1.3 Formation of Limited Partnership

The GPs and the LPs should have a partnership agreement before they set up a limited partnership. In the U.S., "partnership agreement" means the partners' agreement, whether "oral, implied, in a record, or in any combination, concerning the limited partnership."[879] Then, these partners should file a certificate of the limited partnership with the Secretary of State. The certificate must state the name of the limited partnership, the mailing address of the limited partnership's office, the name and the mailing address of each GP, and any other information required by the state laws.[880] The Secretary of State will issue a certificate of existence to the limited partnership if the partners have paid the application fee.[881] A certificate of existence must state the name of the limited partnership, the date of formation of the limited partnership, whether all fees or taxes have been paid, whether the most recent annual report of the partnership has been filed, and other necessary information required by the state laws.[882] Each year, the limited partnership should file an annual report with the Secretary of

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877 Sec. 102 (11), Ibid. "'limited partnership', except in the phrases 'foreign limited partnership" and "foreign limited liability limited partnership', means an entity, having one or more general partners and one or more limited partners, which is formed under this Act by two or more persons or becomes subject to this Act under Article 11 or Sec. 1206(a) or (b)." See also Cumming & MacIntosh (2003: 3).

878 Sec. 102 (13), and Sec. 201, 2001 ULPA. See also Cumming & MacIntosh (2003: 3).

879 Sec. 102 (13), 2001 ULPA.

880 Sec. 201 (a), Ibid.

881 Sec. 209 (a), Ibid.

882 Sec. 209 (a), Ibid.

State, stating the name of the partnership and the mailing address of the partnership's office.[883]

### 3.3.1.4 Management in Limited Partnership

As mentioned, the VCs serve as GPs and the investors are LPs in a limited partnership VC firm.[884] The LPs will invest their money in the firms for a term of two or three years.[885] The GPs operate the firm and search for suitable investment opportunities on behalf of the partnership and the LPs.[886] Typically, the U.S. GPs will try to earn profits for the LPs from the VC investments within a given period, which is around seven to ten years.[887] The VCs will raise a new fund after they terminate the old one. Moreover, a finite life of VC firm is necessary in order for LPs and other potential investors to verify the investments skills of the VCs in a fixed period.[888] The VCs could also maintain their reputation by staging their fundraising.[889]

In a general partnership, all partners are the GPs, and all act as principals of the firm and have authority to operate management and decision-making on behalf of the firm.[890] But as explained above, LPs only act as passive investors with few powers to affect the operation and management of the VC firm.[891] In some cases, however, although the LPs are "passive", having no involvement in the day-to-day management of the VC firms,[892] "safe harbor" mechanisms permit the LPs to participate in certain management

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883 Sec. 210 (a), Ibid. Further, the law requires "the street and mailing address of limited partnership's designated office and the name and street and mailing address of its agent for service of process in this State, and the street and mailing address of its principal office." See the same section.

884 NVCA (2009).

885 Gladstone & Gladstone (2002: 9).

886 Ibid.

887 Fenn et al. (1995: 34).

888 Sahlman (1990: 513).

889 Ibid.

890 Gladstone & Gladstone (2002: 9).

891 Rosenberg (2002: 381). "However, if the general partners are themselves organized as a limited liability entity such as an LLC or a corporation, the individual partners will not suffer personal liability for most debts incurred by the limited partnership." See Rosenberg (2002: 381).

892 Sec. 303, 2001 ULPA. "A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a

or strategic decisions of the firm.[893] The legal design allows the LPs to engage in the firm business without worrying about losing their limited liability status.[894] For instance, the LPs have rights to give investment suggestions to GPs by establishing a consultant committee to suggest on the important deals according to the DRULPA.[895] Finally, the law gives power to the LPs to vote on some core issues of the firm, including the liquidation of the VC firm, the sale of firm's assets, and change of the GPs and managers.[896] The purpose of the legislation is to give authority to LPs to monitor the operation of GPs and the firm.[897] That means LPs could play a positive role in the management and exercise a strong influence on the VC investments through having meetings with the GPs.[898] The GPs inform LPs by monthly or quarterly reports about the progress of the firm, and will conduct at least one formal meeting with all LPs every year.[899] In addition, the LPs will meet quarterly in the consultant committee to evaluate the business of the firm, such as investment strategy, term of the investments, the business of ventures, and possible conflicts of interests.[900]

According to the discussion above, it seems clear that the LPs will only engage in decision-making on matters concerning the strategy and the investments of the fund rather than getting involved in the day-to-day management. If so, how do the GPs and LPs classify the criteria of day-to-day management and strategic activities? The partnership agreement solves the problem by governing the relations among the partners and between the partners and the partnership.[901] In practice, U.S. limited partnerships are created and ruled by a limited partnership agreement between the GPs and LPs

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limited partner, even if the limited partner participates in the management and control of the limited partnership." See the section.

893 Pearce & Barnes (2006: 17).

894 Ibid.

895 Sec. 17-303(b)(2), Tit. 6, Del. Code Ann.

896 Sec. 17-303(b)(8), Ibid.

897 Sec. 17-303(b)(7), Ibid.

898 Pearce & Barnes (2006: 11).

899 Sec. 304, 2001 UPLA. The section gives inspecting and copying rights to limited partners.

900 Pearce & Barnes (2006: 11).

901 Sec. 101, and Comment to Sec. 101, 2001 ULPA.

under state law.[902] In the agreement, the GPs and LPs document the rights and obligations of each party. Thus, the process of contracting a limited partnership agreement is one of the core issues in a VC investment. There are two important issues in the agreement. One is the incentive term; it may encourage the GPs to operate the VC investments actively with high bonuses.[903] The other is the restriction on investment categories to limit the range, and thereby also the risks of VC investments.[904]

Moreover, the U.S. limited partnership agreement usually includes waivers of default rules stipulated by the state laws.[905] Default rules restrict the power of the GPs. But the waiver in the agreement reduces the obligations of the GPs and grants more authorities of management and decision-making to them.[906] Under the waiver, only fraud or willful misconduct of the GPs could be impeded by the LPs. This arrangement gives minimum protection to the LPs from some typical misbehavior of GPs, but also accommodates wide obligation of authority to GPs to operate the firm and undertake high risk investment.[907]

In a VC firm, the interests of the GPs and LPs are not always the same. Although the LPs could monitor the investments of the VC firm, the GPs have exclusive authority to control the management, which presents "many opportunities to take advantage of the people who invest in them."[908] GPs, the professional VCs, tend to operate several VC funds simultaneously. Thus, they might not spend equal time and energy to monitor and manage each firm.[909] Then there are conflicts between LPs and GPs. The GPs might

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902 Sec. 110 (b) (5), Ibid. "The partnership agreement may: (A) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and (B) specify the number or percentage of partners which may authorize or ratify, after full disclosure to all partners of all material facts, a specific act or transaction." See the section.

903 Litvak (2004: 5).

904 Gompers & Lerner (1996: 481).

905 Halloran (2001: 1-88).

906 Weinberg (1994: 35).

907 Gompers & Lerner (1996: 482).

908 Sahlman (1990: 473).

909 Fenn et al. (1995: 35).

ask for disproportionate management fees from the firm, and might try to keep the best investment chances for themselves or other firms rather than recommending the opportunities to this firm.[910] The GPs might want to chase extremely risky investments which might have only slight potential for high returns. But the problem is, under the situation, the GPs' risk is very low because they contribute much less capital to the firm than do the LPs. As one scholar explains, "in some situations it will pay [for] a venture capitalist to make negative net-present-value investments because doing so increases the value of his potential profits by more than the loss in value of his portion of the equity invested in the firm."[911] Such situation requires LPs to consider the limited partnership agreement carefully before the creation of the VC fund.

### 3.3.1.5 Advantages of Limited Partnership Form

Unlike GPs who are personally liable for all of the debts and obligations of the partnership, the LPs are only liable for the debts equal to their contribution,[912] that is, the capital they have contributed if the firm fails.[913] Thus, the shield of limited liability encourages small, individual LPs to invest in high risk industries without fear of losing their personal assets.[914] As discussed above, partners in the limited partnership can enjoy favorable tax treatment because limited partnership income does not need to be taxed at the partnership level.[915] Because the profits of the partnership will "pass through" to the partners directly, only the partners need to pay their personal income tax.[916] In addition, "because the manager of the limited partnership receives her remuneration as a contractually agreed share of profits arising from his ownership interest, these profits are taxable at the capital gains rate, rather than the higher rate applicable to income, use of the LP form lowers the manager's tax payable."[917] So the

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910 Ibid.

911 Sahlman (1990: 496).

912 Black & Gilson (2002: 258). See also Sec. 303, ULPA2001.

913 Ibid.

914 Fu (2001: 490).

915 Fu (2001: 491-492).

916 Fu (2001: 493).

917 Cumming & MacIntosh (2003: 4).

limited partnership is a good choice for investors who want to conduct investments with a low taxation.[918]

Furthermore, another advantage of the limited partnership relates to its limited duration. A limited partnership VC fund typically terminates in seven to ten years unless the LPs agree to extend the fund. The limited duration pushes the GPs to manage the fund efficiently because they must return the contribution and profits to LPs at a specific termination date.[919] The termination of the fund gives LPs a chance to evaluate the outcome of the fund's investments and the skills of the GPs. The LPs could also decide whether they will continue to work with the GPs based on the earnings or failures of the investments.[920]

### 3.3.2 Governance in Venture

#### 3.3.2.1 Problems of Venture

Most VC literature discusses the general problems of VC investment in ventures in terms of the agency theory.[921] Agency risk concerns the probability that entrepreneurs will make decisions that do not maximize the interests of the VC investors in ventures.[922] Some scholars develop a model of financial contracting with multiple investment decisions and show how VC investors reduce the risks caused by informational asymmetries in a venture with a series of contracts.[923] VC investors could reduce investment risks by the use of convertible securities, of investment syndication,

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918 "Investors of short-term investment are always worry about double-taxation when liquidation. But in a long-term investment, investors need not worry about the issue. Double taxation is one of the primary drawbacks of a corporation." See Robert W. Hamiton, Cases and materials on Corporations 150 (6th ed. 1998). "An individual pays personal income tax on income at a rate according to the level of taxable income. Likewise, a corporation pays corporate income tax according to its level of taxable income. When a corporation pays dividends to its shareholders, the corporation has already paid income tax on those dividends. The dividends, however, are also taxable to the shareholder as personal income." See Cumming & MacIntosh (2003: 4). This concept is known as "double taxation." See Fu (2001: 494).

919 Cumming & MacIntosh (2003: 4).

920 Ibid.

921 Feng (2004: 9)

922 Jensen & Meckling (1976: 308).

923 Admati & Pfleiderer (1994).

and of staging investments in ventures.[924] Some measures, including monitoring, bonding, information disclosure, and appointment, could also be applied to reduce the risks.[925] Since most ventures in the U.S. and China are corporations, this study focuses on discussing the problems and legal techniques used by VCs in ventures using the corporate form.

As a type of financial organization, VC firms always play a role in ventures distinct from that of banks or angel investors.[926] There are many reasons why VC investors have more governance power in ventures than do other types of investors. One reason is that the VC investors have professional skills which other investors do not.[927] Another reason is related to the different incentives in VC projects and other financial projects. Furthermore, because VC investors want some control over ventures so as to increase the profits and reduce the risks of their investment, they create a specific governance mechanism and monitoring frameworks in the ventures to reduce the risks that might be caused by the entrepreneur-manager.[928] Therefore, the goal of VC governance is to work out a proper model to balance the relationship between the principal (VC investor) and the agent (entrepreneur-manager).[929] In practice, the entrepreneurs of the venture are better informed than the VC investors. The entrepreneurs might try to benefit from this informational advantage, which could damage the interests of the VC investors.[930] Such misbehavior can lead to three agency problems in the ventures.[931]

One problem is adverse selection. The VC investor cannot distinguish between "good" and "bad" entrepreneurs before the closing of VC investment in the start-ups because she does not know about certain characteristics of the entrepreneur, particularly the

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924 Gompers (1995.

925 Duffner (2003).

926 Lerner (1995: 301).

927 Hochberg (2003: 25).

928 Gilson (2003: 1077).

929 Grossman & Hart (1983: 7).

930 Huse (2005: 43).

931 Alchian & Woodward (1988: 67).

hidden characteristics.[932] For example, a "bad" entrepreneur might immediately build luxurious offices or buy an expensive car immediately rather than purchasing machines after receiving the VC investors' money.

The second problem is "hold-up." After closing the deal on the VC investment, the entrepreneur might reveal her real ideas to the VC investors and force the investors to come back to renegotiate the hard things which were not mentioned in the first negotiation.[933] Further, the venture might not be the only start-up in which VC investors have invested. In contrast to the situation of VC investors, the entrepreneur might put her whole capital and energy into the venture. Thus, the entrepreneur and the VC investors bear different levels of risk in the venture. The VC investors will be interested in high returns based on positive cash flow regardless of risks.[934] The entrepreneur might not like to take such risk. Then the two parties might have conflict about the development strategy of the venture.[935] That the entrepreneur might also prefer to keep all capital of the VC-investors invested in her company if possible. The entrepreneur might want to keep the venture running regardless of whether the projects are profitable or not. But the purpose of VC investors is to invest in profitable projects only. The entrepreneurs and the VC investors may therefore have very different views on the investment strategy of the company.[936]

The last problem is moral hazard. In VC investment, "moral hazard" means that the entrépreneur might benefit from information of which the VC investor is not aware (hidden information) or from actions which the VC investor cannot monitor (hidden action).[937] This prejudices the interests of the VC investor without his knowledge.[938] In

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932 Kleinschmidt (2007: 45).

933 Aghion & Bolton (1992: 473).

934 Wiseman & Gomez-Mejia (1998: 133).

935 Duffner (2003: 38).

936 Denis (2001: 193).

937 Holmstrom (1979: 74).

938 Ibid.

practice, the entrepreneur might use her time to follow her private interests instead of pursuing the goals of the VC investors.[939]

These problems will cause agency risk and business risk for VC investments in the ventures.[940] Most ventures in the U.S. are high-tech companies with special know-how.[941] The ventures will grow and yield high returns depending on the proprietary technology of the entrepreneurs which other competitors do not yet have.[942] Thus, the entrepreneurs in these companies are the "leading actor" with decision-making and control.[943] This causes a high level of agency risk. The characteristics of these ventures are discussed as follows.

Modern manufacturing industries, especially high-tech industries, are very complicated. This demands higher information processing capabilities, which increases agency problems.[944] VC investors who lack such high technology knowledge might not be able to fully understand the business process, the strengths of the technology and other key information about the start-ups.[945] Additionally, the entrepreneurs might not like to fully disclose her technology to other people, including VC investors.[946] This makes it even more difficult for VC investors closely to monitor and control the ventures and the behavior of the entrepreneurs who employ high technology.

On the other hand, besides cash, machines, or other tangible property, a high-tech company's assets include patents, other intellectual property, and specific know-how.[947] These intangible assets make controlling the entrepreneurs even more difficult because

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939 Stefan Duffner (2003).

940 Barney (1989: 64-68).

941 NVCA (2009: 3).

942 Shane (2000: 448).

943 Begley & Boyd (1987: 79).

944 Markman (2001: 289).

945 Ibid.

946 Shane & Cable (2002: 365).

947 Blair & Wallman (2003: 451).

it is very hard for VC investors to judge the value and development of these assets.[948] Additionally, it would be very hard for VC investors to monitor a high-tech start-up by traditional accounting measures due to the valuation problems regarding intangible assets.[949] This increases the agency problems in high-tech start-ups.[950]

Furthermore, start-ups always lack a business record due to their short history.[951] That means little information is available about the previous development of a start-up. This also makes it very hard for VC investors to assess the start-up. Moreover, without historic information, entrepreneurs can more easily offer a false record of the business to VC investors.[952]

In VC investment, business risk exists during the development of the start-ups. Therefore, high business risk will make the venture's profitability more uncertain.[953] Today, most start-ups normally operate in highly competitive environments because of the situation of high technology development. To succeed in these industries and to approach high growth, constant change is required. Start-ups should often explore markets and balance relations among buyers, suppliers, potential rivals, current competitors, and other product or service entities.[954] Furthermore, because of the fast development of high technology, they have to respond quickly to changing conditions affecting the venture in order to succeed.[955] This situation requires great flexibility of the ventures, or the company might fail in the end.[956]

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948 Ibid.

949 Engel (2002: 155).

950 Gompers & Lerner (2001: 155).

951 Hayn (1998: 15).

952 Smith & Smith (2000: 399).

953 Porter (2004: 5).

954 Porter (2004: 215).

955 Prahalad & Hamel (1994: 5).

956 McGuire (2000: 33).

As discussed above, the ventures are highly dependent on their entrepreneurs. These entrepreneurs are always the founders who own the majority shares of the venture.[957] They have unique and exclusive technology or knowledge which will decide the ventures' development.[958] Moreover, they control information about the day-to-day management and the company's future prospects.[959] That means the success of the venture is highly dependent on the entrepreneurs with their personal knowledge and experience. But this may have three negative consequences for VC investors. First, the quality of the entrepreneurs constitutes an important risk factor for the success of the venture.[960] Second, the venture may fail if the entrepreneurs leave the company because they would take key knowledge and information with them and leave the venture without any competitive technology.[961] Third, the possibility of moral hazard is very high because the entrepreneurs control information which the VC investors lack.[962] Therefore, these characteristics of ventures require VC investors to develop more measures to govern and monitor the ventures and the behavior of the entrepreneurs.[963]

Generally, VC investors reduce these risks at the different stages of VC investments by using measures of governance and risk control.[964] As mentioned in Chapter I, the first stage of VC investment is the phase of selecting investments. At this stage, the chief task of VC investors is to screen a large number of start-ups and choose the best ones. The difficulty is that most start-ups are at very early stages of development, and have limited business records. Therefore, VC investors follow a strict screening process. The process is an examination of all aspects of the start-up, including the product, market size, technology, know-how, management team, and financial and legal issues. A

957 He & Conyon (2004: 53).

958 Kirzner (1997: 67).

959 Markman (2001: 275).

960 Shane & Cable (2002: 365).

961 Ibid.

962 Ibid.

963 Bassen (2006: 128).

964 Denis (2001: 195).

typical VC firm in the U.S. invests in only 1% of the business plans of start-ups received.[965]

Once the VC investor invests in a start-up, she often assumes an active role in monitoring the company. Therefore, the second stage is to monitor the selected investments. The VC investors typically expect to exit a venture in seven to ten years. During this period, they assist and monitor the entrepreneurs to ensure that the venture is moving in the right direction.[966] VC investors support their ventures by providing information on customers, suppliers, and other new investors, as well as strategic, financial and legal assistance.[967] At the same time, they monitor the venture's progress by serving on the board, and providing further capital in multiple stages during the venture's life.[968]

The last stage is the exit phase. VC investors can exit their ventures in several ways, including IPOs, mergers and acquisitions, liquidations, or stock buybacks. These are discussed in the following section. VC investors typically wish to earn high returns from their investments. Therefore, VC investors hope to exit with a successful IPO or by selling the ventures at a favorable price.[969] Since the future of early stage ventures is highly uncertain, VC investors know only a small number of their investments in early stage ventures will be successful. Thus, VC investors typically hope to find one or two highly successful ventures that will cover the losses from other failed investments.

Good governance measures in ventures can reduce agency costs by reducing information asymmetries and moral hazard. The goal of governance measures is to introduce effective monitoring and align the diverging interests of entrepreneurs and VC investors, which will reduce agency costs and to enable the venture to earn returns in

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[965] Guler (2003).

[966] Schwienbacher (2008: 196).

[967] Fung, Liu, and Shen (2004: 47).

[968] Schwienbacher (2008: 198-199).

[969] Fung, Liu, and Shen (2004: 38).

the future.[970] The agency problems can also be reduced through investment contracts.[971] These contracts can clarify the entrepreneur's obligations in the venture and give VC investors rights to stage the investment depending on the development of the ventures.[972] These contracts can also map out the structure and objectives of the venture, the internal decision-making processes, the role of VC investors and other shareholders in the board, the governance of boards of directors, sources of financing, legal services, applicable law, and the requirements of business activities.[973] In practice, these measures can be defined as control rights, appointment rights, management rights, information rights, staging VC investments, use of convertible preferred stock, syndication, and different options of exiting the ventures.[974] These measures are discussed in the following sections.

