

Engineering A Venture Capital Market: The Case of China

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Abstract

Replicating the American experience in the creation of a venture capital market brings up the “simultaneity problem” as coined by Professor Ronald Gilson – three central inputs must be simultaneously available: (1) entrepreneurs, (2) providers of capital with the appetite for high-risk, high-return investments, and (3) specialized financial intermediaries which serve as the nexus of a set of sophisticated contracts.

China now ranks second in the world, after only the U.S., in terms of venture capital investments received annually. This article examines how China has addressed the simultaneity problem in creating one of the fastest developing and largest engineered venture capital markets in the world within three decades. Based on quantitative, qualitative and hand-collected data and extensive interviews, this article finds that the Chinese government has helped solve the simultaneity problem with a degree of success and that this has been done mainly through laws and government policies, including: (1) providing public capital through various government programs and increasing private capital through the easing of

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regulatory barriers towards institutional investors; (2) enhancing the availability of financial intermediaries through introducing a new and popular business vehicle – the limited partnership – for venture capital fund raising; and (3) encouraging entrepreneurship and facilitating the setting up and doing of business through revising the country's tax, corporate and securities laws. This finding reinforces Gilson's theory by proving that a government can help solve the simultaneity problem of engineering a venture capital market.

Concurrently, this article seeks to show that although China's venture capital market is established and led by the government, a key reason for its relative success is the central government's efforts at adopting a more market-oriented approach towards capital allocation. The Chinese central government has sought to facilitate the availability of the three essential factors and to provide the necessary legislative and institutional infrastructure while ensuring that it does not exert direct control over the venture capital market. This approach is reflected in: (1) the changing role of the central government – from a direct financial intermediary that decides how exactly capital is to be allocated to a mere facilitator and provider of capital; (2) the evolving regulatory regime governing venture capital; (3) the increased role of private capital; (4) the predominance of private limited partnership-type venture capital funds; and (5) the increased number of private venture capital firms, startups and entrepreneurs. Nonetheless, to realize the industry's full potential, there is still room for improvement in various social, legal, and economic areas.

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I. Introduction

Venture capital, which is the provision of financial capital to early-stage, high-potential, and high-growth entrepreneurial enterprises and technology companies, has been widely recognized as a powerful engine for a nation's innovation, job creation, knowledge economy, and macroeconomic growth.¹ There is a sizable body of research literature emphasizing the significant role of the venture capital market in commercializing cutting-edge science and linking finance and innovation.² Empirical findings also confirm that equity financing in the form of venture capital, instead of debt financing, is predominant in high-tech industries.³

In light of the potential benefits of venture capital, the engineering of a venture capital market is of interest to the governments of many countries. According to Gilson, a leading scholar in the field of venture capital research, three key factors must be simultaneously present for a venture capital market to thrive: (1) providers of capital with the appetite for high-risk, high-return investments; (2) specialized financial intermediaries which properly incentivize all participants in the venture capital market; and (3) entrepreneurs.⁴ The key challenge for governments seeking to engineer a venture capital market is in ensuring the simultaneous availability of these factors – a venture capital market will not succeed if any factor is absent (the ‘simultaneity problem’).

Of course, the engineering of a venture capital market is highly specific to the context of each country. Law and finance literature has discussed many other factors that contribute to the flourishing of a national venture capital market.⁵ These include real economic growth,⁶ sound macroeconomic policies, political stability, a conducive legal environment, strong investor protection,⁷ a large domestic market with investors willing to take risks with younger firms,⁸ liberal bankruptcy laws,⁹ tax incentives that accommodate the establishment of venture

¹ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003). See generally on the importance of venture capital, Marco Da Rin et al., *The Law and Finance of Venture Capital Financing in Europe: Findings from the RICAFE Research Project*, 7(2) EBOR 525 (2006); Brigitte Haar, *Impressions of the First RICAFE Conference: Risk Capital and the Financing of European Innovative Firms*, 5(1) EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 201 (2004).

² Gilson, *supra* note 1, at 1068.

³ John Freear & William E. Wetzel, *Who Bankrolls High-Tech Entrepreneurs?*, 5(2) JOURNAL OF BUSINESS VENTURING 77 (1990); Robert E. Carpenter & Bruce C. Petersen, *Capital Market Imperfections, High-tech Investment, and New Equity Financing*, 112(477) THE ECONOMIC JOURNAL F54 (2002); cited in John Armour & Douglas Cumming, *The Legislative Road to Silicon Valley*, 58 OXFORD ECONOMIC PAPERS 598 (2006).