### 3.3.2.2 Solutions: Legal Measures of Governance

#### 3.3.2.2.1 Purposes of Governance

The purpose of VC governance in ventures is to enable VC investors to be successful in the investment by reducing agency risks and enhancing the performance of the ventures.[975] To fulfill the goal, the governance of the ventures must have three functions: monitoring, bonding, and advice. Agency risks could be reduced by monitoring and bonding, or related to advice to management.[976] As discussed above, this study analyzes VC governance in ventures employing the corporate form since most of the ventures in the U.S. and in China are corporations.

Firstly, the board of the ventures should monitor the performance of the company and the management.[977] Examining the books and other information on the venture's

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970 Rehman (2006: 3).
971 Gompers (1995: 1485).
972 Gompers (1995: 1461).
973 Rehman (2006: 3-4).
974 Bartlett (2006: 53).
975 Becht, Bolton, and Roell (2002).
976 Hillman & Dalziel (2003: 383-396).
977 Duffner (2003).

situation and attending the meetings of the board that decide the strategy of the venture ensure VC investors to sufficient control over the business of the venture.[978] Accordingly, the VC investors could correct the actions of the venture though the board meeting if it is needed. This might reduce agency risks and business risks of the venture.[979]

Second, bonding of ventures and the entrepreneur-manager can also lead to reduced agency risks by a series of investment contracts, including term sheets, investment agreements, and articles of association.[980] The entrepreneur-manager can be bound by these contracts which are in the interest of shareholders, including VC investors. Such contracts often limit the decision-making perogative of the entrepreneur-manager. Thus, bonding should prevent the entrepreneur-manager from taking actions against the VC investors' interest and should reduce agency risks and increase performance of the venture.[981]

Third, offering suggestions to the venture can also augment both the venture's accomplishments and the VC investors' returns.[982] The members of the board can learn more information about the venture to achieve better decision-making. Thus, qualified board members can improve the management skills which might affect the venture's future.[983]

Therefore, good governance provides an effective and efficient mechanism for VC investors to monitor and control ventures to improve their performance.[984] The legal measures establishing good governance mechanisms in ventures can be divided into

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978 Ibid.

979 Reid (1998: 7-8).

980 Admati & Pfleiderer (1994: 394).

981 Admati & Pfleiderer (1994: 395).

982 Ibid.

983 Ingley & Walt (2001: 174-185).

984 Gompers & Lerner (2001: 145-168).

four categories: control rights, management rights, appointment rights, and information rights, depending on the area of monitoring and control to which they relate.[985]

### 3.3.2.2.2 Control Rights

The VC investors' control rights determine their impact on the governance of the ventures.[986] To fulfill this purpose, the VC investors must have the right to enforce their decisions in the venture. Control rights enable them to influence the performance of the ventures, as with the other measures introduced for monitoring and bonding purposes mentioned above.[987] VC investors can reach their goals by introducing controls in the contract such as requirements for the entrepreneurs. This can also be done by drafting investment agreements or changing the articles of association. VC investors use a series of agreements, which might not be applied in common investments, to protect their rights. A distinguishing characteristic of VC investment agreements is they include "positive" or "negative" covenants. These agreements give directives to entrepreneurs on what they must do (*positive covenants*) and what they must not do (*negative covenants*) in day-to-day management.[988] Some of these agreements could be found in many standard financing contracts used by banks or other institutional investors. Other covenants, however, only belong to VC investments.

Control rights include ownership rights, registration rights, first refusal rights, drag-along and tag-along rights, as well as staged financing rights.[989] These rights enable VC investors to own and transfer shares of the venture and receive returns based on the shares they are holding. For instance, VC investors will use "ratchet provisions" to protect their ownership rights and other benefits. The provisions protect the VC investors' ownership rights in the event that the venture is forced to sell new shares to others outsiders. Generally, these provisions ensure that the VC investors' share values

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985 Gompers, Ishii, and Metrick (2003: 107-155).

986 Cadbury Report (1992).

987 Kleinschmidt (2007: 99).

988 Senssfelder (2006: 25).

989 Callison (2000: 97-124).

will be adjusted so that the penalty of selling low-priced new shares is borne more by the entrepreneur than by the VC investors.[990]

Here is an explanation of one such provision given by an international law firm:

> If the VC investors purchased shares initially valued at $1 each, and the venture is subsequently required to sell new share at $0.50 per share, a "full ratchet" provision mandates that the VC investors be allocated one additional new share for each one currently held to compensate them for the decline in stock value (a "partial ratchet" only partially compensates the venture group). Obviously, not many rounds of such financing would be required to completely wipe out a management team's ownership stake, since they have no ratchet protection.[991]

U.S. VC investors also use "registration rights" to ensure their returns through IPOs. The rights provide VC investors with the authority to demand registration of IPOs.[992] For example, the VC investors in Amazon.com had such right.[993] VC investors can use the rights to force the venture to register shares with the SEC for a future public offering in the U.S.

First refusal rights ensure that if an entrepreneur or another shareholder in the venture wishes to sell her shares, she must offer the shares first to other shareholders in the venture.[994] The rights ensure that the VC investors are able to participate in any private sale of shares of the venture.

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990 Miller & Mason (2004: Chapter 6).

991 Ibid.

992 NVCA (2006: 26-28).

993 Perace & Barnes (2006: 15).

994 NVCA (2006: 44).

VC investors might make "co-sale agreements" with the entrepreneurs before the VC investment. The agreements include drag-along and tag-along rights. Drag-along rights allow the VC investors upon sale of their shares to require other non-VC shareholders to sell their shares to the same purchaser at the same time and on the same terms.[995] Further, VC investors in practice will require in the agreement that "holders of Preferred Stock...shall be required to enter into an agreement with the investors that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the venture is transferred..."[996] Tag-along rights allow the VC investors to place their shares with the same purchaser at the time and on the same terms as another shareholder sells her shares.

Staged financing rights allow the VC investors to handle the investment in stages depending on the milestones of the development of the venture. The process of staging VC investment will be discussed in the following sections.

Dividend rights allow VC investors to receive interest from the venture's earning or liquidation.[997] VC investors will also use redemption rights to require the ventures to repurchase VC investors' shares if the company is unable to execute an IPO or arrange a private sale within a fixed duration.[998] In practice, VC investors might specify in the investment agreement that "the Series A Preferred shall be redeemable from funds legally available for distribution at the option of holders of the Series A Preferred commencing any time after the fifth anniversary of the closing at a price equal to the original purchase price. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed."[999] U.S. laws commonly

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995 NVCA (2006: 44-46).

996 NVCA (2006: 46-48).

997 NVCA (2006: 220).

998 Berkery (2007: 226).

999 NVCA (2006: 22-24).

permit share redemption if made "out of surplus or out of earned surplus," however forbids it "only if capital is impaired or [such redemption] will impair capital."[1000] For example, Delaware General Corporation Law prohibits the shares to be redeemed when "such purchase or redemption would cause any impairment of the capital of the corporation."[1001]

One of the most distinguishing measures used to protect VC investors' ownership rights is convertible preferred stock.[1002] Convertible preferred stock means stock which certificates rights superior to those of the common stock.[1003] This stock can be converted into a specified amount of common stock at the shareholder's option under a predefined condition.[1004] Convertible preferred shareholders would also receive a portion of the company's profits, in the form of a dividend, before the common shareholders receive a dividend.[1005] Convertible preferred stock might well consist of the right to convert preferred stock into common stock at a fixed ratio, the right to claim dividends, and the right to require the venture to redeem the shares of VC investors if some conditions have been met.[1006] "Unlike traditional debt-like preferred stock issued by large, publicly-held companies, convertible preferred stock bearing contractual rights help create the necessary relational contract between investors and entrepreneurs."[1007] Using convertible securities is a control mechanism for VC investors;[1008] the convertible stock provides an incentive mechanism that ensures that "the VC investors

[1000] McDermott (1985: 540).

[1001] Sec. 160(a), Tit. 8, Del. Code Ann.

[1002] But Cumming thinks that "for all types of VC funds and entrepreneurial firms, common equity has been the most frequently used security (in 28.66% of all transactions), followed by straight debt (4.9%), mixes of straight preferred equity, and common (1.82%); other combinations comprise 14.64% of all transactions." He is going to prove that "a variety of securities are used and not just convertible preferred equity does not depend on the definition of the term 'venture capital'." See Cumming (2005: 573-622). See also Schmidt (2003: 1139).

[1003] Common stock is the most basic of all corporate securities. Common stock usually holds the exclusive power to elect a corporation's board of directors. See Solomon, Schwartz, Bauman, and Weiss (1998: 223).

[1004] http://www.investorwords.com/1115/convertible_preferred_stock.html

[1005] Ribstein & Letsou (2003: 598).

[1006] Solomon, Schwartz, Bauman, and Weiss (1998: 226).

[1007] Kim (2004: 447).

[1008] Gompers (1995: 1461).

convert if and only if the entrepreneur invested efficiently."[1009] But the VC investors might not receive dividends at the outset since start-ups often do not have income at the beginning.[1010]

There are several reasons for VC investors to choose convertible preferred stock. First, since corporate law requires that all shareholders of the same class be treated equally, VC investors would have to purchase more common stock at the same price to obtain control rights over the company without the convertible preferred stock.[1011] This would be too expensive for VC investors to handle in every investment. It also means that VC investors have to bear the same business risk as the entrepreneurs. It will be the last option which VC investors want to take. Since convertible preferred stock is a separate class of security from common stock, VC investors and the entrepreneurs can negotiate the share price and share's rights freely regardless of the situation of common stock.[1012]

The second reason is that convertible preferred stock gives the VC investors voting rights equal to those of the entrepreneur and other common shareholders.[1013] For example, the articles of association can state that "on any matter presented to the stockholders of the corporation for their action or consideration at any meeting of stockholders of the corporation, each holder of outstanding shares of Series A Preferred Stock shall be entitled to cast the number of votes equal to the number of whole shares of Common Stock into which the shares of Series A Preferred Stock held by such holder are convertible as of the record date for determining stockholders entitled to vote on such matter."[1014] Since the entrepreneurs know more about the business of the venture, the voting rights of convertible preferred stock give maximum protection for the VC investors. Further, because convertible preferred stock is a junior claim to debt,

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1009 Hellmann (2006).
1010 Triantis (2001).
1011 Gompers (1995: 1461).
1012 Hellmann (1998: 57-76).
1013 NVCA (2006: 250).
1014 Ibid.

the venture will still keep its borrowing capacity, making it is easier to borrow new capital from banks.[1015]

#### 3.3.2.2.3 Management Rights

Good governance should ensure that the management team of the ventures fulfills the investment purposes of the VC investors and other shareholders.[1016] This requires a selection of sound managers. The goal of the selection is to ensure the entrepreneurs will act skillfully and dutifully in the VC investors' interest.[1017] In practice, VC investors would ask for a special committee to make the selection.

Apart from an effective selection mechanism, there should also be a mechanism to bond the activities managers.[1018] Bonding focuses on providing proper rules to prevent conflicts of interests between entrepreneurs and VC investors.[1019] If managers are unable to fulfill the business plans of the venture, they should be replaced by others.[1020] After new managers are selected, the VC investors should again closely monitor this process. The existing literature shows that such selection and assessment process is more professional in ventures than in traditional companies.[1021] Therefore, employing management rights in ventures means that VC investors have authority to assess the performance of the managers, fire these people if they fail to do the job well and monitor the selection process of managers.[1022]

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[1015] "The primary rationale for using convertible securities is to give the venture capital group a claim on the portfolio company's earnings and market value in the event the firm is highly successful. In point of fact, most convertible securities are converted into common stock before venture-backed companies execute initial public offerings, partly to present an uncluttered balance sheet to prospective investors and partly to lock in common equity stakes (and capital gains) before inviting in new stockholders." See Megginson (2002).

[1016] Weimer & Pape (1999: 152-166).

[1017] Schwienbacher (2008: 200).

[1018] Cadbury Report (1992).

[1019] Gregory, H. J. & Simmelkjaer, R. T. II (2002).

[1020] Hambrick (1987: 88).

[1021] Hellmann & Puri (2002: 177).

[1022] Hillman & Dalziel (2003: 386).

As explained before, the managers of the ventures play a very important role because they have specific knowledge or technology to maintain the business of the venture. A very important issue for VC investors is not only having good managers but also holding them in the venture. If managers leave the venture, it might be bad for the company's future development because the technology or skills which are taken by these managers might be very important for the ventures, or other competitors may hire these managers and use the technology.[1023] VC investors should reduce this risk by bonding the managers to the venture.[1024] VC investors will negotiate with the entrepreneurs about bonding measures during the contracting phase.[1025] Generally, VC investors would use non-compete agreements to fulfill the bonding.[1026] Such agreements restrict managers of the ventures within a fixed duration from working for the venture's competitors after they leave the venture.[1027]

Bonding measures also include stock option plans. The plans are created for current and prospective managers in the ventures. The ventures would offer stock options to current managers if they perform well.[1028] The plans can also attract new outstanding managers to come in the future.[1029] The plans generally have a vesting duration which only

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1023 Shane & Cable (2002: 365).

1024 Denis (2001: 195).

1025 NVCA (2006: 40).

1026 Cole & Sokol (2002: 6).

1027 Kaplan and Stromberg found in their empirical study that "venture capitalists adopt corresponding measures to prevent managers from leaving the company. Many venture capitalists give managers an incentive to stay in the company by introducing shares for the managers that vest over time. Should the management leave the company before a defined date, the shares that are not vested yet can be bought back by the company for a low value. Additionally, they show that most venture capitalists also introduce non-compete clauses that bar managers from working for a competitor after they leave the company." They also found that "contracts between venture capitalists and portfolio companies can be contingent on continued employment, which is also a sign of the influence of investors on the bonding of managers. According to this analysis, venture capitalists obviously realize the necessity of effective bonding of the managers because they use non-compete clauses and stock options as bonding instruments. So, it can be expected that they use their influence to improve the bonding of managers and thereby improve corporate governance." See Kaplan & Stromberg (2003: 294).

1028 Cole & Sokol (2004: 9).

1029 Cole & Sokol (2004: 9).

allows the managers to switch the options into stock after a certain time.[1030] For example, it could allow the managers to vest 30% of their options after 24 months, "with remaining vesting monthly over next 36 months."[1031] In Amazon.com's IPO, no less than 10.8 million shares were reserved under two stock option plans, and over 4 million had already been granted to the company's management team.[1032]

#### 3.3.2.2.4 Appointment Rights

The right to appoint directors to the board is a core governance right of VC investors. VC investors will ask for a certain number of seats on the venture's board of directors for their monitoring purposes based on their ownership rights.[1033] The rights include the right to remove the directors if they cannot meet the performance goals which are promised.[1034] With a number of board seats, VC investors may also receive financial reports on the venture and have the chance to change the strategy of the venture.[1035] Close monitoring done by the board makes it possible for VC investors to fulfill their monitoring role in the ventures.[1036]

The appointment rights also have a further dimension, namely the selection, evaluation, and compensation of the managers.[1037] To fulfill their monitoring and advice tasks, directors of the board should be independent and qualified.[1038] Independence means that the members of the board are outsiders that "are not members of the top management team, their associates or families; are not employees of the firms or its subsidiaries; and are not members of the immediate past top management group."[1039]

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[1030] Shane & Venkataraman (2000: 217-226).

[1031] NVCA (2006: 42).

[1032] Dodge (1999: 12).

[1033] Berghe & Levrau (2002: 124-135).

[1034] Bartlett (2006: 54-55).

[1035] Ibid.

[1036] Al-Suwailem (1995: 23).

[1037] Al-Suwailem (1995: 22-31).

[1038] Gompers, Ishii, and Metrick (2003: 107-155).

[1039] Zahra, Pearce, and John (1989: 306).

Independence of boards is very important for VC governance,[1040] as it enhances the possibility to control the development of ventures so as to protect VC investors' interests.[1041] It also ensures the effective monitoring of ventures management.[1042] Generally, VC investors would ensure the independence of boards in three ways, including appointing their own representatives to the boards, selecting outside directors, and reducing the power of the entrepreneurs or managers.[1043] Outside directors would include representatives of banks, lawyers, accountants and consultants.[1044]

VC investors will thus influence both the board's membership and the performance of its tasks.[1045] Monitoring the board ensures the board members conduct their duties in an effective and efficient manner.[1046] The boards' work includes two aspects, the form of its procedures and the level of director involvement.[1047] Formalities include constant and well-prepared board meetings. The level of involvement means the board should be involved in the making of strategy and decisions on important issues of the venture.[1048] Thus, the main duties of the board are to offer correct suggestions on the venture's business and production, to monitor the financial and legal issues of the venture, and to supervise the entrepreneurs and the management team.[1049] The VCs' "involvement as directors should be more intense when the need for oversight is greater if they are intensive monitors of entrepreneur-managers."[1050] Board supermajority rights allow VC investors to require supermajority consent for some critical decisions.[1051] Board veto

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1040 Kiel & Nocholson (2005: 623).

1041 Sapienza, Korsgaard, Goulet, and Hoogendam (2000: 333).

1042 Baysinger & Hoskisson (1990: 75).

1043 Weil, Gotshal, and Manges (2002).

1044 Baker & Gompers (2003: 581).

1045 Bartlett (2006: 92).

1046 Callison (2000: 102).

1047 Callison (2000: 117).

1048 Ingley & Walt (2003: 635).

1049 OECD (2004).

1050 Lerner (1995).

1051 Gilson (2000: 30).

rights guarantee the VC investors have the rights to veto board decision-making.[1052] U.S. law usually requires equal treatment of all shareholders holding the same class of shares when voting.[1053] Consequently, good VC governance encourages the board to be involved in all critical issues of the venture. VC investors understand the necessity and meaning of the control of the board and appointment rights, which could protect their interests at the decision-making level.

### 3.3.2.2.5 Information Rights

Effective monitoring has to be based on complete information regarding the venture's operation. Information rights ensure that all important business information of the venture will be disclosed correctly and efficiently to the VC investors.[1054] Information rights also give VC investors the opportunity to be fully informed on important ventures decisions, such as major changes to the venture's product focus. Full disclosure of relevant information provides the VCs with what they need to exercise effective control over the ventures, given the presence of the other complimentary rights, which will reduce agency risks that could be caused by asymmetrical information between the managers and the VC investors.[1055] Hence, the VC investors and the board have to constantly require information from the managers in order to be able to monitor the venture.

The information disclosure process should be strict and the disclosed information should be complete and enable on understanding of the real situation of the venture. The disclosure should include information on the venture's financial situation, performance, ownership, risks, and other governance-related data. In order to ensure the quality of the disclosed information, the disclosure should be done under law or accounting regulations.[1056]

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[1052] Bartlett (2006: 54).

[1053] Berkery (2007: 219-222).

[1054] Gilson (2000: 12-13).

[1055] Ibid.

[1056] Cadbury Report (1992).

Empirical analyses show that VC investors carefully review the financial statements of a start-up in the selecting phase and the investment phase.[1057] They have specific requirements for reports. They will generally demand monthly reports about the current business situation of the ventures.[1058] An annual audit of the financial statements by independent auditors would also be required to ensure that the financial information and data of the venture are correct and comprehensive.[1059] VC investors will require these information rights in the term sheet, which is the first VC investment contract with the start-ups. The rights will usually give the VC investors authority to review "the annual, quarterly (and monthly) financial statements, and other information as determined by the Board, the comprehensive operating budget forecasting the venture's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year, and the promptly flowing the end of each quarter an up-to-date capitalization table, certified by the CFO."[1060]

#### 3.3.2.2.6 Staging Investment

**1) Definition**

The term "staged investment" means the VC investor will invest in a start-up in several installments rather than infuse all capital into the company at once.[1061] Staging VC investment can reduce the business risks caused by moral hazard,[1062] and is therefore one of the measures used by VC investors to control the ventures.[1063] By staging the VC financing, the VC investors can postpone the final investment decision to evaluate whether they will keep investing in the ventures according to the current situation.[1064] Staged investment has been widely used in the U.S. VC investment, and is a very important control measure for U.S. VCs.

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1057 Falconer, Reid, and Terry (1995: 186-196).

1058 Sanlman (1990: 473-521).

1059 OECD (2003).

1060 NVCA (2006: 33-34).

1061 Wang & Zhou (2004: 132).

1062 Ibid.

1063 Gompers (1995).

1064 Witt & Brachtendorf (2006: 188).

The VC investment would be very simple if information were not asymmetric and agency risks did not exit, and if the entrepreneurs would always seek to maximize VC investors' value within the investment period.[1065] VC investors would then have no doubt about investing all their money in the start-ups at once. The entrepreneurs could also make decisions themselves freely on their own experience whether to continue the project.[1066] But this is only a dream. VC investors have to stage their investment in the venture in order to see whether the venture can fulfill the business milestones on time.[1067]

### 2) Advantage of Staging Investment

Many high-tech start-ups are high risk due to the great uncertainty about returns, the lack of tangible assets and the lack of a company history record in operations. Many high-tech start-ups do not have any earnings for a long period before they start to get profits.[1068] VC investors have to monitor these start-ups and assess their performance. Staged investment is a control measure.