⁴ Gilson, *supra* note 1, at 1076-1078, 1093.

⁵ Armour & Cumming, *supra* note 3.

⁶ Armour & Cumming, *supra* note 3, at subsection 5.2.

⁷ *Id.*, at 597. (Armour and Cumming's empirical findings show that the ‘investor friendliness’ of a country's legal and fiscal environment is a significant determinant of the supply of venture capital investment to entrepreneurial firms).

⁸ JOSH LERNER, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP AND VENTURE CAPITAL HAVE FAILED--AND WHAT TO DO ABOUT IT (2009), at 181-182.

⁹ *Id.*, (arguing that a more liberal personal bankruptcy law stimulates demand for venture capital finance). However, as there is no personal bankruptcy law in China, this article will not address this issue in the context of China.

capital funds,¹⁰ an investor-friendly environment,¹¹ a strong stock market¹², and a culture of entrepreneurship.¹³

Efforts at engineering a venture capital market have been made by governments in many countries. A body of literature notes that government intervention has profoundly shaped the venture capital industries of countries such as Israel,¹⁴ Chile,¹⁵ Taiwan¹⁶ and Singapore.¹⁷ However, Lerner¹⁸ argues that government programs have generally not been very successful. Gilson asserts that the “U.S. venture capital market developed organically, largely without government assistance and certainly without government design.”¹⁹ He attributes the success of the U.S. venture capital market to private ordering.²⁰ The “idiosyncratic” history of the U.S. venture capital market had encouraged the simultaneous emergence of a body of entrepreneurs, investors, and the right vehicles which served as the “nexus of a set of sophisticated contracts”.²¹

China offers a fascinating case study of how a national venture capital market can be engineered – its venture capital market is one of the fastest developing and largest engineered venture capital markets in the world.²² Before 1985, venture capital did not exist in China.²³ After three decades of development, China now receives the second greatest amount of venture capital investment in the world, ranking only after the U.S.²⁴ In 2015, 597 new venture capital funds were set up in China, raising more than USD 30 billion of fresh capital

¹⁰ Christian Keuschnigg & Søren Bo Nielsen, *Startups, Venture Capitalists, and the Capital Gains Tax*, 88(5) JOURNAL OF PUBLIC ECONOMICS 1011 (2004); Christian Keuschnigg & Søren Bo Nielsen, *Tax Policy, Venture Capital, and Entrepreneurship*, 87(1) JOURNAL OF PUBLIC ECONOMICS 175 (2003). Armour & Cumming, *supra* note 3, at section 4.

¹¹ EUROPEAN VENTURE CAPITAL ASSOCIATION, BENCHMARKING EUROPEAN TAX AND LEGAL ENVIRONMENTS, EVCA, ZAVENTUM (2006); Cited in Armour & Cumming, *supra* note 3, at 600.

¹² Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, 11(4) JOURNAL OF APPLIED CORPORATE FINANCE 36 (1999); Edward B. Rock, *Greenhorns, Yankees and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and US Markets*, 2(2) THEORETICAL INQUIRIES IN LAW 711 (2001); Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15(2) JOURNAL OF ECONOMIC PERSPECTIVES 145 (2001). Colin Mayer, Koen Schoors & Yishay Yafeh, *Sources of Funds and Investment Activities of Venture Capital Funds: Evidence from Germany, Israel, Japan and the UK*, 11(3) JOURNAL OF CORPORATE FINANCE 586 (2005). The author addresses the correlation between the stock market and the venture capital market in a separate article titled *Venture Capital and the Structure of Stock Market: Lessons from China*, ASIAN JOURNAL OF COMPARATIVE LAW (forthcoming).

¹³ Marc-Oliver Fiedler & Thomas Hellmann, *Against All Odds: The Late but Rapid Development of the German Venture Capital Industry*, 4(4) THE JOURNAL OF PRIVATE EQUITY 31, 37 (2001) (noting the importance of culture in general venture capital market).

¹⁴ *Id.* See also Gilson, *supra* note 1, at 1068; LERNER, *supra* note 8, at 42.

¹⁵ Gilson, *supra* note 1, at 1068; LERNER, *supra* note 8, at 42.

¹⁶ Christopher John Gulinello, *Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience*, 37(4) GEORGE WASH. INT. LAW. REV 845 (2005).

¹⁷ LERNER, *supra* note 8, at 42.