The VC investors can terminate the investment at once if the venture fails to achieve the business milestones. So, it reduces losses from bad projects and creates an exit option for VC investors.[1069] For the entrepreneurs, it is crucial that they receive the next round of VC investment funding, so they work to enhance performance. Therefore, by staging the investment, VC investors can avoid fully bearing the business risks in the ventures, get opportunities to terminate investments, and create performance incentives.

### 3) How to Stage Investment

VC investors should consider the size of the investment, how many rounds they will finance in one start-up, and how much they will invest in each round when they stage

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[1065] Gompers (1995: 1464).

[1066] Ibid.

[1067] Bartlett (2006: 53).

[1068] Wang & Zhou (2004: 131-155).

[1069] Ibid.

the investments.[1070] Staging investment allows VC investor enough time to collect information on ventures through monitoring and reporting mechanism.[1071] By gathering enough information through staging investments, the projects will have more chance to success than that of VC investments which do not employ staging measures.[1072] For staging purpose, VC investors will monitor the venture in each stage to check whether its performance justifies further development.[1073]

Secondly, staging investment requires the ventures to achieve the predefined milestones before they can receive the next round of capital from the VC investors.[1074] The milestones, which could be business plans, marketing proposals, sales targets, or stages of new product development, will be fixed by VC investors and entrepreneurs before the initial investment. If a start-up fails to reach one or several of the predefined milestones, the VC investors have rights not to finance in the new round investment.[1075] But it does not mean the ventures will receive the new round investment automatically if they have reached the milestones. VC investors will evaluate the business outcome in the last round before any new round investments. Moreover, VC investors might launch a new negotiation with the entrepreneurs based on the business outcome of the venture without adjusting the terms and conditions which were agreed upon in the investment agreements.[1076] One thing that would be discussed in the meeting, for instance, might be that the entrepreneurs would transfer more shares at different prices to VC investors for requiring more investments in the future.[1077]

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1070 Witt and Brachtendorf (2006: 188).

1071 Gompers (1995: 1461).

1072 Gompers (1995: 1463).

1073 Ibid.

1074 Block & Macmillan (1985: 184).

1075 Duffner (2003).

1076 Ibid.

1077 Witt and Brachtendorf (2006: 186).

Two well-known companies' examples show how VC investors evaluate the ventures' performance by staging investments. One is Apple Computer.[1078] Apple Computer received three rounds of VC financing. In the first round, VC investors invested $518, 000 in January 1978 at a price of $0.09 per share.[1079] Apple performed well in the first round, which ran to September 1978. Then VC investors financed the second round investment with additional $704, 000 at a price of $0.28 per share.[1080] The last round of $2, 331, 000 was made in December 1980 at $0.97 per share.[1081] At each stage, the increasing price per share and the growing investment reflected increasing certainty concerning Apple's prospects.[1082]

The second example shows how VC investors monitored Federal Express by staging their investment.[1083] Federal Express also received three rounds of VC financing, but the company's situation developed in a different way than did Apple.[1084] The first VC round occurred in September 1973 when $12.25 million was invested at a price of $204.17 per share.[1085] The company's performance was well below expectations and a second VC financing round was necessary in March 1974: $6.4 million was invested at only $7.34 per share due to the poor performance of the company.[1086] Performance continued to deteriorate and a third round of financing was needed in September 1974.[1087] At this stage, the VC investors began to get involved in the management and strategy making of the company. The $3.88 million investment was priced at $0.63 per share.[1088] Ultimately, performance improved and Federal Express went public in 1978

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[1078] Gompers (1995: 1461-1489).

[1079] Ibid.

[1080] Ibid.

[1081] Ibid.

[1082] Ibid.

[1083] Ibid.

[1084] Ibid.

[1085] Ibid.

[1086] Ibid.

[1087] Ibid.

[1088] Ibid.

at $6 per share.[1089] The VC investors reduced the business risks by staging investment and received reasonable profits in the end by the adjustment of share price at each stage based on the performance of the company.[1090]

#### 3.3.2.2.7 Syndication

**1) General**

Besides staging, another key measure in VC investments is syndication, which allows one VC fund to syndicate their investments with other funds. The "narrow" definition of VC syndication is two or more VC firms make investments in one start-up simultaneously.[1091] The broader definition allows the VC investments to count as syndication regardless of whether the investments occurred at the same or different times.[1092] According to the narrow definition, these different VC investors will invest in the same start-up in the same year. Broadly defined syndication means a second VC investor may invest in the same start-up at any time regardless of whether there is any overlap among the first VC investor in time.[1093] Syndication is one of the measures used by VC investors to reduce agency risks.[1094] Syndication may help a VC investor make the right decision about whether to invest in the start-up by sharing information with other potential VC investors.[1095] It also enhances innovation in start-ups and prevents VC investors from stealing proprietary technology or know-how from the entrepreneurs. [1096] Further, at early stages, only the VC firms with a good reputation will be invited as syndication partners.[1097]

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[1089] Ibid.

[1090] Ibid.

[1091] Brander and Amit (2002: 17).

[1092] Ibid.

[1093] Ibid.

[1094] Gompers (1995: 1489).

[1095] Lerner (1994).

[1096] Bachmann & Schindele (2005).

[1097] Ibid.

In practice, if one VC investor seeks syndication, other VC investors will follow. These secondary VC investors will evaluate the project first and then accept or reject the invitation. This evaluation is treated as a second trial and recommendation of a lead VC investor, who then makes a final decision on the investment and syndication.[1098] The comments of other VC investors are very useful because they are made by common investors whom are also familiar with the business. To get the extra information it is necessary to seek syndication.[1099]

In Europe generally, more than 25% of VC investment and more than 30% of VC deals are syndicated.[1100] In Germany, the data show that about 60% of VC investment is syndicated.[1101] In Canada, one survey proves that of 584 VC investments, 341 of them are stand-alone, 195 of them are syndication, including 108 of them involving two VC investors, 59 of them involving three VC investors, and 28 of them involving four VC investors.[1102] An average syndicate involves 4.5 venture capitalists in the US and 2.7 venture capitalists in Europe.[1103] In the U.S., first-round VC investments are syndicated on average by 2.2, second-round by 3.3, and third-round by 4.3 venture capitalists.[1104] These data reveal that syndication is a key technique in VC investment. The results also highlight the fact that syndication is very popular in different countries.[1105] The details on why VC firms would like to syndicate in VC investment are discussed below.

**2) Motives of Syndication**

There are three reasons why VC investors seek syndication in investment. First, syndication reduces agency risks in VC investment. Second, VC investors can share

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1098 Manigart, Lockett, Meuleman, Landstrom, and Desbrieres (2002: 9).

1099 Manigart, Lockett, Meuleman, Landstrom, and Desbrieres (2002: 29).

1100 Sorenson & Stuart (2001: 1578).

1101 But the scholars also point out that their descriptive statistics show "the percentage of syndication investments is overrepresented in their sample since only about 33% of the investments are syndicated in Germany." See Lehmann & Boschker (2002: 12).

1102 Brander & Amit (2002: 24).

1103 Schwienbacher (2005).

1104 Lerner (1994).

1105 Manigart, Lockett, Meuleman, Landstrom, and Desbrieres (2002: 64).

information on the start-ups though syndication, which includes the information of business development, company record, and management.[1106] Third, syndication is also a method to increase the deal flow of the VC firm.[1107] Of course, syndication may also help entrepreneurs to choose favorable VC investors. Some entrepreneurs use syndication to protect their technology and ideas.

As mentioned, the risks of VC investment can generally be divided into agency risk and business risk.[1108] VC investors use syndication to reduce the risks by separating one investment into several units and requiring more VC investors to share the units together.[1109] Especially in early stage investment, VC investors need to spread their risks through syndication.[1110] In contrast, since the ventures at later stage already have good management teams, mature production, and strong business connections and marketing strategy, they would not require syndication from VC investors. Of course, some VC investors would still like to use syndication in late stage investment to reduce the chance and impact of misbehavior by the entrepreneurs or managers.[1111] In a word, syndication helps the VC investors to reduce their risks by mutualizing them and sharing information of the ventures.[1112]

Syndication also helps reduce informational uncertainties in start-ups. An investment decision made by several independent VC investors is better than one made by a single VC investor. It is more efficient to select available start-ups by two or more VC investors because each learns something from the others' evaluations.[1113] In the syndication process, the lead VC investor will send the start-up's business proposal to

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1106 Admati & Pfleiderer (1994: 371-402).

1107 Manigart, Lockett, Meuleman, Landstrom, and Desbrieres (2002: 69).

1108 Bachmann & Schindele (2005),.

1109 Lockett & Wright (2001: 375-390).

1110 Lockett & Wright (2001: 377).

1111 Cumming (2005: 573-622).

1112 Manigart, Lockett, Meuleman, Landstrom, and Desbrieres (2002: 26).

1113 Lerner (1994: 2).

other VC investors for their assessment.[1114] Other VC investors' comments will influence the decision-making of the lead VC investor.[1115] The double-check process will reduce investment risks.[1116]

There might be informational asymmetries between a VC investor who has already invested in the ventures and other VC investors who are going to invest in the ventures. Syndicated investment would reduce these asymmetries. Since VC investors might not engage in the day-to-day management of the ventures, the entrepreneurs could exaggerate the company's value and then increase the share price before the VC investors launch a new round financing in the venture.[1117] The only way to avoid the informational asymmetry is for the lead VC investor to keep a constant number of shares in the venture. The situation shows that later-round financings must be syndicated.[1118]

Syndication is also a measure to increase deal flow. VC investors should maintain a great number of deals so that they can make successful investment cases from a wide basis.[1119] The bargaining power of the entrepreneurs becomes strong as many VC investors have to chase one opportunity. Thus, syndication reduces the bargaining advantages of start-ups.[1120]

Furthermore, the deal in the start-up may be too "big" for one VC investor. The VC investor who lacks enough money can solve the problem by syndication. It could also give the VC investors an opportunity to invest in a larger number of start-ups than they could otherwise do without syndication, thereby "increasing diversification and

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1114 Sorenson & Stuart (2001: 1576).

1115 Lockett & Wright (2001: 376).

1116 Brander, Amit, and Antweiler (2002: 426).

1117 Ibid.

1118 Lerner (1994: 2).

1119 Lockett & Wright (2001: 378).

1120 Lockett & Wright (2001: 379).

reducing the overall risk of the investments."[1121] VC syndication could also provide more capital to start-ups which need greater cash flow in a given period.

Idea theft is a big problem in the VC financing of start-ups, especially in high-tech companies.[1122] As discussed above, when investing in the start-ups, VC investors always require a series of control rights, including management, information, and appointment rights. These rights may give VC investors a channel to understand the entrepreneurs' ideas, technology, and know-how. On the other hand, because the VC investors will simultaneously be engaged in more than one project, there is a risk that some VC investors will try to use the ideas or technology of one venture to benefit their other projects.[1123] Syndication can reduce the problem. There might be conflict or litigation between the VC investor and the entrepreneur if the latter finds her ideas have been stolen by the VC investor.[1124] Such litigation will hurt the reputation of the VC investors. Syndication enables a number of VC investors to monitor each other to prevent one of them from stealing ideas from the common venture.[1125] Thus, syndication serves also as a monitoring instrument protecting the technology and ideas of start-ups at the growth stage.[1126] Entrepreneurs can fully disclose the information of the start-ups to the VC investors without worrying about theft.[1127] Hence, investments in high-tech start-ups are more often syndicated by VC investors than those in traditional industries.[1128]

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1121 Manigart, Lockett, Meuleman, Landstrom, and Desbrieres (2002: 12).

1122 Bachmann & Schindele (2005: 1).

1123 Ibid.

1124 Brander, Amit, and Antweiler (2002: 423-452).

1125 Bachmann & Schindele (2005: 31).

1126 Casamatta & Haritchabalet (2003).

1127 Lehmann & Boschker (2002).

1128 Bygrave (1987: 139-154).

### 3.3.3 Exits

#### 3.3.3.1 General

As discussed above, when seeking funds from VC investors, an entrepreneur should know that the VC investors will seek solid rights enabling them profitably to exit the venture at some point in the future. Generally, VC investors will exit their investments by using one of the following five measures: IPOs, acquisitions, buybacks, secondary sales, or liquidations. Since many start-ups are young companies lacking cash flow and profitability, and thus cannot pay dividends to shareholders at the early stage,[1129] VC investors will closely evaluate each investment for exit possibilities when they select start-ups.[1130] VC investors will not invest in a start-up if there is no chance to exit the company with high returns in a fixed duration.[1131] For this reason, understanding the measures by which VC investors exit their ventures is critical to an understanding of VC projects.[1132] In addition, once VC investors decide to make the investment, they will seek a favorable exit structure from the entrepreneur for maximizing the returns.[1133]

Exits are a hot topic in VC research. A VC investor's decision on whether to invest in a start-up is based on its exit potential.[1134] Some scholars argue that "a well developed stock market that permits VCs to exit through an IPO is critical to the existence of a vibrant VC market."[1135] VC investors and entrepreneurs typically make the decision before the investment whether the venture will exit though IPOs, mergers, liquidations, or other measures.[1136] Informational asymmetries are one of the reasons why exits are an important topic. VC investors gain more from exit if they solve the problems of

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[1129] Cumming, MacIntosh (2002: 3).

[1130] Schwienbacher (2005).

[1131] Ibid.

[1132] Cumming & MacIntosh (2002: 3).

[1133] Ibid.

[1134] Cumming (2008: 1947-1982).

[1135] Black & Gilson (1998: 243-277).

[1136] Smith (2005: 315).

informational asymmetries for new investors, who will pay more for the shares of VC investors if informational asymmetries are low.[1137]

### 3.3.3.2 IPOs

Although always costly, in the U.S. IPO is the most important exit measure for VC investors, since they create the highest returns.[1138] Table 3.2 presents data on U.S. IPOs of VC ventures for the thirty year period from 1978 to 2009. Although in 2008, the IPOs of ventures in the U.S. fell down because of the financial crises, the trend has generally been upward. With respect to 2008 and 2009, the president of the NVCA explains that "the weak exit environment resulting from an unstable public market combined with a challenged limited partner base sent a strong message to the venture community to pull back the reins—and the VC's listened."[1139] Year on year from 2008, the number of IPOs doubled because "the economy has begun to show signs of improvement."[1140]

In an IPO, the venture sells its shares to public investors. The public markets give the VC investors an exit channel and an opportunity to sell their shares in the venture at a favorable price.[1141] The VC investor will typically not sell all its shares in the venture at the date of the public offering due to contractual or legal transfer restrictions. These securities will be sold gradually, during several months or years following the IPO, based on the contractual restrictions and the climate of the stock markets.[1142] There are a great number of reasons for VC investors to choose IPOs. Public offerings will usually give VC investors chance to sell their securities at a higher price than that of a private deal. The entrepreneurs also like IPOs since they will receive new capital much easier if their companies have been listed on the public markets.[1143]

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[1137] Cumming, Fleming, and Schwienbacher (2006: 214-245).

[1138] Allen & Song (2002).

[1139] NVCA (2010: 1).

[1140] Ibid.

[1141] Gladstone & Gladstone (2002: 311).

[1142] Cumming & MacIntosh (2002: 51).

[1143] Gladstone & Gladstone (2002: 311).

**Table 3.2 The Ventures IPOs Events in the U.S. by Year, 1978-2009**

| Year | Number of VC-backed Companies IPOs | $M Amount raised in the ventures IPOs |
|---|---|---|
| 1978 | 6 | 165 |
| 1979 | 4 | 76 |
| 1980 | 24 | 823 |
| 1981 | 50 | 962 |
| 1982 | 21 | 907 |
| 1983 | 101 | 4,243 |
| 1984 | 44 | 898 |
| 1985 | 35 | 1,007 |
| 1986 | 79 | 2,463 |
| 1987 | 69 | 1,970 |
| 1988 | 36 | 1,125 |
| 1989 | 39 | 1,365 |
| 1990 | 43 | 1,560 |
| 1991 | 119 | 4,715 |
| 1992 | 157 | 5,308 |
| 1993 | 193 | 6,031 |
| 1994 | 159 | 4,190 |
| 1995 | 205 | 7,685 |
| 1996 | 284 | 13,495 |
| 1997 | 134 | 5,249 |
| 1998 | 77 | 4,063 |
| 1999 | 257 | 20,841 |
| 2000 | 226 | 21,652 |
| 2001 | 37 | 3,118 |
| 2002 | 24 | $2,474 |
| 2003 | 29 | 2022.7 |
| 2004 | 94 | 11378 |
| 2005 | 57 | 4485 |
| 2006 | 56 | 5075.1 |
| 2007 | 86 | 10326.3 |
| 2008 | 6 | 470.2 |
| 2009 | 12 | 1642.1 |

Sources: The IPO Reporter and the Venture Capital Journal,

Thomson Reuters & National Venture Capital Association, available at www.nvca.org.

#### 3.3.3.3 Mergers and Acquisitions

Sometimes a VC investor will exit through mergers or acquisitions by selling the whole venture to a third party, which could be an individual or a company. The deal will allow the entrepreneurs and VC investors to launch a new business or investment after receiving a lump sum amount for the venture.[1144] There are several ways to structure the deal, including selling the shares, a merger, or selling the assets of the venture. The potential buyers could be anybody. In some cases, the purchaser will be another VC investor.[1145] In the majority of cases, however, the purchaser will be a strategic buyer, which is a business firm in the same industry as that of the target company.[1146] This strategic buyer might also be a competitor, supplier, or customer of the target company.[1147] Unlike a VC investor who only seeks higher returns from the transaction, a strategic buyer conducts the merger or acquisition for purposes of production, growth, or marketing.

There are six general ways in which an entire venture may be sold. One is a stock sale for cash. The simplest of all methods is to sell the stock of the venture to someone else for cash.[1148] The second one is a stock sale for notes. The buying company may buy the stock of the ventures by giving the VC investors debt instruments that pay off over a fixed period of time.[1149] The third one is stock sale for stock. The VC investors may take stock in a large buying company or other strategic buyer in exchange for the stock that they own.[1150] In the U.S., this will give the VC investors the advantage of not paying taxes until they sell the stock received from the buying company.[1151] The fourth one is an asset sale for cash. In this situation the venture may sell all or part of its

1144 Ibid.

1145 Cumming & MacIntosh (2002: 56).

1146 Cumming & MacIntosh (2002: 58).

1147 Geriger (1988).

1148 Gladstone & Gladstone (2002: 324-327).

1149 Ibid.

1150 Ibid.

1151 Ibid.

operating assets for a specified cash amount.[1152] The advantage for the buyer is that the buyer does not assume the venture's liabilities unless he agrees to do so. The fifth one is an asset sale for notes. Sometimes the buying company may not have the cash necessary to pay for the assets it is buying from the venture.[1153] In that situation, the venture may have to take notes, secured by the assets being sold as payment.[1154] The last one is an asset sale for stock. The VC investors receive the shares of the buyer as payment for the venture's assets.[1155] Then the VC investors can file a plan of liquidation and distribute these shares to other shareholders of the venture.[1156]

### 3.3.3.4 Buyback

In a buyback, the entrepreneur, the managers, or the venture will repurchase the shares held by the VC investors. In many cases buybacks will be contractual agreed by the VC investors and the entrepreneurs at the beginning of the investment. The entrepreneurs will not buy VC shares back if they do not want to own 100% of the venture. Such rights will often include the rights of VC investors to transfer their shares back to the entrepreneurs or the venture if the venture fails to achieve predefined milestones or launch an IPO.[1157]

There are two ways for entrepreneurs or the venture to buyback the VC investors' shares. One is for the venture or the entrepreneurs to negotiate a fair price for the shares held by the VC investors. The venture would then borrow funds to cash out the shares of the VC investors if the company lacks money. If the entrepreneurs do not want to borrow money from banks, they could use an ESOT to buyback the VC shares. [1158] Like a pension and profit sharing plan, the ESOT receives money from the venture's

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1152 Ibid.