¹⁸ LERNER, *supra* note 8, at 192.

¹⁹ See Gilson, *supra* note 1, at 1070.

²⁰ *Id.*, at 1069, 1093.

²¹ *Id.*, at 1069, 1093.

²² Anette Jönsson, *Venture Capital Continues to Flow into Chinese Startups*, THE WALL STREET JOURNAL (Apr 28, 2015), <http://www.wsj.com/articles/venture-capital-continues-to-flow-into-chinese-startups-1430244889>; *Venture Capital Soars and Investor Expectations Follow*, NIKKEI ASIAN REVIEW (Feb 18, 2016), <http://asia.nikkei.com/Politics-Economy/Economy/Venture-capital-soars-and-investor-expectations-follow>; Lucida Shen, *China is the Biggest Venture Capital Firm in the World*, FORTUNE (Mar 9, 2016), <http://fortune.com/2016/03/09/investors-venture-capital-china/>.

²³ The first venture capital firm was established in 1985.

²⁴ See *Back to Reality: Global Venture Capital Trends 2015*, ERNST & YOUNG (2016) at 3, 10-12, [http://www.ey.com/Publication/vwLUAssets/ey-global-venture-capital-trends-2015/\\$FILE/ey-global-venture-capital-trends-2015.pdf](http://www.ey.com/Publication/vwLUAssets/ey-global-venture-capital-trends-2015/$FILE/ey-global-venture-capital-trends-2015.pdf).

for investment. This represented a 57.89% increase from the previous year.²⁵ Additionally, there was a total of 3445 venture capital investment deals in 2015, an increase of 79.9% from the previous year in terms of number.²⁶ In terms of volume, venture capital investments in China totaled USD 48.9 billion, surpassing that of the whole of Europe.²⁷ Of the top five venture capital deals worldwide in 2015, three were made in China.²⁸ Venture capital exits were at a healthy level, with the amount raised from exits via IPO and M&A reaching USD 8.2 billion and USD 11.5 billion respectively in 2015.²⁹ As of end-2014, venture capital investments contributed directly and indirectly to 9.3% of China's GDP.³⁰ Indeed, these figures underline the significance of the Chinese venture capital market and its influence on China's economy.

The exponential growth of the venture capital market in China over the past decade seems to be without historical precedent. While India's venture capital market is also developing rapidly, the value of venture capital investments added up to a comparatively smaller amount of USD 8.0 billion in 2015.³¹ In the UK, venture capital investments peaked in 2007 and have been relatively stagnant since,³² totaling USD 4.8 billion in 2015.³³ The value of venture capital investments in Germany and France amounted to USD 2.9 billion and USD 1.9 billion respectively in 2015.³⁴ This stands in stark contrast to China's venture capital market, which has been maintaining a rapid growth rate since 2002, with fund raising, investments and exits reaching a record high in 2015, as illustrated above.

Notably, China's venture capital market did not emerge by virtue of private ordering, but was instead consciously and strategically designed by the state from the outset. Specifically, the government aimed to develop the nation's venture capital market to encourage innovation and technology, and to stimulate structural reforms of the economy.³⁵ Nonetheless, the development of the venture capital market was not without its difficulties. China's legal system has long been regarded as problematic,³⁶ and private ordering in China has also been criticized as less functional because of weak investor protection,³⁷ ineffective judicial

²⁵ Zero2IPO Research Center, *Venture Capital Annual Report 2015*, ZERO2IPO PUBLISHER (2016).

²⁶ See *Id.*; summary of 2015 Annual reports available at: <http://research.pedaily.cn/201601/20160112392433.shtml>

²⁷ Ernst & Young, *supra* note 24.

²⁸ *Id.*, at 10.

²⁹ *Id.*, at 10.

³⁰ Jiang Hua, *China Venture Capital Forum Held in Shenzhen*, CHINA ECONOMIC NEWS NETWORK (Jul 10, 2015), <http://www.cet.com.cn/fgj/yzt/1585202.shtml>.

³¹ Ernst & Young, *supra* note 24, at 2-3. See also *Venture Capital in India*, PREQIN (2015), <http://www.preqin.com/docs/reports/Preqin-Venture-Capital-India-September-2015.pdf>.

³² *Annual value of venture capital investments on the UK market from 2007 to 2015*, STATISTA (2016), <http://www.statista.com/statistics/438743/venture-capital-investments-value-united-kingdom-uk/>.