1153 Ibid.

1154 Ibid.

1155 Ibid.

1156 Ibid.

1157 Cumming & MacIntosh (2002).

1158 Gladstone & Gladstone (2002: 318-319).

contributions and could then buyback VC shares with this money.[1159] This might be a costless way for entrepreneurs to push VC investors out of the venture.[1160]

### 3.3.3.5 Secondary Sale

In a secondary sale, the VC investors sell their shares to a third party, rather than the entrepreneurs.[1161] The entrepreneurs and other investors will still keep their shares in the venture. If the buyer is a strategic buyer, she will seek a "window" on the target company's technology through the secondary sale, which means the buyer will acquire some form of option right on the remaining shares held by the entrepreneurs or other investors.[1162]

### 3.3.3.6 Liquidation

A venture company can be liquidated when the VC investors want to escape from an unsuccessful venture. It might be the only way for VC investors to cash out at least part of their investment from a failed venture.[1163] For a venture which is going to fail, it is easier to liquidate the company by selling its valuable assets than to seek a buyer of the venture's shares.[1164] This is because the land, building, cars, machines, computers, furniture, and other assets may well be worth more in liquidation than they are operating as components of the unsuccessful business. [1165]

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1159 Ibid.

1160 Ibid.

1161 Cumming & MacIntosh (2002).

1162 Ibid.

1163 Ibid.

1164 Gladstone & Gladstone (2002: 333).

1165 Ibid.

### 3.3.4 Stimulus

#### 3.3.4.1 General

It has been observed that many countries' VC industries could not develop without the support of or stimulus provided by the governments.[1166] The usual measures used by governments are to allocate financial stimulus to attract other private investors to invest in the VC industry.[1167] The government can give capital to other private partners in joint VC funds (the government would set up such joint VC funds with private investors), promote the skills of VC funds' managers, or loan money at subsidized rates to qualified VC funds for some special VC investments.[1168] Unlike a private VC fund, the purpose of the governmental stimulus programs is not primarily to gain return, but to receive "environmental return" or "social return" from the investments.[1169]

Therefore, the VC industry cannot take off without the stimulus of the government. Firstly, the government could offer additional finance support to the VC industry.[1170] Compared with the private VC investors, the government's stimulus programs can bear more financial risk and can therefore support the development of high-risk start-ups.[1171] The government can more effectively ensure that the VC funds' managers are qualified than can the entrepreneurs.[1172]The entrepreneurs can use the collected information offered by the government's stimulus programs to choose good VC funds, which can save them considerable amounts of money. Moreover, these stimulus programs are not competitors of the private VC funds and can play as "honest brokers" in the VC industry. Thus, the government can balance interests among the players of the VC industry with stimulus programs.[1173]

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1166 Lerner, Moore, and Shepherd (2005).

1167 Gladstone & Gladstone (2002: 333).

1168 Ibid.

1169 Ibid.

1170 Consulting (2001).

1171 Ibid.

1172 Lerner, Moore, and Shepherd (2005).

1173 Megginson (2001).

Since creating new jobs, increasing the competitive ability of the country, stimulating technological development and innovation are very important for the U.S. economy, the U.S. government provides incentives directly or indirectly to high-tech early stage start-ups through governmental VC stimulus programs.[1174] These programs play a very important role in assisting the transfer of high technology formulated in research labs to the markets.[1175] The most successful governmental VC stimulus programs in the U.S. should contain two conditions.[1176] The first is these VC programs should be funded by the government. The second is the programs should be managed by private VCs.[1177] Borgdorff also says:

> Public funds should only act as co-investors. It should be up to private investors to determine if a venture capital firm is solid enough to receive any money and, if so, how much and under what conditions. Once a private investor commits its money, the public one can follow as a co-investor.[1178]

In the governmental stimulus programs, the governments do not need to select the start-ups. Its tasks are to establish the criteria of how to guide VC funds to select start-ups and raise capital for the funds through the programs.[1179] In practice, the governments would especially encourage private VCs to invest in high risk early stage start-ups by giving them money and other supports.[1180] The missions of these private VCs are to find good start-ups, manage the start-ups with their professional skills, and ensure these VC investments are a success.[1181] Then the governments can take the capital back from the successful ventures and invest the money in the new start-ups.[1182]

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[1174] Leleux, Surlemont, and Wacquier (1998: 642-643).

[1175] Ibid.

[1176] O'Shea & Stevens (1998).

[1177] Ibid.

[1178] Borgdorff (2004).

[1179] Ibid.

[1180] Ibid.

[1181] Ibid.

[1182] Karsai (2004).

In the stimulus programs, the governments act as LPs of the VC funds. The governments will raise a VC fund cooperating with the private VCs. The governments contribute money to the fund and private VCs contribute their experience and professional investment skills.[1183] The governments will not operate the day-to-day business of the fund. They select suitable GPs to verify the investments and manage the fund. Unlike other private LPs of the funds, the governments will monitor the investments of the fund and will have right to terminate the stimulus if they find the GPs misuse the governments' capital or the investments failed.[1184] In the stimulus programs, the governments typically use two measures to give incentives to private VCs, downside protection and upside leverage.[1185]

The first measure is downside protection. As discussed, it is very risky to invest in high-tech early stage start-ups. The reason why a lot of private VC funds are not interested in early stage start-ups is because they fail more frequently than later stage companies. For the purposes of reducing failures and encouraging private VC funds to focus on early stage start-ups, governmental stimulus programs offer loans or equity guarantees to private VC funds for such investments.[1186] The loans or guarantees transfer part of risk from the private VC fund to the government. The government will thus share the loss if such VC investments fail. The measures used by the governmental stimulus programs for reducing risk are called downside protection.

In the U.S., the government sets up public stimulus programs, including SBIC and SBIR programs, to prevent private VC funds from failing at an early stage. In the programs, loan guarantees encourage banks to lend money to the early stage start-ups that might not meet the regular requirements of the banks.[1187] Without the guarantees, private VC funds would avoid these early stage start-ups which lack business records,

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1183 Ibid.

1184 Ibid.

1185 Ibid.

1186 Jaaskelainen, Maula, and Murray (2007: 903).

1187 Ibid.

capital, and mature management teams.[1188] By decreasing credit risk, the government's stimulus programs are an efficient measure to support private VC funds to invest in early stage start-ups.[1189]

Another measure in the stimulus programs is upside leverage.[1190] Compared with downside protection, up-side leverage is more active for the incentive of VC development.[1191] As Jaaskelainen explains:

> Although there is little empirical evidence on the effects of different profit sharing models on the quality of investors attracted, several more successful government programs have explicitly targeted supporting the entry of new professional teams in the early-stage market. These programs have used upside incentives that are supposedly more attractive for the most competent investors including an open bidding process and professional due diligence process.[1192]

Downside protection is designed to reduce the risk of private VC funds' investments in early stage start-ups, while upside leverage does not protect the private VC funds from failing, but allows them to transfer part of their contribution obligations to the government.[1193] Through the measure, the government will invest in the early stage start-ups simultaneously with their private partners.[1194] The government will bear part of the losses if the investment fails. But if the venture is successful, the government will only take the original contribution back without additional profits.[1195] All additional returns belong to the private VC funds.

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1188 Ibid.

1189 Murray & Marriott (1998).

1190 Karsai (2004).

1191 Jaaskelainen, Maula, and Murray (2006).

1192 Jaaskelainen, Maula, and Murray (2007: 913-929).

1193 Ibid.

1194 Ibid.

1195 Ibid.

Upside leverage is very important to small private VC funds which lack enough financial resources to develop their business in the VC market independently.[1196] Further, the limited involvement of the government in the VC funds' returns encourages more private VC funds to set up partnerships with the governments though such stimulus programs.[1197]

### 3.3.4.2 The SBIC program

As mentioned, the SBIC program, created in 1958, was the first direct stimulus provided by the U.S. federal government to encourage the development of the VC industry. The program, launched under the 1958 SBIA, is also a main governmental stimulus program for VC development in the U.S.[1198] In the program, an SBIC is a private VC fund which raises capital from the government and other private investors and then invests the money in start-ups.[1199] The SBICs can borrow part of money from the government and collect the rest of the capital from the public market. The U.S. government operates the stimulus program though downside protection and upside leverage measures. That means the government has authority to be the loan guarantor of the SBICs when the funds invest in early stage start-ups or to be the co-investor of the SBICs with other private VC investors.[1200]

In the 1960s, the SBIC program granted $3 billion to start-ups, more than three times the then current amount from private VC investments.[1201] The SBICs also gives a chance to many people to become VCs and professionals in the VC industry. However, due to some design flaws in the program, several SBICs failed in the 1970s and 1980s.[1202] In 1992, the Small Business Equity Enhancement Act was promulgated for the promotion of the program. The new law removed the tax liability for normally

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1196 Karsai (2004).

1197 Ibid.

1198 Kenney, Han, and Tanaka (2004: 52-83).

1199 Ibid.

1200 Ibid.

1201 Lerner (1996).

1202 Ibid.

exempt institutional investors. It also allowed the SBA to take responsibility for the program's risks and benefits. SBIC investment continues to be very important in the U.S. VC industry. In 2001, the total VC investment by SBICs reached $4.5 billion, of which 72% were directly invested in start-ups.[1203] These public funds have the same business passion as their private rivals.

An SBIC can be organized in any state of the U.S. as a limited partnership, an LLC, or a corporation. The SBA has authority to grant licenses to the SBIC founders. An SBIC should meet two criteria before receiving a license. An SBIC must have qualified management teams as well as enough private capital. The SBA will evaluate the qualification and previous VC investment experience of the management teams. An SBIC should also raise a minimum of $5 million from private investors before the application.[1204] If the SBIC wishes to conduct securities transactions, the minimum capital requirement increases to $10 million.[1205] When applying for the grant, the founders should submit a business proposal to the SBA with information on potential investment targets, the investment structure, the favorable industries, the stages of the targets, and other issues related to the VC investment.[1206] The founders should also report the background of their management team to the SBA, including the educational background of the managers, and whether they have enough experience and enough knowledge to handle VC investments.[1207] After receiving the application of the founders, the SBA will run a due diligence process in the fund for four to seven months.[1208] One official of the SBA points out that during the due diligence, they "primarily review the management of the firm, to make sure they have venture capital experience...but ... aren't looking for a return as much as we want to facilitate capital getting to small businesses."[1209] The SBA will invest more money in the larger SBICs.

[1203] Ibid.

[1204] Ibid.

[1205] Ibid. The SBA may require additional capital in certain domain if it is necessary.

[1206] Lerner (1996).

[1207] Perace & Barnes (2006: 15).

[1208] Ibid.

[1209] http://www.bizjournals.com/seattle/stories/2000/08/21/newscolumn5.html

For example, The SBA will invest $15 million in a SBIC if the private partners can raise another $5 million. The maximum contribution of the government's upside leverage in a single SBIC is $90 million. The government and the private investors could pool a $135 million VC fund if the private partners will collect $45 million private capital.[1210] Thus, the private VC investors would receive huge awards if the investments were success.

After establishment, the SBICs should file annual reports to the SBA. The SBIC VC firms will offer direct investments, long-term loans, and other financial and legal services to start-ups. The SBA will monitor the investments of the SBICs. Long-term loans are a special VC support from the SBICs, which will be offered independently or in cooperation with other funds.[1211] Commonly, the maturity of the loan will not exceed twenty years.[1212] When making investments, the SBICs can borrow money from the U.S. federal government at favorable rates. An SBIC may receive leverage of up to 300% of its private contribution, up to a maximum amount of $108.8 million.[1213] The SBICs might issue debentures in the public markets to fund their contributions. The government stipulates that such debentures should have a term of ten years with semi-annual interest payments and a lump sum principal payment at maturity, which also allows a prepayment during the first five years.[1214]

Such loans could only be made for some start-ups which are predefined by the SBA regulations. Unlike private VC firms, the SBICs could not invest in other SBICs, other private VC funds, investment companies, real estate, or companies with less than one-half of their assets and operations in the U.S.[1215] The SBICs are forbidden to offer capital to their employee or to borrow money from their ventures or the ventures'

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[1210] Murray & Marriott (1998).

[1211] Ibid.

[1212] Only under certain conditions the SBIC may renew the loan's maturity to another ten years.

[1213] Murray & Marriott (1998).

[1214] Ibid.

[1215] Ibid.

entrepreneurs.[1216] SBICs cannot be the majority shareholder of the ventures without prior approval of the SBA.

The SBIC program has often been criticized that its selection of SBICs was too political.[1217] Kenney indicates that "nine out of ten SBICs had violated agency regulations and dozens of companies had committed criminal acts."[1218] The result was that during the 1960s private VC investors were not interested in investing in the SBIC program. In 1965, the U.S. federal government also began to investigate offenses in the SBIC program, e.g. fraud or misconduct by some SBICs. "Starting in 1965 Federal criminal prosecution was necessary to rectify the misappropriation of funds, incompetence, and fraud undertaken by some SBICs."[1219] Except for these problems in the early stage of the program, the SBIC program is a successful governmental stimulus program in the U.S. Under the program, many high-tech start-ups are developed with the investments of SBICs.[1220] The SBICs also give chances to many individuals to gain experience in VC investments. Moreover, many people and institutions become professional VCs or VC funds though the program.[1221]

**3.3.4.3 Other Stimulus Programs**

The SBIR program was established under the Small Business Innovation Development Act of 1982 to support R&D activities of start-ups. The program specially supports early stage R&D projects in high-tech startups with a billion dollars per year. These projects usually serve the demand of the governments.[1222] Many successful high-tech companies are supported by the SBIR program.[1223] Using government funding to

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1216 The SBA defines "associates" as "1) certain of its shareholders, officers, directors, and employees, or in an unincorporated SBIC, its members, control persons, and employees."

1217 Lerner (2002).

1218 Kenney, Han, and Tanaka (2004: 52-83).

1219 Kenney, Han, and Tanaka (2004: 54).

1220 Sorabella (2000: 18-19).

1221 Kenney, Han, and Tanaka (2004: 52-83).

1222 Chabbal & Maeda (2000).

1223 Etzkowitz, Gulbrandsen, and Levitt (2001: xxii).

support the private VC industry and private R&D is considered essential to maintain U.S. competitiveness.

The NMVC program encourages VC investments in low-income areas to improve employment opportunities and the development of the economy.[1224] NMVC companies can issue debentures in the public market which are guaranteed by the SBA. [1225] The total amount of the guarantee is limited to 1.5 times the capital of the NMVC companies.[1226] NMVC companies can enjoy the NMTC.[1227] This would provide "a credit against the federal income taxes of the shareholders of the NMVC companies equal to 39% of the amount invested over a seven year period."[1228]

An NMVC company could be organized as a corporation, a limited partnership, or an LLC.[1229] The program requires that an NMVC company should raise at least $5 million from private investors when funding a venture.[1230] The U.S. federal government will provide a ten-year loan matching the NMVC investment through SBA debentures to encourage these companies to invest in low-income areas.[1231] The program requires that an NMVC invest 80% of its capital in "small enterprises" in "low-income geography" through "equity investments."[1232]NMVC companies cannot invest in real estate, other financial institutions, or lending projects.[1233]

The NMVC Program is different from other governmental stimulus VC programs in the U.S. Unlike the SBIC program, which provides debentures to SBICs and requires a

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1224 Sec. 108.10, NMVC program.

1225 Sec. 108.1150, Ibid.

1226 Sec. 108.1150, Ibid.

1227 Rubin & Stankiewicz (2005: 1).

1228 http://www.db.kosbi.re.kr/download.asp?uri=/attach_files/U11/U111293.pdf

1229 Sec. 108.100, NMVC program.

1230 Sec. 108.210, Ibid.

1231 Sec. 108.160(b)(1), Ibid. See also http://www.db.kosbi.re.kr/download.asp?uri=/attach_files/U11/U111293.pdf

1232 Sec. 108.710, NMVC program.

1233 Sec. 108.720, Ibid.

credit history of the applicants, NMVC companies should invest cash in the start-ups in the low-income areas.[1234] While some SBICs will invest 40% of their capital in low-income areas, NMVC companies should make 80% of their investments in these areas.[1235] Further, NMVC companies could engage in the management of the venture in order to ensure success.[1236]

Other policies and programs launched by the U.S. government also play a key role in supporting VC investment and promoting the VC industry. More than 7% of U.S. institutional capital, including pension funds and insurance companies, is invested in public or private VC funds.[1237] In the UK, the amount is less than 1%.[1238] For example, the Advanced Technology Program, established in 1988 by the National Institute of Standards and Technology, provides money to support the R&D activities of the start-ups. Between 1990 and 2002, the ATP awarded $0.98 billion to start-ups.[1239] The Small Business Technology Transfer, established by the Small Business Technology Transfer Act of 1992, also provides capital to the R&D activities of public or private start-ups.

VC Investment regulations for other financial institutions were visited in 1999. The Financial Modernization Act (also known as the Gramm-Leach-Bliley Act) tried to grant more freedom to financial institutions by the modification of the Glass-Steagall Act of 1933, which prohibited financial institutions from conducting both businesses of investment banking and commercial banking, or both business of banking and insurance.[1240] Very generally speaking the new Act allowed a financial institution to combine the businesses of banking, insurance, securities, and insurance.[1241] The change

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1234 Sec. 108.320, Ibid.

1235 Sec. 108.710, Ibid.

1236 Sec. 108.320, Ibid.

1237 Rubin & Stankiewicz (2005: 1).

1238 Ibid.

1239 Ibid.

1240 Ibid.

1241 Ibid.

gives these financial firms more opportunities to offer various products to their clients and more investment channels, including collecting capital more easily from the public and then investing in VC industry.[1242]

### 3.3.4.4 Tax Incentives

The government's stimulus could also focus on lowering the tax rate.[1243] Tax incentives can lower the cost of VC investments and thereby stimulate investors to invest in high-tech start-ups. In the U.S., the ratio of capital income tax rates to those for ordinary income serves to encourage investors to make VC investments. The U.S. experience shows that the VC industry becomes more active if the government reduces the relevant tax rates.[1244]

VC investments in the U.S. have been stimulated by both low capital gains tax rates and targeted tax incentives. Capital gains are taxed differently depending on whether the investment is a long-term or a short-term investment. The holding period of a long-term investment should be more than one year.[1245] The purpose of such reduced capital gains tax rate is to encourage more investors to engage in long-term value investing, exactly the kind of investing that is done in the VC industry. Pursuant to the SBIA and applicable provisions of U.S. tax law, if an investor and the investment in a small business, including a VC enterprise, meet certain conditions, capital gain is exempt from federal income taxation up to a specified amount.[1246] A comparable exclusion exists for sale of shares of a VC investment firm.[1247] Moreover, a low capital gains tax rate is in itself a powerful incentive for VC investment. The rate was reduced from a high of 49% in 1978, to 20% between 1981 and 1986, and in 2009 it ranged from 0% to 15%.[1248] The 0% rate is scheduled to expire at the end of 2010, when capital gains rates

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[1242] Ibid.

[1243] Megginson (2001).

[1244] Maeda & Johnson (2004).

[1245] Siegle (2010: 1).

[1246] *See* Sec. 681, 15 U.S.C.A. and Sec. 1202, 26 U.S.C.A.

[1247] *See* Sec. 681, 15 U.S.C.A. and Sec. 1044, 26 U.S.C.A.

[1248] Hall (2010: §§ 22A:40), Legutki (2010: 2:32). See also Perez (2009).

will increase to at least 15%.[1249] Thus, adjustments, particularly decreases, in capital gains taxes encourage institutional investors to infuse money into the VC industry.

As discussed above, the NMTC, which is also intended to improve the economy and job opportunities in low-income areas, permits taxpayers to be granted a credit to offset their federal income taxes for conducting VC investments in low-income areas.[1250] The maximum amount of the credit for the taxpayer could cover 39% of her tax in the VC investments, and the period of validity is over seven years.[1251] The federal tax expense for this program is estimated at $15 billion per year.[1252]

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1249 Ibid.

1250 Sec. (c)(ii), NMTC.

1251 Ibid.

1252 U.S. Environmental Protection Agency (2005).

# Chapter IV. Comparing the U.S. and Chinese VC Legal Frameworks

## 4.1 Introduction

In China, the VC industry has played an increasingly important role in the national economy. But the Chinese VC industry also faces more and more challenges.[1253] One venture capitalist complains that "most if not all early stage venture capital being invested in ... China will be lost."[1254] But such failures do not only happen in China. In some mature VC industries, including the U.S., VC investments in start-ups mostly fail.[1255] However, it can be assumed that the complaint quoted above referred not only to the universal risks connected with VC investments, but also meant to express that China still lacks a mature legal framework to support VC development and reduce risks, especially when compared to that of other mature VC industries.[1256]

In the U.S., VCs can reduce investment risks by using a series of legal techniques.[1257] The U.S. laws have created some legal rights to help VCs reduce risks when they conduct due diligence, manage and monitor the ventures, and plan exit strategies during the investment.[1258] Therefore, U.S. VCs can reduce investment risk easier than their Chinese counterparts by virtue of a mature legal system.[1259]

As discussed in Chapter III, the U.S. experience shows that a high quality legal system can help to reduce risk during VC investment.[1260] In China, as mentioned in Chapter II, over-strict legal limitations and underdeveloped institutional stability block the development of the Chinese VC industry, and prevent VCs from protecting their

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1253 Liu, Zhang, and Hu (2006: 161-184).