³³ Ernst & Young, *supra* note 24.

³⁴ *Id.*, at 9.

³⁵ *Infra* text accompanying notes 61-102.

³⁶ See generally Jiangyu Wang, *China: Legal reform in an emerging socialist market economy*, in *LAW AND LEGAL INSTITUTIONS OF ASIA: TRADITIONS, ADAPTATIONS AND INNOVATIONS* (E. Ann Black & Gary F. Bell eds., 2011), ch 1; Donald Clarke, Peter Murrell, & Susan Whiting, *The Role of Law in China's Economic Development*, in *CHINA'S GREAT ECONOMIC TRANSFORMATION* (Loren Brandt & Thomas G. Rawski eds., 2008).

³⁷ See generally Nicholas C. Howson & Vikramaditya S. Khanna, *The Development of Modern Corporate Governance in China and India*, in *CHINA, INDIA AND THE INTERNATIONAL ECONOMIC ORDER* (M. Sornarajah and Jiangyu Wang eds., 2010) (on investor protection).

enforcement of laws, and the lack of judicial independence.³⁸ Despite these problems, China's national venture capital market was established, with a high growth rate, within three decades. China's fascinating experience seems to challenge the orthodox view that top-down efforts by governments are likely to be unsuccessful in promoting venture capital. The pivotal question is: if empirical studies show that government programs have not been very successful on average and across countries, how has China managed to create the second largest venture capital market despite having premature legal infrastructure?

This article seeks to fill the gap in literature³⁹ by examining, based on quantitative, qualitative and hand-collected data and extensive interviews, how China has addressed the simultaneity problem with a degree of success.⁴⁰ The focus of this article is on the role of the government in laying down the legal and institutional infrastructure for the venture capital market through the enactment of laws. This article does not focus on venture capital contracting in detail as it is a separate and complicated issue which will be addressed in another of the author's articles.⁴¹ The main findings of this article would provide guidance for constructing a rough template for government efforts at engineering venture capital markets around the world through law reform. This article should be of particular interest to policymakers and legislators in jurisdictions such as Australia,⁴² Taiwan⁴³ and Singapore⁴⁴ who have explicitly sought to develop a national venture capital market.

The remaining parts of this article are structured as follows. Part II provides fresh insights

³⁸ See generally JIANFU CHEN, *LEGAL INSTITUTIONS IN CHINESE LAW: CONTEXT AND TRANSFORMATION* (2008), ch 4.

³⁹ Although there exists literature discussing the legal infrastructure and contractual designs that are used to address the agency problem within the venture capital cycle, theoretical studies on the key legal and institutional determinants of a viable venture capital industry, and sophisticated comparative studies between the two largest venture capital markets (i.e., U.S. and China) are limited. In particular, the special characteristics of Chinese venture capital market, and the peculiar legal problems which the Chinese market faces remain largely unexplored. See generally Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete*, 74 N. Y. U. L. REV. 575 (1999); Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 H. L. REV. 874 (2003); Ronald J. Gilson, *Engineering Venture Capital Markets: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003); Ronald J. Gilson & Bernard S. Black, *Does Venture Capital Require an Active Stock Market?*, 11 JOURNAL OF APPLIED CORPORATE FINANCE 37 (1999); Ronald J. Gilson & Bernard S. Black, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 JOURNAL OF FINANCIAL ECONOMICS 243 (1998).

⁴⁰ The empirical study consists of three parts. The first part is a study on a sample of fifty venture capital limited partnership agreements. These agreements are obtained from leading Chinese law firms and venture capital firms, i.e. Gaorong Capital, Chengwei Capital, Beijing Fangda Law Firm, Beijing Global Law Firm, Beijing Jincheng Tongda Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm and Shenzhen Huashang Law Firm. The second part is the interviews with practitioners. This consists primarily of venture capitalists, counsel, and investors from twenty venture capital funds. The interviewees come from the six cities that are the major places of venture capital investments in China, i.e. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, and Guangzhou. The last part comprises the study of a wide range of official data and reports published by the leading service providers in China's venture capital industry, i.e. the Annual Report of the Venture Capital Market in China published by the Zero2IPO Research Center, the *China Venture Capital Yearbook* published by China Venture Capital Research Institution, and the annual reports on venture capital published by the VentureChina.cn.

⁴¹ Lin Lin, *Venture Capital Contracting in China: A Law and Economic Analysis*, NUS CBFL WORKING PAPER (2016).

⁴² The Treasury and the Department of Industry, Innovation, Science, Research and Tertiary Education, Australian Government, *Review of Venture Capital and Entrepreneurial Skills*, THE AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION LTD (2012), <https://www.avcal.com.au/documents/item/516> at para. 4.4, p. 13 ("Australia's venture capital sector is an important component of Australia's innovation system"); at para. 4.18, p. 17 ("In terms of venture capital support, the Australian Government provides a range of equity- and tax-based venture capital programs"). Examples of governmental supports include the Innovation Investment Fund (equity-based) (see para. 4.19, p. 17) and the Early Stage Venture Capital Limited Partnerships program (tax-based) (see para. 4.23, p. 18).

⁴³ See Gulinello, *supra* note 16.

⁴⁴ See LERNER, *supra* note 8.

into the evolution, special characteristics and legal framework of China's venture capital market. Part III specifically examines the Chinese experience in tackling the simultaneity problem as coined by Gilson. It also identifies the salient issues within each factor and makes suggestions for future reforms. Part IV returns to the theoretical basis of this article and systematically explores the role of law and government in engineering a venture capital market. Part V concludes.

II. The Venture Capital Market with Chinese Characteristics

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

The concept of venture capital was first debated in China in 1985 in the central government's "Decision to Reform the Science and Technology System".⁴⁵ Prior to that, and before the launch of the open-door policy and economic reform (*gaige kaifang*) in 1978, the legacy of the planned economy was such that all decisions regarding production and investment were embodied in a government-formulated plan. Consequently, there were no private enterprises in China, let alone startups or venture capital.

Today the understanding of "venture capital" in China amongst professionals is consistent with international practice, in the sense that venture capital is a subset of private equity,⁴⁶ and consists of an equity investment in high-growth, high-risk, and often high-technology firms that need capital to finance product development or growth. Although venture capital and private equity share similar legal structures, incentive schemes and investors, venture capital tends to focus on early-stage high-risk companies that are technologically intensive, whereas private equity invests in virtually every industry, especially later-stage companies.⁴⁷ Also, venture capital does not include restructuring or leveraged buyout financing whereas it is common for private equity firms to acquire majority control of an existing or mature firm from its current owners.⁴⁸

Nonetheless, due to the short history of the Chinese venture capital market, the understanding of venture capital amongst ordinary investors is limited and the term "venture capital" is commonly confused with "private equity".⁴⁹ The number of venture capital firms which strictly invest in the venture capital sector but not the private equity sector is much smaller than reported.⁵⁰ Many existing Chinese venture capital firms arose from the capital market boom and have limited experience in the venture capital industry,⁵¹ and most venture capitalists were investment bankers prior to entering the industry and hence do not possess

⁴⁵ *The Decision to Reform the Science and Technology Systems*, CPC CENTRAL COMMITTEE (Mar 13, 1985), <http://cpc.people.com.cn/BIG5/64162/134902/8092254.html>.

⁴⁶ My interviews with lawyers, legal counsel and venture capitalists indicate that their understanding on venture capital is consistent with the international definition of venture capital (on file with author).

⁴⁷ *Id.*

⁴⁸ See Gilson, *supra* note 1; see also James A. Brander, Qianqian Du & Thomas Hellmann, *The Effects of Government-Sponsored Venture Capital: International Evidence*, 19(2) REVIEW OF FINANCE 571 (2014), available at <http://strategy.sauder.ubc.ca/hellmann/pdfs/BranderDuHellmannRoF2014.pdf>.

⁴⁹ My interviews with lawyers, legal counsel and venture capitalists indicate that ordinary investors do not have clear idea on the difference between private equity and venture capital (on file with author).

⁵⁰ Interview with Mr. A (anonymity requested), Vice President, Shanghai X Capital Co, Nov 2015 (on file with author).