1254 Aragon (2006: 1).

1255 Jensen (1993: 831-880).

1256 Yan & Lin (2004: 1-2)

1257 Christensen (2000: 19-38).

1258 Vaughn (2002: 249-250).

1259 Bruton, Ahlstrom, and Yeh (2004: 72-88).

1260 Ibid.

interests, collecting exact data on the business, monitoring the management, and finally reducing the risks of the investment.[1261] Some scholars have examined the elements of the Chinese legal system that support VC activities. There are many barriers to the development of a mature VC industry in China, including that the Chinese government does not create a favorable VC investment environment for foreign VC investors, and the current public share trading structure, in which shares are divided into A, and B classes and traded separately, restricts VC investors to exit their investments.[1262] Besides economic reasons, China's socialist tradition limits private ventures to acquire resources.[1263] VC investors, especially foreign VC firms, have to spend more to research Chinese VC rules because some regulations provide unclear guidance.[1264] Further, due diligence for foreign VC investment in China was limited in scope because the regulations in China do not require that the same level of public information be provided to the government as those in the U.S.[1265] Further, China also lacks a mature company law to meet the requirements of the complex investment techniques employed by VC investors.[1266]

Another two main problems with the Chinese VC industry are the problems of entry and exit.[1267] There are many restrictions to foreign VC investment entering into some sensitive areas, including aviation, telecommunications, and insurance. The procedural requirements to establish a foreign-invested venture in China are over-complex. In contrast, to be the largest foreign direct investor and the largest recipient of foreign direct investment in the world, the U.S. has "important economic, political, and social interests ... in the development of international policies regarding direct investment. With some exceptions for national security, the United States has established domestic

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[1261] Le, Venkatesh, and Nguyen (2006: 209-227).

[1262] Fu (2001: 515-524).

[1263] Bruton & Ahlstrom (2003: 241-244).

[1264] Ibid.

[1265] Ibid.

[1266] Peng, Luo, and Sun (1999: 73-100).

[1267] Vaughn (2002: 241-244).

policies that treat foreign investors no less favorably than U.S. firms."[1268] Strict listing requirements make it impossible for not-yet-profitable ventures to issue shares on the domestic markets of Shanghai or Shenzhen. In contrast, China's M&A market is underdeveloped, decreasing the chances of finding a buyer for the venture. This means it is hard for VC investors to exit the ventures efficiently.[1269] Thus, China still lacks a successful VC legal framework, namely large capital, liquidity, incentives, labor, and risk tolerance.[1270]

The purpose of the comparisons is to understand selected fundamental features of VC legal frameworks in both nations. Nevertheless, some might doubt the meaning of such comparisons because different legal systems in different countries are based on different histories, cultures, policies, and legal tradition.[1271] For example, one might argue whether it works to compare a legal framework under a civil law system with the framework of a common law system. China has the civil law system and the U.S. follows the common law system.[1272] All comparisons of specific legal system are actually incomplete, especially when comparing a new legal system with a "long-standing" law system.[1273] Sometimes the legal experience of a mature legal framework, however, may help a primary legal framework to promote its system and structure.[1274] This is the cornerstone of this comparison.

The VC legal framework in every country also depends on its political and cultural context.[1275] The factors affecting the VC legal framework include the level of the country's economy, political system, current legal system, especially corporate law,

[1268] Jackson (2010: Summary).
[1269] Vaughn (2002: 241-244).
[1270] Lu, Tan, and Chen (2007: 244-271).
[1271] Fordham (2006: 11).
[1272] Glendon, Gordon, and Osakew (1982: 261).
[1273] Wu & Geu (2007: 136).
[1274] Ibid.
[1275] Çetindamar (2003).

securities law, tax law, and the business culture.[1276] These factors are defined as the "institutional environment" by scholars; VC industries around the world are dependent on the national institutional environment.[1277] These factors can bring both advantages and disadvantages to the development of the VC industry. The function of a proper VC legal framework is to conquer the disadvantages and encourage the advantages. China could set up its VC legal framework by sharing some characteristics of the U.S. VC industry, but also needs to develop its own characteristics.

Therefore, this chapter will examine the key features of both of the U.S. and Chinese VC legal frameworks and compare the characteristics present in the two countries. Specifically, four important aspects of the VC legal framework will be compared, including funding, VC governance in ventures, exits, and stimulus. Based on the comparison, a discussion of future prospects for establishing a proper VC legal framework in China will be considered.

## 4.2 Comparison

### 4.2.1 Funding

#### 4.2.1.1 Limited Partnership

As mentioned, the mainstay of U.S. VC funds is the limited partnership.[1278] China's situation is different. In 2008, 56.98% of Chinese VC funds were organized as corporate firms, and 24.58% of funds were limited partnerships.[1279] In the first quarter of 2009, corporate funds increased to 64.52%, and the limited partnership VC funds decreased to 19.35%.[1280] But another important fact is there was no limited partnership VC firm in China before 2006 in which year China modified its partnership law. The data show the

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1276 Ahlstrom, Bruton, and Yeh (2007: 248).

1277 Ibid.

1278 Leamon, Hardymon, and Lerner (2004).

1279 China Research and Intelligence (2009: 20).

1280 China Research and Intelligence (2009: 21).

tendency that more and more Chinese VCs would like to set up their firms under the legal structure of limited partnerships.[1281]

One basic operational principle in China's limited partnership law is that the GPs must bear unlimited liabilities for the debts of the limited partnership and the LPs bear the liabilities for the partnership's debts to the extent of their capital contributions.[1282] The U.S. laws provide the same principle in limited partnership. Firstly, GPs have the "liabilities of a partner in a partnership without limited partners."[1283] Secondly, the LPs are not liable for the debts of a limited partnership.[1284] Some scholars argue that the U.S. law does not give a clear statement that the LPs are only liable to the "extent of their contributions" as does the Chinese law, but the legal results of two countries are actually the same.[1285]

Although most provisions of 2006 PEL are similar to those of 1985 RULPA, there is one significant difference.[1286] In China, an LP who conducts a transaction on behalf of the limited partnership might be liable as a GP if the third party thought the LP is a GP of the partnership.[1287] Correspondently, China's law sets up a safe harbor for LPs allowing them to conduct some activities without being perceived as "executing" partnership business.[1288] This stipulation is very important because it emphasizes that only GPs may execute the partnership business.[1289] But the difference between the U.S. and China's law is China does not "directly and unambiguously correlate executing partnership affairs by an LP with the LP's liability to third parties."[1290] Thus, lacking clear statement on "execute" makes it actually very difficult for people in China to

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1281 Zero2IPO (2008: 395).

1282 Art. 2, 2006PEL.

1283 Sec. 403, 1985 RULPA.

1284 Sec. 303(a), Ibid.

1285 Wu & Geu (2007: 161).

1286 Ibid.

1287 Art. 76, 2006 PEL.

1288 Art. 68, Ibid.

1289 Art. 72, Ibid.

1290 Wu & Geu (2007: 161).

classify which activities of LPs are "executive" activities. Further, the lack of a clear definition on "executing" partnership affairs will cause conflict between GPs and LPs on management of the partnership. For example, the GPs might refuse the LPs to conduct some activities of the partnership, and the LPs might argue that these activities do not belong to "executing" partnership affairs, so they have rights to conduct the affairs. They might have to raise a law suit to solve the conflict because of lacking a clear definition on "executing." In the U.S., an LP "who knowingly permits his/her name to be used in the name of the limited partnership...is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner."[1291] The 2001 ULPA even allows LPs to manage the affairs of the partnership without bearing unlimited liability.[1292] There is no similar stipulation under China's law.

Capital "contributions" of LPs is another key feature which distinguishes the limited partnership form in China and the U.S. Firstly, in the U.S., an LP will be liable to the limited partnership for the amount of any returned contribution for one year, but only "to the extent necessary to discharge the limited partnership's liabilities to creditors who extended credit to the limited partnership during the period the contribution was held by the partnership."[1293] If the distribution of the contribution breaches the partnership agreement, the LP should be liable to the partnership for six years "unmitigated by the amount of credit extended in reliance thereon."[1294] Clearly, LPs in the U.S. enjoy limited liability rather than unlimited liability, because the amount they should be liable for is limited to the distribution they have received.[1295] In China, the law only states that the partners should decreases or increases of contributions according to the partnership agreement or to the unanimous consent among all partners.[1296] The Chinese law lacks clear statement to describe the limited liability of LPs.

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[1291] Sec. 303(d), 1985 RULPA.

[1292] Comment to Sec. 302, 2001 ULPA.

[1293] Sec. 608(a), 1985 RULPA.

[1294] Sec. 608(b), Ibid.

[1295] Sec. 608(c), Ibid.

[1296] Art. 34, 2006 PEL.

Secondly, China has stricter rules on the obligation to pay contributions. An LP should pay off the capital contributions in a given time according to the partnership agreement, or she will be liable for the delay, including bearing the liabilities for infringement of the partnership agreement to other partners.[1297] The U.S. law simply state that all issues related to contributions should be in the written documents.[1298] The stipulation of the U.S. is more flexible. The U.S. law grants the freedom to partners themselves to decide how to set up their own partnership based on their specific business purposes. The prohibition of Chinese law indicates that LPs in Chinese limited partnership have less freedom than their U.S. counterparts. As Keller notes, "[a] person cannot live in China long without becoming aware of the complex, interwoven web of social rules which governs every aspect of Chinese life."[1299] This also applies to the law of limited partnership in China.

Like the directors and managers in a corporation, the GPs in a limited partnership have a fiduciary duty of care to the partnership and the LPs. In theory, the LPs can file suit against the GPs if the GPs breach their fiduciary duty. However, the standard of the fiduciary duty is very low in the U.S. "By statute, a general partner in a limited partnership…will only breach the duty of care if her misconduct is grossly negligent or reckless or intentional."[1300] The situation of Chinese LPs is not better than that of the U.S. Although Chinese LPs can file suit against their GPs if GPs damage the firm or fail to fulfill their obligations, the law does not give any clear directives or standards on how to classify the mistakes of GPs.[1301] The legislation gives the GPs wide latitude in management and investments. On the other hand, LPs have to provide stronger evidence to prove whether GPs have breached their fiduciary duty.[1302] That means it is very difficult for LPs to file suit against GPs' misconduct in the U.S. or China.[1303]

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1297 Art. 65, 2006 PEL.

1298 Sec. 502, 1985 RULPA.

1299 Keller (1994: 711).

1300 Lee Harris (2009: 16).

1301 Art. 68, 2006 PEL.

1302 Rosenberg (2003: 431).

1303 Steele (2007: 32).

The U.S. and China all provide tax preference to limited partnership. As discussed in Chapter III, income of a limited partnership in the U.S. passes through to the partners directly.[1304] The capital gains rate of partners in limited partnerships is only 15%.[1305] In China, the partners of an LP have rights to pay their income tax respectively, which means under Chinese tax laws only the partners of a limited partnership are the taxpayers. There is no taxation at the partnership level either. The partners of a Chinese limited partnership can enjoy the pass-through treatment with the rates ranging from 5% to 35%.[1306]

In conclusion, the limited partnership laws of China and the U.S. are more alike than different.[1307] The purpose of the Chinese law is to encourage the VC industry through providing an appropriate organizational form. That is also one of the purposes of the U.S. limited partnership laws, as discussed in Chapter III. One regretful thing for the Chinese VC industry is that the government still has not allowed foreign VC investors to set up FLPs in China, which obstacle does not exist in the U.S.

#### 4.2.1.2 Registration and Exemptions

China and the U.S. both note that VC investments present high risks. But they try to reduce such risk through different mechanisms, particularly with respect to their raising of funds. Unlike the U.S. VC laws, Chinese VC laws have few exemptions for VC funds, but have rather strengthened requirements in recent years.[1308] First, a Chinese VC fund cannot freely make a public offering upon filing with the government, as is done in the U.S. For example, the NDRC released rules against illegal fund-raising activities by VC funds in 2009. VC funds cannot make any public offer and promotions through advertisements, public seminars or lectures, or the government will reject the

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1304 Sec. 701, and Sec. 702(a), IRC.

1305 Fleischer & Blackstone (2008: 95-97)

1306 Art. 3, 2008 SAT Circular No. 159.

1307 Wu & Geu (2007: 172).

1308 Ibid.

registration application of the fund.[1309] But the NDRC does not define what "illegal fund-raising" is. The Chinese government also fails to offer a channel to private VC funds which want to file with the government for public offering. The lack of legislation limits the fund-raising source of Chinese VCs. In the U.S., a VC fund can issue public securities with a prior registration statement to the SEC.[1310] The fund can also choose to issue shares to a limited number of persons or accredited investors. Thus, in the U.S., VC funds can enjoy more funding opportunities than their Chinese counterparts. This option of the U.S. encourages VC funds to arrange their plans depending on their own strategy. The Chinese laws limit the fund-raising channels and the development of VC funds. Furthermore, a U.S. VC fund would also not have to register with the SEC if it does not raise money from "U.S. persons."[1311] On one hand, this requirement focuses on protecting the benefits of U.S. citizen and promoting the economy of the U.S., and on the other hand, it encourages foreign investors to infuse money into U.S. VC funds. In contrast, Chinese foreign exchange laws strictly limit investment size and areas of foreign VC investors as discussed in Chapter III.

Second, Chinese VC laws stipulate high entry standards to VC funds through capital contribution requirements. A fund that fails to meet the requirements may not register as a VC fund in China. For example, the minimum contribution of a DVCF is RMB30 million.[1312] The requirements of setting up an FVCF are higher: the minimum contribution is $5 million for a limited partnership FVCF and $10 million for a corporation FVCF.[1313] There is no such requirement in U.S. VC legal system. A U.S. VC fund can decide the size of the fund only based on its business plan, not the legal requirements. The U.S. laws only look to a minimum capital when they review whether the investors of a VC fund are "qualified institutional buyers." The 1940 Act allows VC funds to issues unregistered shares to qualified institutional buyers, which include

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1309 See the Circular on Strengthening Record Filing Administration and Strictly Regulating the Fund-Raising Activities in Venture Capital Enterprises, July 10, 2009.

1310 Sec. 77e, 15 U. S. C.

1311 Sec. 230.903, 17 CFR.

1312 Art. 9(3), 2005 DVCM.

1313 Art. 6(2), 2003 FVCP.

investment companies and pension funds that manage capital over one million dollars, as well as banks which manage capital over $100 million and have an audited net worth of at least $25 million.[1314] China on the other hand seeks to guarantee the quality of VC funds through high required capital, but whether a VC fund can operate safely and successfully does not only depend on the capital, but also on its management team and investment ability of GPs.[1315] The capital requirements deprive small and middle investors of their chance to enter into China's VC industry.

Third, the U.S. has created a "qualified purchases" system to stipulate the qualification of VC investors which does not exist in China.[1316] As discussed in Chapter III, a U.S. VC fund does not need to register with the SEC if its investors are accredited investors under the securities laws or qualified purchases under the 1940 Act.[1317] Thus, U.S. VC funds usually remark in their memorandum that their offering is limited to accredited investors for the purpose of exemption from registration and disclosure.[1318] The VC fund can also save costs if it only raises money from accredited investors without registration. But the SEC will check the "qualified purchases" status of these investors at the time of each investment deal.[1319] The LPs of a VC fund can avoid having to submit to this verification requirement if they have a binding capital commitment with the fund. Further, in an offshore VC fund, only the U.S. LPs are required to be

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[1314] Sec. 230. 144A, 17 C.F.R.

[1315] Wu & Geu (2007: 172).

[1316] A VC fund may avoid registration if all LPs of the fund are "qualified purchases." The 1940 Act defines a "qualified purchaser" as: (1) a natural person who owns not less than $5 million in investments; (2) any company that owns not less than $5 million in investments and that is owned directly or indirectly by or for two or more natural persons who have certain specified close family relationships to one another, or a foundation or trust established by or for the benefit of such persons; (3) any trust that is not covered by item (2) and that was not formed for the specific purpose of acquiring the securities of the Section 3(c)(7) company, and as to which the decision-making trustee, and each settler or other person who has contributed assets to the trust, is a person described in clause (1), (2), or (4); or (4) any person, acting for its own account or for other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25 million in investments. (See Sec. 80a-3(c)(7), 15 U.S.C)

[1317] Sec. 230.506, 15 U. S. C. The purpose of such requirement of the U.S. is that the law assumes an accredited investor might have enough ability and knowledge to fully understand the risk of VC investments and does not need to require related information from the SEC.

[1318] Halloran et al. (1997: 3-9).

[1319] Chan (2008: 453).

confirmed as the qualified purchaser when the fund issues the offering.[1320] The non-U.S. LPs of the fund do not need to meet the requirement as qualified purchaser, as their exemption comes from being non-U.S. persons.[1321] Clearly, the U.S. requirement focuses on protecting the interests of U.S. persons.

China does not have any requirements on whether the LPs are "qualified" or not. It only stipulates that the minimum contribution by every investor must not be less than RMB1 million.[1322] It can be concluded that such requirement tries to keep small investors who lack the ability to bear high risk out of China's VC industry. But such protection is still at primary level without reviewing the qualifications of investors. Fortunately, China has another mechanism to reduce the risk of investing in VC funds. As discussed above, a successful VC fund does not only depend on contribution, but also on a good management team. China's VC laws state that either a DVCF or an FVCF should have at least three professional managers with prior experience of VC investment when registering.[1323] Such requirement aims to ensure that the VC fund will be operated safely by professional managers. Except for the similar requirements in the SBIC program, the U.S. laws do not have the requirement of qualified managers. It can be concluded that the U.S. tries to reduce the investment risk by disclosure or restricting the qualification of investors, whilst China approaches the same goal by monitoring the qualifications of managers.[1324]

Fourth, China and the U.S. have different treatments on registration. A Chinese VC fund has to register with the VC administration if it wishes to enjoy preferential tax treatments and governmental funding support.[1325] It means the VC fund does not need to fulfill such registration if it does not want to receive financial stimulus from the

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[1320] Sec. 80a-3(c)(7), 15 U.S.C.

[1321] Chan (2008: 456).

[1322] Art. 9(4), 2005 DVCM.

[1323] Art. 9(5), Ibid. Art. 6(5), 2003 FVCP.

[1324] Ibid.

[1325] See the Circular on Strengthening Record Filing Administration and Strictly Regulating the Fund-Raising Activities in Venture Capital Enterprises, July 10, 2009.

government. In the U.S., a VC fund can be exempt from the registration only when it is not involved in offering investment to the general public.[1326] It is more flexible for U.S. VC funds to arrange their business and decide whether to benefit from government stimulus without registration. The U.S. requirements reduce the transaction costs of operating VC funds.

Furthermore, U.S. VC funds can enjoy a number of exemptions which do not exist in China. For example, A VC fund should register under the 1940 Act as an investment company unless it can meet the exemption requirements of the Act.[1327] But it is exempt from such registration the 1940 Act if its investors are less than one hundred persons.[1328] The securities laws also stipulate that VC funds can enjoy the registration exemption if they only raise money from no more than thirty five non-accredited investors.[1329] This creates a non-exclusive safe harbor for U.S. VC funds.[1330]

The equivalent requirements of China are too simplistic. China's laws only state that the maximum number of investors in a limited partnership VC firm is two hundred

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1326 Sec. 77d(2), 15 U. S. C.