⁵¹ *Id.*

sufficient venture capital expertise or market track records.⁵² Therefore, when selecting portfolio companies to invest in, Chinese investors tend to focus more on business models, firm size and cash flows instead of the company's growth potential. Naturally, these investors are unwilling to commit too much capital to high-risk, early-stage startups.⁵³ Instead, they are inclined towards making short-term investments in later stage portfolio companies in traditional industries to achieve quicker returns.⁵⁴ Further, unlike a typical venture capital cycle in the U.S., which usually lasts for seven to ten years, a recent survey has shown that the average cycle in China is merely 32 months (two to three years).⁵⁵

In recent times, the boundary between venture capital and private equity has become increasingly blurred. Many *venture capital* firms which used to invest in early-stage startups, having had to cope simultaneously with fund-raising difficulties after the 2008 global financial crisis as well as investors' expectations for higher returns, have become more inclined to invest in later-stage and lower-risk enterprises, especially pre-IPO companies, to gain quick returns.⁵⁶ Meanwhile, recent government efforts in building up a multi-layered capital market framework, coupled with the rapid development of the mobile internet industry, have prompted traditional *private equity* firms to shift their investment preferences from later-stage and pre-IPO companies to early-stage companies.⁵⁷ Significantly, the catchphrase used to reflect the industry trend in China has changed from "*quanmin PE*" (which translates to "everyone invests in the private equity industry") in 2010 to the current "*quanmin VC*" (which translates to "everyone is keen on venture capital investment").⁵⁸

B. The Need for Venture Capital in China

The importance of a national venture capital market is widely accepted by governments around the world.⁵⁹ The venture capital market provides "a unique link between finance and innovation, providing start-up and early-stage firms organizational forms particularly well-suited to innovation with capital market access that is tailored to the special task of financing these high-risk, high-return activities."⁶⁰ Developing a national venture capital market is high on the agenda of the Chinese government for two major reasons: firstly, to satisfy the demand

⁵² Lin Lin, *The Private Equity Limited Partnership in China: A Critical Evaluation of Active Limited Partners*, 13(1) JOURNAL OF CORPORATE LAW STUDIES 185, 200 (2013).

⁵³ *Id.*

⁵⁴ *Id.*, at 187 and 192.

⁵⁵ Zhong Zhimin, *287 VC/PE backed Companies Are Applying for Listing*, CHINA SECURITIES JOURNAL (Zhongguozhengquanbao) (Jun 20, 2012). The survey was conducted using data as of June 14, 2012. Statistics show that the investment cycles of two venture capital firms were less than 20 months, and only 5 firms had cycles above 40 months. 17 firms had investment cycles between 20-40 months.

⁵⁶ See Zhou Ming, *PE and VC Investment Strategies Are Converging* [*PE yu VC Touzi Shuangshuang Houyi*], CHINA SECURITIES JOURNAL (Zhongguozhengquanbao) (Mar 17, 2008).

⁵⁷ See *The Booming of the New Third Board* [*Xin sanban chixu huobao de PE / VC daju jinru juejin*], CHINA SECURITIES JOURNAL (Zhongguozhengquanbao) (Jan 17, 2015).

⁵⁸ Yu Tian Er, *The Movement from Mass PE to Mass VC is the Product of the Times* [*Changjiang guohong touzi hehuo ren lichunyi: Quanmin PE dao quanmin VC shi shidai chanwu*], GRAND YANGTZE CAPITAL, Dec 3, 2014, http://www.grandyangtze.com/article/article?parent_id=3&id=39.

⁵⁹ See LERNER, *supra* note 8, at 63-64.

⁶⁰ Gilson, *supra* note 1, at 1068.

for capital from startups and small and medium size (“SME”) firms, and secondly, to re-chart the economic development of the nation.⁶¹

1. Satisfying Demand for Capital

The growth of startups and SME firms has long been constrained by a substantial capital gap in China, as China’s stock markets are unable to serve as viable financing channels for SMEs. Apart from dealing with the prohibitively high costs and long waiting times (caused by the current approval system) involved in an IPO, startups and SMEs, by virtue of their youth or size, also face difficulties in meeting the stringent listing requirements set by the two Main Boards.⁶² Moreover, unlike state-owned enterprises (“SOEs”), which are able to receive low-interest loans from state-owned banks (in part due to administrative influence), private companies face enormous difficulties in securing bank loans.⁶³ Such problems with securing debt financing are exacerbated for startups, which typically have insufficient collateral to offer as security.

Meanwhile, the number of businesses has been increasing, particularly after a streamlining process in 2014, spearheaded by the enactment of the revised Company Law of the People’s Republic of China (PRC).⁶⁴ From January to September 2015, 3.16 million new companies were registered, a 19.3% rise from the same period the previous year.⁶⁵ In Beijing’s Zhongguancun district, the so-called “Chinese Silicon Valley”, an average of 7 new companies were registered every minute from March 2014 to May 2015.⁶⁶ This inadvertently contributed to a high demand for venture capital as an important means of startup financing. Such demand is appositely complemented by the venture capitalists’ appetite for high-risk, high-return investments and their ability to provide access to industrial connections and managerial skills.

Further, Chinese innovation and IT infrastructure have been greatly improved after the launch of various state programs promoting science and technology, such as the 985 Program and the Torch Program launched in late 1980s (see Appendix 2 on “entrepreneurship”). As of March 2015, there were more than 1,600 technology incubators supporting more than 80,000 startups.⁶⁷ In 2015, China saw 1,102,000 invention patent applications, which was 18.7% more than the previous year, with 359,000 of them being authorised.⁶⁸ The importance of venture capital is further exemplified by the fact that many of today’s Chinese internet giants

⁶¹ Developing science and technology was one of the “Four Modernizations” set forth by Premier Zhou Enlai in 1963, and enacted by Deng Xiaoping from 1978, to modernize the four fields of “agriculture, industry, national defense, and science and technology”.

⁶² Lin Lin, *Venture Capital and the Structure of Stock Markets: Lessons from China*, NUS CBFL WORKING PAPER, ASIAN JOURNAL OF COMPARATIVE LAW (forthcoming) at 17.

⁶³ See Lan Yuping, *Venture Capital can Effectively Solve the Problem of Capital Financing of Small and Medium Enterprises* [Fengxian Touzi ke Youxiao Jiejue Zhongxiao Qiye Rongzi Nan], INTERNATIONAL FINANCING (Guoji Rongzi) (Sep 8, 2010).

⁶⁴ *The Company Law of the People’s Republic of China*, National People’s Congress [2005] Presidential Decree No. 42.

⁶⁵ *China’s New Companies Surge 19.3% in Q1-Q3*, CHINA DAILY ASIA (Oct 15, 2015), http://www.chinadailyasia.com/business/2015-10/15/content_15329850.html.

⁶⁶ Zhang Lulu, *China’s Startup Boom: 7 New Firms Every Minute*, CHINA.ORG.CN (Jun 9, 2015), http://www.china.org.cn/business/2015-06/09/content_35775291.htm.

⁶⁷ See *Science and Technology Minister Wan Gang answers reporters’ questions* [keji buzhang wangang da jizhewen], CHINA.ORG.CN (May 30, 2015), http://www.china.com.cn/zhibo/zhuant/2015lianghui/2015-03/11/content_34996059.htm.

⁶⁸ *China Received over 1 Million Invention Patent Applications in 2015*, STATE INTELLECTUAL PROPERTY OFFICE OF THE PRC (Jan 20, 2016), http://english.sipo.gov.cn/news/official/201601/t20160120_1231391.html.

that have assumed macroeconomic significance and influence, such as Sina,⁶⁹ Sohu⁷⁰ and Alibaba⁷¹, were former recipients of venture capital backing in their early days.

2. Re-charting Economic Development

China's Gross Domestic Product ("GDP") growth rate fell from 10.4% in 2010 to 7.3% in 2014,⁷² with traditional economic sectors such as manufacturing and real estate sectors showing signs of weakening.⁷³ Also, with a population of 1.3 billion and a labor force of 900 million, China faces strong pressure to address an increasingly significant unemployment issue.⁷⁴ It is thus imperative for the government to foster the development of high-technology industries and a knowledge-based economy to enhance competitiveness and promote sustainable growth.

In short, China's need for sustainable economic development has resulted in a greater emphasis on innovation and IT infrastructure, a huge increase in eager investors with excess capital,⁷⁵ a new generation of entrepreneurs⁷⁶ and an increased number of small businesses. This mix of factors has translated into a strong demand for high-risk, high return venture capital.

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

1. Emerging Phase (1985-1990)

Venture capital has had a much shorter history in China than in the U.S.⁷⁷ The Chinese government has only sought to replicate America's success in developing an effective venture capital market since the 1980s,⁷⁸ with the concept of venture capital being first officially introduced in China in 1985.⁷⁹ The industry only began to emerge in the same year when the first venture capital firm, the China New Technology Venture Capital Company

⁶⁹ Sina is one of the largest Chinese online media companies for Chinese communities.

⁷⁰ Sohu is one of the largest Chinese Internet companies.

⁷¹ Alibaba is a Chinese e-commerce company that provides consumer-to-consumer, business-to-consumer and business-to-business sales services via web portals.

⁷² GDP Growth (Annual %), WORLD BANK (Feb 11, 2016), <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD/countries/CN?display=graph>. World Bank figures for China's GDP in 2015 were not available at the time of this article.