1327 Money Manager's Compliance Guide (2000: Tab 300-55).

1328 Sec. 80a-3(c)(1), 15 U.S.C.

1329 Sec. 230.506, Ibid.

1330 It does not mean the U.S. will give up monitoring the operation of VC funds. The U.S. laws stipulate that VC funds must meet the "attribution" requirement if they wish to enjoy the exemptions. "Attribution" means if "an entity owns 10% or more of the voting securities of the private investment company, and if the entity is itself an investment company, the SEC counts the shareholders or other owners of the investing entity as separate persons for purposes of the 100 owner limit." (See Money Manager's Compliance Guide (2000: Tab 300-56)) This requirement is designed for preventing investors from being defined as an investment company by "operating under a pyramid structure in which no entity has more than 100 shareholders." (See Money Manager's Compliance Guide (2000: Tab 300-56)) Individual investors of the fund are excluded from this requirement. (See Money Manager's Compliance Guide (2000: Tab 300-56)) As mentioned, a VC fund with no more than 100 investors can enjoy the exemption. But, if one LP of the fund is holding 10% or more of the voting right in the fund as well as in an investment company, the SEC will counts the shareholders of the LP as separate person for purposes of the 100 owner limit. (See Money Manager's Compliance Guide (2000: Tab 300-56)) For instance, Green Pine VC fund has 80 LPs. One of them is White Tree Investment Company that has 50 shareholders. When Green Pine applies for a "less than 100 investors" exemption from the SEC, the SEC will reject the application because it will count the 50 shareholders separately into the amount. Thus, the attribution requirement is designed to prevent funds from "evading the definition of investment company by operating under a pyramid structure in which no entity has more than 100 shareholders." (See Money Manager's Compliance Guide (2000: Tab 300-56))

persons,[1331] and in a Chinese LLC VC firm, the number reduces to fifty persons.[1332] The laws want to reduce the investment risk simply by limiting the number of investors, whereas the U.S. requirements go to the quality of disclosure that is likely in face-to-face sales. The Chinese requirements also contain no attribution rules to prevent VC funds from operating under a "pyramid structure."

In conclusion, compared with the U.S. laws, the Chinese VC laws lack financial liberalization. Chinese Lawmakers should loosen their absolute control of VC fund-raising. China should set up a transparent and flexible legal framework for Chinese VC funding system, including establishing disclosure rather than permission based fund-raising, an accredited investor system for private fund-raising, and reduction of the amount of the minimum capital contribution. More detailed recommendation will be given in Chapter V.

### 4.2.2 Governance in Ventures

VC investors will face a lot of problems during investment because financing start-ups is difficult and risky.[1333] In general, the problems of moral hazard,[1334] information asymmetry,[1335] and managerial opportunism[1336] are the problems that need to be solved by VC investors during their investment, as discussed in Chapter III.[1337] To address these problems, private persons and governments in the U.S. have developed a series of legal measures in company laws and related to contractual techniques in VC practices.[1338] These VC contracting techniques are "highly effective legal mechanisms through which proper and necessary written documentation of a transaction can be

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1331 Art. 9(4), 2005 DVCM.

1332 Art. 9(4), Ibid.

1333 Smith (1998: 134-136).

1334 Smith (1999: 960-963).

1335 Utset (2002: 56-57).

1336 Smith (1998: 134-135).

1337 Milhaupt (1998: 180-184).

1338 Bratton (2002: 939-944).

accomplished,"[1339] primarily aiming to restrict the behavior and guide the business goals of the entrepreneur managers. The most common techniques, as discussed in Chapter III, include convertible preferred stock rights, liquidation and dividend preferences, conversion rights, anti-dilution adjustment provisions, share transfer restriction provisions, class voting rights, and supermajority voting rights.[1340] VC investment in the U.S. could be defined as a process constituted by a series of complex contracts between VC investors and entrepreneurs, and VCs and their LPs in VC funds.[1341] These contracting theories and practices can also be treated as a part of the U.S. VC legal framework.[1342] Since economic results have proven the U.S. VC contracting practices to be the best VC legal techniques in the world, studying and adopting the U.S. VC legal measures, especially VC contracting techniques, is helpful for China to set up a proper VC legal framework and an active VC industry.[1343]

There are also some obstacles to China's direct transplant of U.S. VC governance techniques. Firstly, applying U.S. VC contracting techniques in Chinese VC investment agreements might make the agreements illegal and unenforceable. For example, some VC contracting techniques, including provisions on liquidation and dividend preferences, mandatory/optional conversion rights, anti-dilution adjustment provisions (including pre-emptive rights), and share transfer restriction rights,[1344] can protect VC investors' benefits in ventures. These techniques are the most important characteristics of U.S. VC investments, and display great differences from traditional "debt-like" investment instruments.[1345] They provide a standard and common ground to both VC investors and entrepreneurs.[1346] Unfortunately, China's company laws do not

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1339 Kim (2004: 445).

1340 Bagley & Dauchy (2003: 445-466).

1341 Klausner & Litvak (2001).

1342 Dent (1992: 1044).

1343 Chemla et al. (2004: 1-3).

1344 Tannenbaum & Guan (2008: 28-34).

1345 Klausner & Litvak (2001: 15).

1346 Bagley & Dauchy (2003: 446-448).

accommodate these VC contracting techniques.[1347] Unlike a U.S. corporation, which should meet the requirements of the state company law where it is incorporated, a corporate venture by VC investors in China is subject to the requirements of China's national company laws.[1348] The PRC Company Law is the primary source of company law in China, and the main statute that rules start-up ventures.[1349] Its statutory framework, as explained in Chapter II, is overly complex.[1350] Although the amendment of the PRC Company Law in 2006 "grants tremendous power to the articles of association and allows shareholders to stipulate rules of conduct in the articles by changing the discretionary provisions of the [PRC] Company Law,"[1351] the articles of association, bylaws, or other agreements of China's company related to VC contracting techniques discussed in this dissertation are generally mandatory and made unconditionally binding by China's registration departments in practice.[1352] Since most Chinese VC investment must be implemented under the PRC Company Law, failure to fully comply with the provisions of the PRC Company Law may cause the articles of association, shareholder agreement, or VC contracts of a venture to be illegal and unenforceable.[1353] Therefore, it might be illegal to use these U.S. VC contracting techniques in Chinese ventures if they conflict with the PRC Company Law.

In contrast, the U.S. law offers special treatment in several ways to private, small ventures and VC investments.[1354] The U.S. courts give significant contractual freedom to VC investors and entrepreneurs of ventures.[1355] Many states of the U.S. have statutory regulations specifically for private companies, including start-ups and

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[1347] Peng (2005: 258).

[1348] Art. 6, PRC Company Law.

[1349] Art. 1 and Art. 2, Ibid.

[1350] See Art. 9-22, PRC Company Registration Regulations.

[1351] Wang (2008: 27).

[1352] See Art. 6, Art. 7, Art, 12, PRC Company Law. See also Art. 17, PRC Company Registration Regulations.

[1353] Ibid.

[1354] Choper et al. (1995: 696-700).

[1355] See Donahue v. Rodd Electrotype of New England, Inc., 328 N.E. 2d 505, 512 (Mass. 1975)

ventures.[1356] Such regulations permit private ventures or start-ups "more flexibility in corporate governance" and "an increased degree of protection for minority shareholders."[1357] These provisions give freedom to VC investors and entrepreneurs to balance their risks and interests though complex contracting techniques without worrying about whether the governments or courts would not recognize the contents of these agreements.[1358] Thus, the parties can in most cases document their business purposes and rights easily even if these provisions are drafted contrary to the provisions provided by the company laws as enforced by courts.[1359] Compared to the U.S. greater contractual freedom in company laws,[1360] the Chinese company laws related to VC investments are "unaccommodating."[1361]

Secondly, because the PRC Company Law and other VC regulations do not provide enough contractual options, the U.S. techniques if inserted in Chinese VC investment agreements might render the agreements invalid. The U.S. VC legal techniques would be implemented through private agreements between VC investors and entrepreneurs. Chinese VC investors could also use the same techniques and contracts to negotiate with entrepreneurs. The efficacy of the provisions of private VC investment agreements which are not stated in the PRC Company Law, however, is uncertain. The reason is also because the PRC Company Law and other business organization laws are silent with respect to some of the VC contracting techniques normally used by U.S. VC investors.[1362] Chinese laws fail to offer clear rights and legal techniques to ventures and VC firms which have their own nature, and operate their business differently from general business organizations.[1363] For example, convertible preferred stock can help

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1356 Choper et al. (1995: 698).

1357 Gitlin (2003: §2(a)).

1358 Kim (2004: 448).

1359 For case on the enforceability of VC contracts, see, Orban v. Field, No. 12820, 1997 Del. Ch. Lexis 48 (Del. Ch. Apr. 1, 1997)

1360 Symposium (1989: 1416).

1361 Peng (2005: 258).

1362 Ibid.

1363 Smith (1997: 103-104).

VC investors to enforce their contractual rights during their investment.[1364] VC investors thus use convertible preferred stock as a vehicle in which to cluster all these legal techniques. But Chinese VC investors have to face the dilemma of choosing the mandatory articles of association under the PRC Company Law or private shareholder agreements. If they choose mandatory documents, Chinese VC investors cannot use VC techniques, such as convertible preferred stock, that have proved so successful for their U.S. counterparts to reach their investment purposes, for Chinese laws are silent with respect to convertible preferred stock.[1365] If they choose to employ private shareholder agreements, these agreements containing U.S.-style VC techniques may be invalid if they are not stipulated in terms of the mandatory articles of association or the provisions of the PRC Company Law.[1366] In contrast, the U.S. laws, which are enabling rather than mandatory, permit VC investors and the entrepreneurs to use private agreements to balance VC investments and such contracts may be entered into in almost all cases with extremely low legal risk.[1367]

In conclusion, China can develop its own mature VC legal techniques by learning from the U.S. experiences because these legal techniques can benefit the interests of VC investors and entrepreneurs. China can revise its laws by copying some VC contracting techniques from the U.S., including convertible preferred stock, conversion rights, and anti-dilution rights. For example, class voting rights, which exist in the U.S. company laws, were not expressly authorized in the PRC Company Law or the JV laws because the PRC Company Law states that "a shareholder shall have one vote for each share."[1368] But, on the other hand, Article 43 of the PRC Company Law gives an exception that the shareholders would not vote according to their capital contribution ratio if the articles of association have another arrangement. That means VC investors in a Chinese LLC venture could have voting rights regardless of their capital contributions

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1364 Kim (2004: 447).

1365 Ibid.

1366 Ibid.

1367 Sec. 7.32, Model Bus. Corp. Act.

1368 Art. 43 and Art. 104, PRC Company Law.

if they have an agreement with the entrepreneurs. China has transplanted class voting rights into its law through this exception. In addition, the PRC Company Law should be made more flexible, so as to accommodate reasonable private ordering. Such recommendation will be provided in Chapter V.

### 4.2.3 Exits

#### 4.2.3.1 Redemption Rights and Drag-Along/Tag-Along Rights

U.S. VC investors use some legal techniques to exit their investment, hopefully cashing out with high returns. Popular techniques are redemption rights and tag-along/drag-along rights which partly exist under Chinese laws.[1369] As discussed in Chapter III, redemption rights and tag-along/drag-along rights can protect VC investors' interests when the venture is approaching failure, and ensure VC investors have enough power to participate in the business of the venture.[1370] In practice, U.S. VC investors can sell their shares under these rights to the public through IPOs, or to other outside investors, or to the management team of the venture, or even to the venture itself.[1371]

The U.S. VC investors would require redemption rights in the venture.[1372] Through such rights, they may force the venture to buy their preferred stock back at a fixed price in the future.[1373] Most states allow companies to redeem or buy their stock back, provided basic capital maintenance requirements are met.[1374]

Although there is no statutory redemption right in Chinese company laws, the PRC Company Law explicitly allows a venture to acquire its own shares in certain cases as an exception to the general rule against share repurchases.[1375] The shares could be repurchased by the ventures if they want to reduce registered capital or to merge with

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1369 Bagley & Dauchy (2003: 467).

1370 Bagley & Dauchy (2003: 445-447).

1371 Gilson (2003: 1075).

1372 Smith (1997: 128-129).

1373 Bagley & Dauchy (2003: 453-455).

1374 Sec. 160, Tit. 8, Del. Code Ann, and Sec. 6.31(a), MBCA.

1375 Art. 143, PRC Company Law.

other companies which are holding the shares of the venture.[1376] The ventures could also repurchase their shares if the shares are to be distributed as part of an employee share incentive scheme (subject to a cap of 5% of the total value of employee shares of the company).[1377] But compared with an EJV, a CJV may be a better structure for ventures permissibly to repurchase shares from their investors. The CJV Law allows foreign VC investors to cash out before the termination of the venture. But when redeeming the shares, the VC investor must waive the right to participate in the distribution of the liquidation of the venture.[1378] Although redemption rights ensure VC investors to exit the ventures with some returns whether the venture succeeds or fails,[1379] they are not always a safe harbor for Chinese or U.S. VC investors in practice. VC investors may fail to reap returns through their redemption rights if the venture has no money or limited assets to buy their shares back.[1380]

Another method of exit is to sell VC investors' shares to other outside investors through a tag-along right or drag-along right.[1381] A tag-along right allows the VC investors to sell their preferred stocks to the outside investors at the time if the entrepreneur sells his common shares to the outside investors.[1382] The right is very important for VC investors who are the minority shareholders in the venture. By applying the rights, VC investors can fix their interests with majority shareholders who are going to sell the shares to an outside party. In contrast, a drag-along right gives VC investors the right to force the entrepreneur to sell his common shares to the outside investors simultaneously if the VC investors decide to sell their preferred stocks to the same outside investors.[1383]

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[1376] Ibid.

[1377] Art. 143(2), PRC Company Law.

[1378] Art. 143, Ibid.

[1379] Smith (1997: 128-129).

[1380] Bagley & Dauchy (2003: 445).

[1381] Smith (1977: 131-132).

[1382] Bagley & Dauchy (2003: 470-471).

[1383] Ibid.

In the U.S., these rights always appear in the private shareholder agreement.[1384] In China, fulfilling these two rights should be possible under the PRC Company Law because the effect of these rights is strongly related to a share transfer. The PRC Company Law states that a proposed transfer of shares should be approved by the other shareholders.[1385] In practice, the VC investors would document the drag-along and tag-along rights in the voting agreement. But the Chinese laws do not clearly indicate whether the voting agreement is enforceable. Thus, although the Chinese company laws in theory do not prohibit VC investors from using drag-along and tag-along rights, the enforceability of the voting agreement or the drag-along and tag-along rights is still a "grey area" in China's legal system.[1386] This reflects the generally disadvantageous position of a legal system with very new laws, legislative history that is not generally available for inspection, and little judicial or scholarly interpretation to flesh out details.[1387]

#### 4.2.3.2 GEM and NASDAQ

The first and the most successful growth enterprise stock market in the world is the NASDAQ exchange. The market provides a platform for small companies which have not met the requirements of the main boards to raise money from the public.[1388] In 2009, China copied the experience of the NASDAQ exchange and set up its own growth enterprise stock market, the GEM. The GEM helps small business firms to collect money from the public without meeting the strict standards of main boards. Thus, the GEM is a stock market with low entry requirements, high risk, and strict supervision, which has similar features as NASDAQ exchange. China's small companies face the same problems as those of their U.S. counterparts: lacking enough cash flow to promote the business and lacking enough assets or business history to borrow money from

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1384 Smith (1997: 128).

1385 Art. 72, PRC Company Law.

1386 Smith (1997: 128).

1387 Ibid.

1388 Lsaacman (2001: 5).

Banks.[1389] But these small companies provide more than 80% employment opportunities in China.[1390] Just as the U.S. established the NASDAQ exchange to solve these problems, it was urgent for China to set up a new financing platform for these companies to keep the long-term development of Chinese economy on track.[1391] The GEM is the outcome of that demand.

Just as the NASDAQ exchange is a good exit channel for U.S. VC investments, the GEM is also an exit channel for VCs in China. As discussed in Chapter II, most listed companies on the GEM are ventures. The GEM not only brings funding to listed companies, but also helps VC firms to get high returns on their investments through IPOs.

One difference between the GEM and the NASDAQ exchange is that the GEM has only one market but the NASDAQ exchange has two. The NASDAQ exchange consists of two sub-markets: the National Market and the SmallCap Market.[1392] There are over 4100 companies listed on the National Market, including some of the biggest and best-known companies.[1393] There are 1400 companies listed on the SmallCap Market.[1394] The difference between the two markets is that the companies listed on SmallCap Market are smaller companies with less capital than those on the National Market.[1395] The SmallCap Market is the "backup" of the National Market. The GEM lacks such backup mechanism for listed companies. That means a company which is going to fail in its application to list on the GEM has no chance to move down to the backup market as an alternative. In the case of NASDAQ, a company listed on the SmallCap Market could stay on the market for some time and when it grows, move up

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1389 Committee of Yearbook of China Small and Medium Enterprises (2008: 73).

1390 Ibid.

1391 Ibid.

1392 See the website of NASDAQ at http://www.nasdaq.com.

1393 Ibid.

1394 Ibid.

1395 Lsaacman (2001: 5).

to the National Market.[1396] This binary structure gives the companies on the NASDAQ exchange more opportunities to list and stay listed than their Chinese counterparts on the GEM.

Although the NASDAQ exchange has two different sub-markets, the National Market and the SmallCap Market enjoy the same corporate governance listing standards.[1397] The GEM also sets up similar corporate governance listing standards to reduce the investment risk following the experience of the NASDAQ exchange. For example, the shareholders of listed companies on the NASDAQ exchange should have voting rights; some important business decisions should receive the prior approval of the shareholders; the company should have an annual shareholder meeting as well as an audit committee; the board should have a majority of independent directors; and the shareholders have a right to review the books and the annual reports.[1398] China follows these monitoring mechanisms of the NASDAQ exchange. The CSRC also sets up an issuance audit commission to monitor the listed companies on the GEM. The GEM requires higher exchange transparency and a higher level of control of transactions in the new stock during its first public day. All these mechanisms can enhance the monitoring level of the market, as do the rules of the NASDAQ exchange.

To date, the NASDAQ exchange is an international market. By contrast to the NASDAQ exchange, the GEM is still a domestic exchange. For example, many Polish companies and Indian companies choose the NASDAQ exchange to be their first public market when they go to the U.S.[1399] The NASDAQ exchange now searches for international partners in the world. In 2001, it formed a partnership with the SEHK with a joint Internet platform to support information exchange.[1400] The venture developed a trading system for European and Japanese investors investing in the NASDAQ global

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[1396] See the website of NASDAQ at http://www.nasdaq.com.

[1397] Ibid.

[1398] Ibid.

[1399] Lsaacman (2001: 11-12).

[1400] Ibid.

market.[1401] But on the GEM, the foreign companies cannot list on the GEM. The foreign investors are also prohibited to buy shares of the listing companies of the GEM as does the NASDAQ exchange. China is going to promote the GEM to an international exchange but it needs to loosen its strict foreign investment and foreign currency exchange policies before any significant reform can take place.

After all of the above is considered, however, the creation of the GEM has still changed the listing environment in China. The high listing standards and the effect of the GEM's liquidity will promote the start-ups and the VC industry of China. The GEM also enriches the diversity of Chinese capital markets and promotes the development of the Chinese financial industry, which is also an important process to perfect Chinese industrial structures and economy. It is a new beginning for the Chinese capital market.

#### 4.2.4 Stimulus

Many countries have learned from the U.S. stimulus experience in encouraging private VC projects with government capital. For instance, Israel has developed its own governmental stimulus of the VC industry.[1402] The Chinese governmental VC stimulus policies also follow the U.S. stimulus programs.[1403] Creating a mature, well-developing VC industry is a declared aim of the Chinese government. The support of the government is an important aid towards this end.

The Chinese government did not have stimulus for the VC industry until 2006. In 2006 and 2008, the Chinese government promulgated two regulations respectively, the 2006 MGFISME and the 2008 NDRC Opinion No. 10.[1404] The two regulations allow Chinese local governments to invest in private VC funds for supporting the development of early stage start-ups in China. In 2010, Shenzhen sets up its own VC

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[1401] See the website of NASDAQ at http://www.nasdaq.com.

[1402] Gilson (2003: 1098).

[1403] Zero2IPO (2008: 413).

[1404] The 2006 MGFISME was promulgated by MOF and MOS on July 6, 2007. The 2008 OVCGGF was promulgated by NDRC, MOF, and MOFCOM on Oct. 18, 2008.

guiding fund, namely Shenzhen VC Guiding Fund, with RMB 3 billion capital invested by the Shenzhen government. The fund specially focuses on early stage start-ups in Shenzhen and plays a role as a "fund of funds" in VC investment. In practice, the fund will establish a sub-VC fund with other private investors to run the VC business. Shenzhen VC Guiding Fund will hire professional management teams to manage the sub-VC funds rather than itself becoming closely involved in day-to-day business. As the structure is presented in the two regulations, it can be concluded that Chinese local governments have borrowed a significant portion of the features employed by the SBIC program of the U.S.

Nevertheless, as helpful as they may be, these two regulations only set up general principles on governmental VC stimulus. They fail to provide a mature national VC stimulus program as do the SBIC and SBIR programs in the U.S. There is no doubt that the SBIC and SBIR programs of the U.S. played a critical role in the process. In past decades, the U.S. government was seen as a prime source of new technology. A lot of high technologies are sponsored directly from the labs or universities by the governments' capital.[1405] The purpose of Chinese governmental stimulus is to improve its access to advanced technology, especially the technology in the early stage start-ups, which is similar to the purpose of the U.S. government.

The Chinese laws also show that the Chinese government is beginning to get involved in the VC industry by cooperating with private VC firms based on the experience learned from the U.S. In the U.S., the investments from private VC firms are very important supports for the entrepreneurs to form their small start-ups and to create their enterprise. As mentioned, the founders of the ARD indicated that the goal of their firm was to offer a chance to the entrepreneurs with capital and other business services to help them to achieve their dreams.[1406] But today most entrepreneurs find it is very difficult to receive capital from the private VC firms to support their early stage programs, as the risk of early stage start-ups and higher returns from late stage or

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[1405] Etzkowitz, Gulbrandsen, and Levitt (2001: xxii).

[1406] Etzkowitz, Gulbrandsen, and Levitt (2001: 1).

pre-IPO investment lures away private investors.[1407] Thus, the meaning of the U.S. governmental stimulus is that the government is able to take more risks and long-term responsibilities in the VC industry based on cooperation of government and private VC investors.[1408] As mentioned in Chapter II, in the past the Chinese government liked to set up big state-owned VC firms. At the time, the state-owned VC firms and private VC firms were rivals rather than collaborators. Now, following the experience of the U.S., the Chinese government and the private VC firms invest into early stage start-ups as co-investors.

Unlike private VC firms, the purpose of governmental stimulus programs is not to earn interests from the investment, but to create jobs and to develop the state economy. Thus, the programs might not require taking shares in the start-ups and their intellectual property rights. Chinese governmental VC stimulus programs have also copied features from their American counterparts. Although there is no national governmental VC stimulus regulation in China, some local governments have promulgated their own stimulus regulations. The Chinese stimulus regulations emphasize that the principle of the stimulus is not to compete with the private VC firms for a high return.[1409] Rather, they state that the stimulus programs should focus on the early stage start-ups which have potential impact on the state economy. However, Chinese VC stimulus programs do not support the start-ups directly.[1410] They work to raise stimulus VC funds by cooperating with other private VC partners.[1411] The government's money is invested in qualified start-ups through these joint funds.[1412] Also, the Chinese governments will not be involved in projects selection.[1413] Their private partners are given the full authority to select the ventures and operate and manage the VC stimulus funds.[1414] Under the

1407 Ibid.

1408 Ibid.

1409 Jeng & Wells (2000: 241-245).

1410 Perace & Barnes (2006: 15).

1411 Jeng & Wells (2000: 241-245).

1412 Sorabella (2000: 18-19).

1413 Coyle (2000: 2-3).

1414 Perace & Barnes (2006: 15).

Chinese VC stimulus regulations, private VC firms and early stage start-ups all benefit from the programs.[1415]

In the U.S., the selecting process of the SBIC or SBIR programs is strict and highly competitive. Thus, the start-ups actually awarded funds have more chance to be a success. Private VC firms would like to invest in these start-ups which have prevailed in the rigorous governmental evaluation. The Chinese stimulus programs follow this U.S. model. After choosing the best high-tech early stage start-ups, the guiding funds will then invest in the companies with their private partners. The government will contribute 25% to 30% of the capital investment, and the rest will be contributed by private VC contributors.[1416] Based on this model, the government funds reduce the capital requirements and risks of many private investors in start-ups, thereby encouraging private VC firms to join projects that otherwise might present prohibitive risks for their contributions.[1417]

Governmental stimulus could also promote the development of private VC firms.[1418] As discussed in Chapter III, in the U.S., some governmental VC programs help entrepreneurs to reach private VC firms by setting up information platforms or hosting conferences at which the start-ups and private VC firms can get to know each other and share information on their businesses.[1419] The Chinese programs have no such services yet.

The U.S. has established a complex stimulus system from the federal to the state level to encourage private VC firms to invest in early stage start-ups. At the beginning, these programs only helped start-ups to gain government contracts on R&D. Over time, the programs try to support the entrepreneurs to establish their own companies with

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[1415] Lu, Tan, and Chen (2007: 231).

[1416] Milhaupt (1997: 866).

[1417] Ibid.

[1418] Ibid.

[1419] Etzkowitz, Gulbrandsen, and Levitt (2001: xxii).

government capital. Besides the capital support, these programs will also offer managers to the start-ups. These managers could give business advice to the entrepreneurs and help them to operate the company and reduce risk. The Chinese stimulus regulations also require that their private VC partners have at least two or three professional managers when applying for the government cooperation.[1420] The duty of these managers is to give business advice, technology services, and funding services to the ventures.[1421] But the U.S. stimulus programs would give more flexible policies to the applicants which do not exist in Chinese programs. For example, in the SBIR program, the applicants do not need to quit their current job when they apply for government funding.[1422] That means they can receive the grant before leaving their current jobs without setting up their own start-ups. The policy reduces the risks connected with an unsuccessful application. The Chinese policy is stricter. The guiding funds can only be applied for by an existing start-up. Thus, a Chinese applicant could not receive the grant if she only has some ideas or technology in the labs without holding a company or having already launched the production.[1423] The Chinese stimulus regulation stipulates that the governmental funds could only support high-tech start-ups, which have no more than three hundred employee.[1424] The regulation does not provide any opportunities to individuals to apply for the grants.

Initially, VC investments could not receive any of the tax incentives which were the exclusive rights for production-oriented enterprises in China traditionally.[1425] The Chinese government began to appreciate the value of tax incentives for VC development beginning in 2007, after the promulgation of tax incentives for Chinese VC industry.[1426] A VC firm can enjoy a 70% deduction if it has invested in a high-tech

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[1420] Lu, Tan, and Chen (2007: 231).

[1421] Ibid.

[1422] Ibid.

[1423] Milhaupt (1997: 866).

[1424] Art. 7 and Art. 11, 2006 MGFISME.

[1425] Wang (2007).

[1426] Ibid.

start-up in China for at least two years.[1427] The deduction is similar to the tax stimulus in the U.S.[1428]

In conclusion, the key characteristic of these stimulus programs in the U.S. and China is that the governments wish to combine technology and business together, as well as combine the government's capital and private money together. These stimulus programs bring research results to the market, solve the business problems with related technology from labs or universities, and use new technology to support the development of society and the state. Although the governments will not help the entrepreneurs to sell the products or promote their marketing skills directly, these stimulus programs will encourage private VCs to be involved in the operations. The programs could also help the start-ups improve their research abilities. The Chinese government should consider under which stimulus framework the VC investors would become active based on the current situation and the experience learned from the U.S. Some recommendations will be given in Chapter V.

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[1427] Art. 1, 2007 SAT Circular No. 31.

[1428] Wang (2007).

# V. Summary and Recommendation: Recommended Changes to Chinese Venture Capital Law and Practice

## 5.1 Summary

This study offers evidence on how a proper legal framework may be established for China's VC industry. Since the importance of VC has been widely accepted in China, it follows that a successful VC industry is an important goal for China to develop its drive to strengthen its economy and high technology industry.[1429]

A well designed legal system will attract more investors to engage in China's VC industry,[1430] while a poorly designed legal regime will throw obstacles in the way of investments for the industry.[1431] As this study shows, China needs an improved VC legal framework to stimulate its VC industry. As mentioned in Chapter II, the issues and problems of Chinese VC industry are decided by several legal sectors of China, including Chinese corporation laws, foreign exchange laws, and securities laws. It is not necessary for China to have a central "all-China" VC law now. Since the current Chinese VC system is still at the primary stage, the critical task for Chinese lawmakers is to fix problems in these related legal sectors and to improve its corporation laws, foreign exchange laws, and government policies. This study has yielded concrete suggestions for the improvement of the Chinese VC industry.

China's lawmakers have adopted some laws related to VC in order to promote its high technology and economic development. These laws encourage Chinese start-ups to develop high technology business and innovation through the support of VC.[1432] But the current Chinese VC system is still at the primary stage.

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1429 Yu (2007: 68).

1430 Lu, Tan, and Chen (2007: 271).

1431 Ibid.

1432 Lu, Tan, and Chen (2007: 231).

The main problems of China's VC legal system include the problems of fundraising, the overly complex foreign VC investment restrictions, limited exit channels, and ineffective governmental stimulus.[1433] In an attempt to solve these problems, this study examines six key factors that influence the nature and performance of a proper VC legal framework. These factors include the formation and fundraising of VC firms, the usual life cycle of VC investments, the economic and political impact on VC development, the governance of ventures, the established financial market, and the governmental VC stimulus.

Since the future of China's VC industry is likely follow the model presented by the VC industry in the U.S., which has proved the best VC industry in the world,[1434] China should study the important lessons learned from the century old VC legal experiences in the U.S.[1435]

To this end, the key elements of the U.S. VC legal framework are explored in this study. The first element is the formation and fundraising of VC funds. The main legal form of the U.S. VC firms is the limited partnership. The life cycle of fundraising of VC funds can be divided into four phases. In the first two phases, VCs operate the investments and manage the ventures. In the last two phases, they will design exit measures and begin to raise new funds for new round investments.[1436]

The second element is the governance of ventures. The VC investment process could be separated into three stages, including the early stage, the middle stage, and the late stage.[1437] In each of these phases, VCs face risks due to the problems of adverse selection, hold-up, and moral hazard. U.S. VC investors solve these problems at different investment stages by employing a series of governance measures. The legal

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1433 CVCA (2009: 21).

1434 Ahlstrom, Bruton, and Yeh (2007: 265).

1435 Vaughn (2002: 251).

1436 Gilson (2003: 1085-1086).

1437 Fraser-Sampson (2007: 128-135).

governance measures used in U.S. ventures include control rights, management rights, appointment rights, information rights, staging the investments, syndication, and contractually arranged exits.[1438] The VC investors' control rights determine their impact on the governance decisions in ventures.[1439] Management rights ensure VC investors have authority to select suitable managers and projects, as well as regular monitoring of the management team. VC investors will demand the right to appoint a certain number of seats on the venture's board of directors.[1440] Information rights ensure all important business information concerning the venture will be disclosed promptly and accurately to VC investors. Staging a VC investment, i.e., investing in the ventures stage by stage rather than injecting all funds at the beginning, creates incentives for venture management and helps ensure VC investors have control over their investments.[1441] Syndication of VC investments allows diversification of risk and sharing of information, which may lead to better decisions about whether to invest in the firm.[1442] The chance to yield satisfactory returns from a venture at the close of the investment period will also determine whether VC investors will invest in a firm. Exiting is thus an important part of the VC investment. VC investors will exit their investments by one of five means: IPOs, acquisition, buyback, secondary sale, or liquidation.

The last element is government stimulus. In the U.S., the government plays a very important role in the VC industry by providing incentives to early stage start-ups and private VC firms directly or indirectly.[1443] The government allocates financial stimulus to attract private investors to the VC industry. The purpose of government stimulus programs is not to gain "money return," but to receive "social return" from the investments. The U.S. government's stimulus programs also include tax incentives.[1444]

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[1438] Gompers, Ishii, Metrick (2003: 107-155).

[1439] Cadbury Report (1992).

[1440] Berghe & Levrau (2002: 124-135).

[1441] Gompers (1995).

[1442] Lerner (1994).

[1443] Leleux, Surlemont , and Wacquier (1998).

[1444] Megginson (2001).

VC investment in the U.S. could enjoy both low capital gains tax rates and targeted tax incentives.

This study compares the Chinese VC legal system with that of the U.S. in four aspects, funding, governance in ventures, exits, and stimulus. Government regulation of funding is somewhat more burdensome in China than in the U.S. Both governments require some form of registration, but U.S. laws provide certain exemptions to VC funds which do not exist in the Chinese VC system. For example, the U.S. laws do not require registration and statutory disclosure for sales to "qualified purchasers," a system for the VC industry which does not exist in China.

In governance, the U.S. VC legal framework incorporates a series of practical legal measures derived from contract and company laws, which allow VC investors to protect and manage their investments in ventures.[1445] There are some obstacles to China transplanting these U.S. VC legal techniques directly. Because the PRC Company Law and applicable VC regulations do not provide the same range for private ordering, applying the U.S. techniques in Chinese VC investment agreements might render the agreements invalid as in conflict with Chinese law.[1446] On the other hand, although the PRC Company Law and other business organization laws do provide governance provisions that apply to VC firms, these laws fail to offer clear rights and legal techniques to ventures and VC firms, which often have their own nature and operate their business differently from general business organizations.[1447] As a result, the China's VC legal system is "unaccommodating" when compared with the U.S. framework.[1448]

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1445 Bratton (2002: 939-944).

1446 Ibid.

1447 Smith (1997: 103-104).

1448 Lu, Tan, and Chen (2007: 231).

U.S. governments have also established a stimulus system at the federal and state levels to encourage private VC firms to invest in early stage start-ups. U.S. stimulus programs give more flexible options to the applicants than those that exist in Chinese programs.

Although China's legal and policy environment for the VC industry is improving, Chinese policy makers who wish to promote VC in China need to increase the regulatory supply of and legal demand for VC. Against the background of this study of the experiences of the U.S. VC industry, it becomes clear that some VC legal techniques employed in the U.S. should be adopted in China.[1449] These include rights related to funding sources, management rights, risk control, exits, and stimulus. Recommended amendments to the current Chinese VC legal system are set forth below.

## 5.2 Recommendation

Based on the experiences learned from the U.S., several reforms could be made to promote the Chinese VC industry and to establish a proper legal framework:

### 5.2.1 China should improve its financial liberalization

In general, this study suggests that China should rethink the role of foreign VC investors and the pace of financial liberalization. Chinese lawmakers consistently promote a policy of controlling the national economy. On the one hand, they welcome foreign capital to invest in China, but on the other hand, they have established high barriers to prevent foreign VC from entering many sectors. They wish to restrict foreign VC to a limited zone with a limited channel. Fortunately, this circumstance has been changing under the impact of economic globalization and social pressures.[1450]

The OECD, in comparing its own policies with China's position, points out that "all OECD countries have accepted the principle that foreign investors should be allowed to invest without limit in their domestic equity markets, although some countries make

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[1449] Ibid.

[1450] Ibid.

exceptions for certain 'strategic' industries."[1451] In the VC industry, foreign VC investors can not only expand the Chinese capital pool, but also provide financial innovation and fresh tools to the domestic capital market. These foreign VC investors could also offer good corporate governance measures to China by conveying "international expectations concerning disclosure governance and profitability into markets and so encourage listed companies to adhere to global standards."[1452]

One may doubt whether the "international expectations" of foreign VC capital could really benefit China's VC industry. Two counter-arguments might refute this opinion. Firstly, foreign investment can benefit any economy's development. Foreign VC investors could bring international standards and advanced VC techniques so as to advance the level of Chinese VC development. Secondly, adopting international VC standards encourages more international VC investors to invest in China's VC industry, for it signals that "shareholder value is becoming an accepted standard by which corporate performance is assessed throughout the world."[1453]

Of course, one negative aspect of international capital flow is the risk of the development of one country's economy in the event of at global financial crisis.[1454] The "Asian Financial Crisis" in 1997 showed that foreign investors can play a crucial role in destabilizing an economy by quick transfers of capital into and out of the host economies, "making the host economies more susceptible to volatility and sometimes causing their collapses."[1455] China successfully avoided at least two crises only because its financial system is less liberalized than many of other countries. Take the Asian financial crisis in 1997 for example, one scholar points out that "China's experience in the Asian financial crisis supports the view that premature capital account liberalization increases a country's vulnerability to a currency crisis."[1456] Capital account

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[1451] OECD (2003: 526).

[1452] Ibid.

[1453] Ibid.

[1454] Lee (2000).

[1455] Lee (2000). See also Stiglitz (2002: 89-132).

[1456] Lardy (2003). The most famous account of this comes from Stiglitz, who was an advisor of the

liberalization is, however, very different from the type of liberalization that would be necessary for non-Chinese VCs to enter the Chinese market and take out their returns at a later date. This means that China should not confuse protection against damaging currency speculation with permission to conduct valuable and innocuous investment.[1457]

Therefore, this study suggests that China could firstly loosen its current foreign exchange control polices, especially the control over capital inflow and outflow of foreign VC investors.[1458] According to a survey of CVCA, "74.4% of respondents are of the opinion that the circular makes it more difficult for foreign VC/PE firms to conduct exchange settlements for their onshore equity investments in China, which is the main policy problem regarding foreign exchange settlement."[1459] It also showed that 69.2% of respondents are of the opinion that the capital inflow and outflow of foreign VC investors is under strict control.[1460] (See Table 5.1) More specifically, China could loosen the control imposed by 2008 SAFE Circular No. 142 on exchange settlement of foreign VC investors for their onshore equity investments in China.[1461] For example, China should revise the circular to allow an FIE VC fund to make an investment by converting its registered capital from foreign exchange to RMB and then make such investment in China with this RMB.[1462]

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World Bank during the crisis and has a Nobel Prize in economics.

[1457] "For example, there could be a requirement that the returns from a venture be kept in RMB and be reinvested in another venture, thus allowing investment while fighting the kind of speculation that caused the Asian Financial Crisis." (Donald, D. C. (2010)).

[1458] CVCA (2009: 24).

[1459] CVCA (2009: 23).

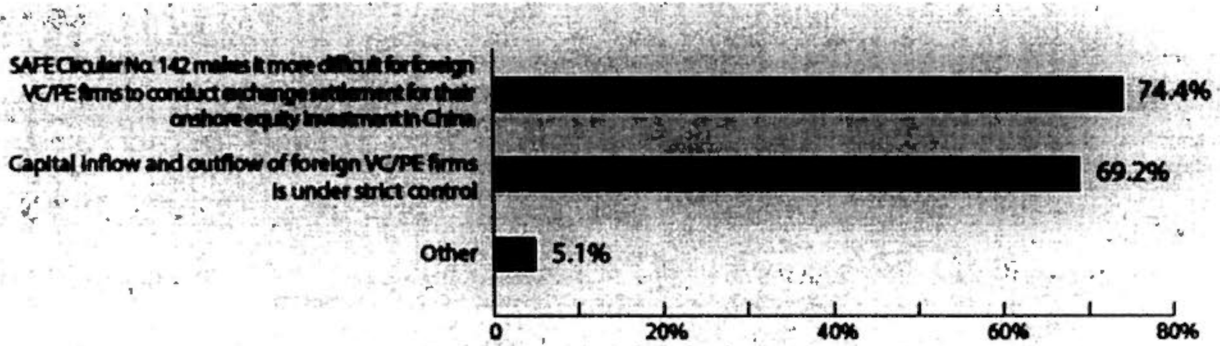
[1460] Ibid.

[1461] CVCA (2009: 24).

[1462] Akin Gump Strauss Hauer & Feld (2008: 1).

**Chart 5.1 Main Policy Problem Regarding Foreign Exchange Settlement**

**Main policy problem regarding foreign exchange settlement**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

China can approach financial liberalization with a focus on one aspect. The main legal problem regarding FVCFs is the lack of a legal foundation for foreign VC investors to set up FLP VC funds.[1463] It is also unclear whether and how the 2007 Industry Catalogue affects FLP RMB VC funds.[1464] According to 61.5% of respondents, the standard is high for foreign VC investors to get approval to set up FVCFs and the approval process takes a long time.[1465] (See Table 5.2) Thus, a transparent and flexible legal framework for Chinese VC funding system is required. This study suggests that Chinese legislation should widen the VC investment sources and expand the investment areas of both Chinese and foreign investors. China should continue to encourage foreign VC investors with reforming the current legal system (of course, China does not need to abandon all restrictions on foreign VC at once until a mature VC legal framework has been established.[1466] As a research of the World Bank indicates, "the greatest danger is removal of most restrictions on capital ... transactions before major problems in the domestic financial system are addressed. Countries in which these problems are severe, but that choose to suddenly and fully open the capital account, run the risk of incurring a crisis."[1467]).

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[1463] CVCA (2009:20).

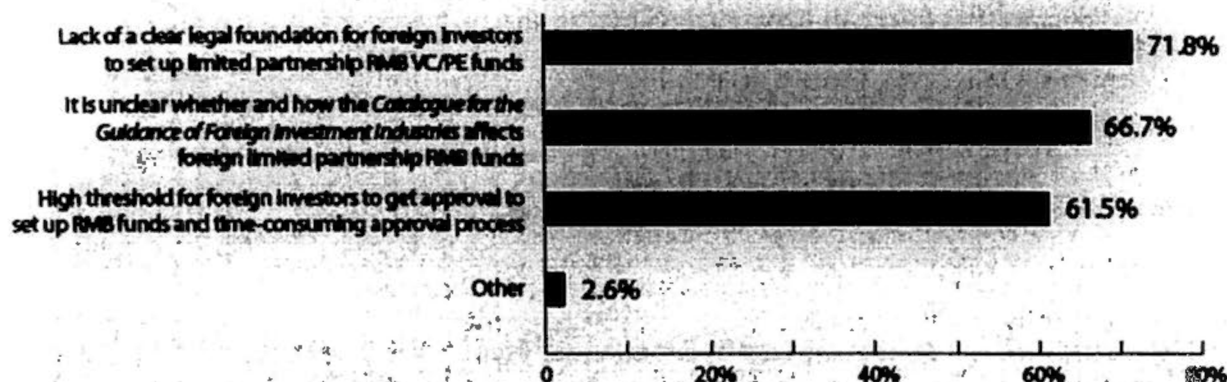
[1464] Ibid

[1465] Ibid.

[1466] Wang & Chen (Feb. 2010: 16).

[1467] Lee (2000).

**Chart 5.2 Major Policy Problems Regarding Fund Formation**




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

More specifically, China could firstly set up an FLP legal form. Foreign VC investors strongly desire China to promulgate regulations to allow them to invest in, and manage onshore VC funds in the form of limited partnerships.[1468] As discussed in Chapter II, however, China does not accommodate an FLP legal form to foreign VC investors in the 2009 FIPM. The 2009 FIPM only indicates "in the event China has other provisions for the establishment of partnership enterprises by foreign enterprises or individuals in China with investment as the main business, it should be subject to the provisions."[1469] But the problem is China has not had any other provisions on this issue up till now. Thus, it is still unclear how to set up FLP VC funds in China. This study suggests that an FLP VC fund could have both domestic and foreign VC investors; such funds could also have the right to enjoy pass-through tax treatment; the fund could raise RMB in China directly without applying for a foreign investment approval from Chinese governments.[1470]

Secondly, foreign VC firms could be given more freedom of entry to China. For instance, the paid-up capital ($5 million for corporate VC firm, and $10 million for

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1468 Wang & Chen (Feb. 2010: 16).

1469 Art. 14, 2009 FIPM.

1470 Wang & Chen (Feb. 2010: 16).

non-corporate VC firm) requirements of FVCFs are higher than the contribution requirements of DVCFs.[1471] That means some medium and small foreign VC firms with sophisticated managers and excellent investment experience have no chance to enter China's VC industry.[1472] This study suggests that China could reduce the amount of registered capital of FVCFs.

Thirdly, China could permit insurance companies, banks, and other big financial institutions or wealthy individuals to enter the VC industry under proper and appropriate conditions through the "qualified purchaser" system which is used in the U.S. As discussed in Chapter III, the U.S. laws require VC funds to register with the SEC when offering their shares, unless the investors in the fund are "qualified purchasers" or few in number, and this has the purpose of preventing common consumers without either sophisticated investment experience or the chance for direct bargaining to be involved in such high-risk ventures without regulatory control.[1473] This study suggests that China could offer a proper and reasonable restriction on the qualification of VC investors through the "qualified purchaser" system in its 2003 FVCP and 2005 DVCM.

Based on the classification of "qualified purchaser," the Chinese VC system could expand its financial sources and establish a multiple VC funding system. Expanding VC funding sources under a proper "qualified purchaser" system could solve the problems of Chinese VC industry, including insufficient capital supply and narrow entry qualification of VC investors, as well as the long-term development of Chinese financial industry.[1474] Thus, China could allow more types of investors to participate in the VC industry. For instance, the 2003 FVCP and 2005 DVCM could stipulate that all VC investors should be "qualified purchasers." The standards of a "qualified purchaser" can be drafted as a natural person who invests no less than RMB1 million in a single VC

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1471 Art. 6(2), 2003 FVCP.

1472 Wang & Chen (Feb. 2010: 16).

1473 Ibid.

1474 Ibid.

fund, or a natural person with income exceeding RMB200, 000 in each of the two most recent years or a couple's with income exceeding RMB300, 000 for those years. A natural person whose position is a director, executive officer, or GP of the partnership could also be treated as a qualified purchaser. Corporate investors, banks, insurance companies, trust companies, investment companies, securities companies, VC funds, and other financial firms could be automatically treated as qualified purchasers. A non-finance firm with assets exceeding RMB5 million could also be classified as a qualified purchaser. Further, the laws could restrict the proportion of these financial institutions' investment in the VC industry and require that such investments should only be operated through qualified VC funds.

### 5.2.2 China should create new legal techniques for VC governance

This study suggests that China should protect VC investors against the failure of investments and the various types of moral hazards found in the power of venture managers by establishing a good VC governance system for ventures.[1475] Providing full protections to VC investors in ventures could encourage more investors to enter the industry. Protecting investors' interests through a series of rights and duties, as well as enforceable private techniques, is the chief task of the legal framework.[1476] Therefore, China should supplement existing law with certain legal provisions relevant to governance rights, including the rights of liquidation and dividend preferences, conversion rights, anti-dilution adjustment rights, and share transfer restriction rights, which are popularly employed in the U.S. VC industry.[1477] In China, these techniques should be adopted in the laws.

Firstly, China could legally provide for the creation of convertible preferred stock. As discussed in Chapter IV, VC ventures could not issue convertible preferred stock under the articles of association in China because the PRC Company Law only allows one

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[1475] Bagley & Dauchy (2003: 446-449).

[1476] Ibid.

[1477] Ibid.

class of shares—common shares in the company.[1478] All shareholders must partake in the equity based on their capital contributions upon liquation.[1479] After the creation of convertible preferred stock, Chinese VC investors could have some priorities, including the liquidation and dividend preference.[1480] Although dividend preferences rights are available under the PRC Company Law, it does not mean all types of FVCFs could enjoy the rights under the PRC Company Law. The PRC Company Law stipulates that "unless otherwise agreed upon by all shareholders, shareholders shall draw dividends in proportion to their actual capital contributions and, where a company increases capital, shall have priority in subscription for new shares in proportion to their actual contributions."[1481] That means shareholders of the venture shall distribute dividends according to the proportion of their actual capital contributions; the exception based on unanimous vote would allow a single shareholder to block any agreement to adjust the proportion of dividends to meet the needs of the VC investors.[1482] All domestic ventures can enjoy this exception provided they obtain unanimous approval for the agreement.

However, the PRC Company Law states that the FIE laws will prevail over the PRC Company Law if there are any conflicts among the provisions of these laws.[1483] The PRC EJV Law stipulates that the shareholders of an EJV should share the profits only based on their capital contributions.[1484] That means the VC investors in an EJV could not enjoy dividend preferences rights. However, the PRC CJV Law allows the investors to contractually determine how to share the profits by their own agreements.[1485] VC investors of a CJV will thus also be able contractually to shape dividend rights. These different and diverging treatments will both confuse foreign VC investors and add to

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1478 Art. 126, PRC Company Law.

1479 Art. 187, Ibid.

1480 Bagley & Dauchy (2003: 449-450).

1481 Art. 35, PRC Company Law.

1482 Gilson (2003: 1091).

1483 Art. 218, PRC Company Law.

1484 Art. 4, PRC EJF Law.

1485 Art. 21, PRC CJV Law.

transaction costs. This study suggests that China should modify the conflicts between these various laws and allow all types of FVCFs freely to structure dividend preferences rights as desired.[1486]

Secondly, China should enact legislation to allow the creation of conversion rights. The right of conversion permits VC investors to transfer their convertible preferred stock into common stock if it is necessary during the life of the VC investment.[1487] As discussed above, there is only one class of shares—common shares—in ventures.[1488] Thus, there is no conversion right in China's VC legal system.

Thirdly, China should legislatively provide for create anti-dilution rights.[1489] The creation of anti-dilution rights can be enabled in the company law in two ways: structural anti-dilution adjustments and preemptive rights. Structural anti-dilution adjustments will provide protection to Chinese VC investors if the venture is going to issue more preferred stock to other outside investors.[1490] They ensure that "the number of shares of common stock issuable upon conversion of the preferred stock represents the same percentage of ownership that existed prior to such recapitalization."[1491] Such adjustments also prevent the venture from issuing preferred stock to other outside investors at a lower price than the VC investors had paid for the existing shares.[1492] A

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1486 Bagley & Dauchy (2003: 455).

1487 Ibid.

1488 Art. 126, PRC Company Law.

1489 In China, where there is no classification of shares into different classes, the calculation of the equity interest of a shareholder in relation to another shareholder is not on an "as-converted" basis. Furthermore, in a Chinese LLC, equity interest should be a "dollar-for-dollar" function of the actual capital contribution amount paid by VC investors. Thus, there is little room for the dilution when issuing new shares in a venture. However, there is one exception in the instance of foreign acquisition of a Chinese LLC. Under the Article 18 of the MOFCOM Provision No. 10, "for a foreign VC investor to invest in the start-up through subscription to an increase in registered capital, the shareholders' equity interests at closing will be adjusted with reference to the post-funding appraisal value of the venture." In the case, it is possible that a lower appraisal value of the target company may cause dilution when the company issues new shares. Under current Chinese law system, VC investors could use preemptive rights to against dilution. But VC investors still lack the protection of preferred stock system.

1490 Bagley & Dauchy (2003: 456-457).

1491 Kim (2004: 458-459).

1492 Bartlett & Garlitz (1995: 595).

preemptive right allows Chinese VC investors to purchase a proportionate amount of any new shares the venture may decide to issue to new outside investors. The right will protect Chinese VC investors by maintaining their percentage ownership in the venture.[1493] The right could either be a term in a private shareholder agreement or a provision in the articles of association.[1494]

### 5.2.3 China should promote exit channels

Exit is very important for the VC industry. VC investors cannot receive high returns without proper exit channels. Thus, a sound capital market is an important mechanism for the exits of VC funds. Currently, the exit channels for Chinese VC funds are still narrow and restricted by many rules and policies.[1495] This study suggests that China could promote its stock markets to support VC exits by protecting the safe operation of the capital market and VC exit channels, including promoting the stock markets, preventing insider dealing, and allowing reasonable and restricted stabilization of ventures' share price.[1496] Chinese stock markets have become large if highly volatile during their hitherto brief period of development.[1497] Nevertheless, VC projects cannot exit by listing on the main board market owing to listing requirements designed for longer standing companies with mature business models and profit records.[1498] With the launch of the GEM in 2009, this situation has been improved. But, China still needs to promote the GEM by verifying the monitoring mechanisms and risk control systems, and considering allowing foreign companies to list on the GEM.[1499] Further, the distinction between A and B shares should be discarded for VC exit purpose. China should also renew its foreign investment and currency exchange policies and then promote the GEM as an international exchange.[1500] For example, China could allow

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1493 Dent (1992: 1055).

1494 Bagley & Dauchy (2003: 458).

1495 Kan (2002: 387).

1496 Ibid.

1497 Ibid.

1498 Li, Feng, Wang (2007: 61).

1499 Ibid.

1500 Ibid.

foreign companies to raise money through the GEM and permit foreign investors to buy shares of the companies listed on the GEM from aboard, as does the NASDAQ exchange.[1501]

Some current regulations restrict ventures' IPOs and buybacks. For instance, the exit activities of ventures were seriously affected by 2006 MOFCOM Provisions No. 10 and 2007 SAFE Circular No. 106, as discussed in Chapter II. The main problems caused by these two circulars is that they make it difficult for domestic ventures to list on overseas stock exchanges through the red-chip model, which is one of the major desires of VC investors when considering exit strategy (See Tables 5.3 and 5.4).[1502] This study suggests that China should cancel the approval requirement for offshore holding companies, requiring domestic ventures through round-trip investment; China should also reduce the three-year business history requirement for domestic ventures when they are acquired by foreign VC investors because many domestic start-ups seeking VC investment do not have three years operation history.[1503] Loosening the restrictions of these regulations will enable VC investors and other Chinese to share the achievements from the success of ventures and the development of capital market.[1504]

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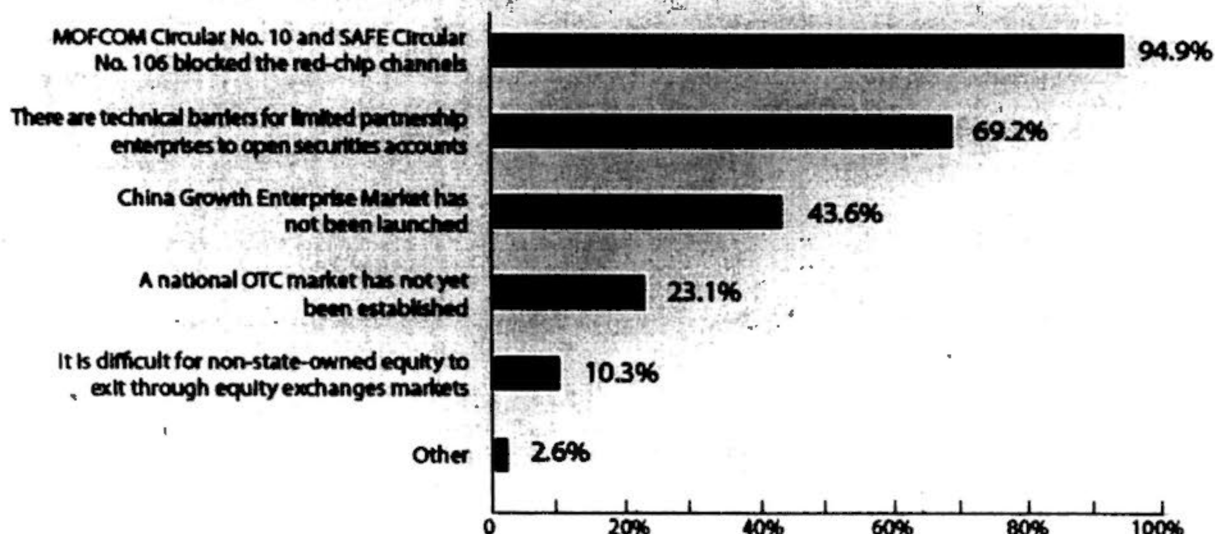
1501 Kan (2002: 152).

1502 Ibid.

1503 Chao & Xu (2008: 2).

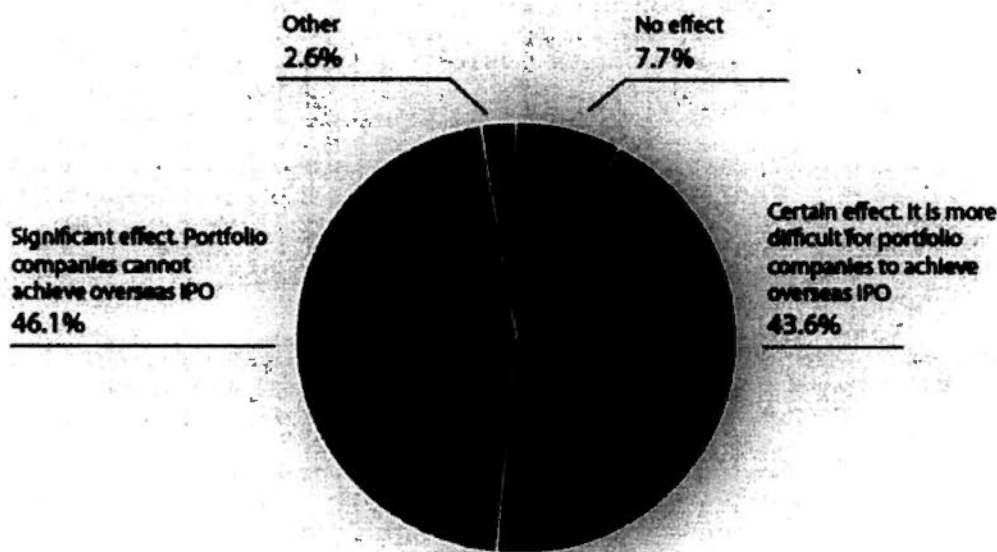
1504 Ibid.

### Chart 5.3 Main Policy Problems regarding Exit




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

### Chart 5.4 The Effect of MOFCOM Provision No. 10 and SAFE Circular No. 106 on Exit




Source: CVCA, 2009 China Private Equity Survey: Industry and Regulatory Environment

### 5.2.4 China should provide a proper stimulus policy

In the past, the Chinese government tended to control all areas of the economy and business by administrative measures. As China moves from a "plan" to a "market" economy, the role of the government should also be changed from the controller to a functional institution which offers good governance, including good services, financial supports, and guidance, especially in VC industry.[1505] China should adopt the description of "good governance" offered by the World Bank:

> Good governance includes the creation, protection, and enforcement of property rights, without which the scope of market transactions is limited. It includes the provision of a regulatory regime that works with the market to promote competition. And it includes the provision of sound macroeconomic policies that create a stable environment for market activity. Good governance also means the absence of corruption, which can subvert the goal of policy and undermine the legitimacy of the public institutions that support market.[1506]

In the VC industry, one mission of the Chinese government is to provide proper stimulus to support the development of the Chinese VC industry.[1507] The Chinese government should provide a mature stimulus legal system for the VC industry as follows.[1508]

This study suggests that China's government should strengthen the guiding functions of the governmental VC funds and stimulus programs in order to promote private VC investment and start-ups. Compared with private VC funds absolutely chasing high

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1505 Ibid.

1506 World Bank (2002: 99).

1507 OECD (2003: 368).

1508 A governmental stimulus system under proper legal framework is required. A proper legal framework means the system should be built "from respect by both government and citizens for the legitimacy of regulation, from high-quality regulations, from openness and clarity in the regulatory system, and from processes by which regulators can be held accountable for the contents of rules." (See OECD (2003: 368))

returns, Chinese governmental VC funds could focus on promoting innovation, the long-term development of the VC industry, creating more employment opportunities, and supporting small enterprises and the development of high technology.[1509] Governmental stimulus VC funds could play a key role in supporting those high-tech start-ups that have small-scale operations and poor (i.e., short) financial records.[1510] British scholars found that British VC funds can obtain higher returns from high-tech early stage ventures than from non-technology early stage ventures.[1511] Because, given the high risk involved, it is very difficult for these small companies to borrow money from banks, private VC funds, and other financial firms or angel investors, governmental stimulus VC funds could provide capital, expert guidance, legal advice, and other business services to promote these ventures.[1512]

China could set up governmental VC guiding funds at national level. At present, only some provinces have established local governmental VC stimulus funds.[1513] Under a national governmental stimulus regulation, Chinese guiding funds could set up joint funds with private VC funds.[1514] These private VC firms can be granted exclusive authority to operate joint VC funds, specifically operating VC investment in early stage ventures. Just like the role played by U.S. insurance companies in the VC industry, China could allow Chinese insurance companies to invest in these joint VC funds under strict conditions and oversight by governmental VC funds.[1515] These government funds could hire professional private VCs to manage the funds. Then the governmental funds could guide the management of the investment by selecting proper professional VCs. This government action would not select start-ups and conduct ventures' business directly, but only help entrepreneurs to select private VC firms by establishing an information platform at which the start-ups and the private VC firms can know each

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[1509] Kan (2002: 398).

[1510] Ibid.

[1511] Manigart & Beuselinck (2001: 13).

[1512] Ibid.

[1513] Zero2IPO (2008: 67).

[1514] Li, Feng, Wang (2007: 55)

[1515] Pan, Qian, and Qing (2006: 366).

other and share business information.[1516] These governmental VC funds should invest in high-tech start-ups, including environmental protection, in new material technologies, and in new energy companies, which China greatly needs.[1517] China should also allow applicants to the governmental stimulus programs to leave their then current jobs only after they receive the funding.[1518] A flexible policy of this type would help the applicants to reduce their economic risk and encourage more scientists to join the programs.

China should also draft detailed measures on eliminating the double taxation of capital gains of the limited partnership VC funds and adopt more favorable tax policies for VC funds.[1519]

In conclusion, China's legal framework for the VC industry is still at a primary level. Some regulations are overly complex and overly restrictive, e.g. foreign currency regulations and foreign investment regulations, which causes high transaction costs for foreign VC investors and their domestic partners.[1520] Some aspects of China's VC industry, and the capital market used for exit, lack sufficient legal protections and do not enable adaptation for flexible private ordering, such as the difficulty in providing for convertible preferred stock rights.[1521] These disadvantages prevent China from building a proper VC legal framework. China's government should realize that only a proper legal framework can promote the development of its VC industry.[1522] In order to accomplish this goal, the chief task is to establish clearly formulated, sophisticated laws that serve the needs of the VC industry, as well as to create strong incentives for VC participants to enter this very important activity.[1523]

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[1516] Li, Feng, Wang (2007: 62).

[1517] Hu (2006: 358).

[1518] Ibid.

[1519] Hu (2006: 353).

[1520] Ibid.

[1521] Ibid.

[1522] Ibid.

[1523] Ibid.

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