⁷³ Mark Magnier, *As Growth Slows, China Highlights Transition From Manufacturing to Service*, THE WALL STREET JOURNAL (Jan 19, 2016), <http://www.wsj.com/articles/as-growth-slows-china-highlights-transition-from-manufacturing-to-service-1453221751>; Michael Lelyveld, *China Growth Slows Despite Stimulus Spur*, RADIO FREE ASIA (May 2, 2016), http://www.rfa.org/english/commentaries/energy_watch/china-growth-slows-despite-stimulus-spur-05022016102142.html.

⁷⁴ *Views of the State Council on Policy Measures relating to Mass Public Entrepreneurship* [Guowuyuan guanyu dali tuijin dazhong chuangye chuangxin. Ruogan zhengce cuoshi de yijian], STATE COUNCIL NEWS RELEASE (Jun 16, 2015), http://www.gov.cn/zhengce/content/2015-06/16/content_9855.htm.

⁷⁵ See *infra* text accompanying note 169.

⁷⁶ See *infra* text accompanying notes 286 - 287.

⁷⁷ See LERNER, *supra* note 8, at 8. The U.S. has over 70 years of experience in venture capital since the 1940s.

⁷⁸ After the open door and economic reform, Chinese policy makers have made consistent efforts to study the experience of Silicon Valley in developing the venture capital industry. In the 1980s, a large number of scholars were sent to the U.S. to pursue higher degrees. Some of them, including the "Godfather" of venture capital in China – Mr. Cheng Siwei, brought back the idea of venture capital and started to promote it. See *A Historical and Modern Look at the Chinese Venture Capital Market*, XINHUAWANG (May 13, 2008). See Cheng Siwei, *Developing Venture Capital, Revitalizing China*, 3(2) CHINA VENTURE CAPITAL (Jun, 2004), at 1.

⁷⁹ *Supra* text accompanying note 45.

(*zhongguo xinjishu chuangye touzi gongsi*) was set up as a government-initiated project.⁸⁰ Prior to that, there were no venture capital firms, let alone a market for venture capital in China. To facilitate technology and innovation, the Ministry of Science and Technology launched the influential Torch Program in 1988, which kick-started a nation-wide focus on high-tech development and innovation. However, venture capital developed slowly in this period due to the lack of a stock market and unfamiliarity with the new concept.⁸¹ Thereafter, a number of government-backed companies were set up to provide financing to high-tech startups.⁸²

2. Experimentation Phase (1991-2000)

The year 1998 marked a turning point, when Mr. Cheng Siwei,⁸³ the then vice chairman of the National People's Congress Standing Committee presented a groundbreaking "No.1 Proposal" urging the development of a venture capital market in China.⁸⁴ After the proposal, a series of policies were issued, including the Strategy of Invigorating China through Science and Education (*kejiao xingguo*) and the Law on Promoting the Transformation of Scientific and Technological Achievements 1996 (see Appendix 2 on "entrepreneurship").⁸⁵ Meanwhile, a number of government funds were set up to provide capital to high-tech startups.⁸⁶ Foreign venture capital firms like IDG Capital Partners and Walden International also started to enter the Chinese market. Significantly, the establishment of the Shanghai Stock Exchange and the Shenzhen Stock Exchange in 1990 offered new exit channels for venture capital investments. Before that, venture capital-backed firms were unable to exit via IPOs. Nonetheless, government-backed venture capital firms still dominated the industry during this period,⁸⁷ and the role of private venture capital firms was very limited due to the limited choices of business vehicles available at that time.⁸⁸

3. Decline and Subsequent Growth (2001-2005)⁸⁹

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

⁸⁰ See ZHU SHAOPING & GE YI, THE AMENDMENT OF THE PARTNERSHIP ENTERPRISE LAW OF PEOPLE'S REPUBLIC OF CHINA, 4 (2004). See also Lu Haitian, Tan Yi & Chen Gongmeng, *Venture Capital and the Law in China*, 37 HKLJ 229 (2007).

⁸¹ *Id.*

⁸² Cheng Siwei, *Preface*, in CHENG SIWEI ON VENTURE CAPITAL (2008).

⁸³ Mr. Cheng Siwei is known as the "Godfather" of venture capital in China. He began to promote the concept of venture capital when he returned from his MBA studies from the University of California, Los Angeles, in 1984. He presented this proposal to the first meeting of the 9th Chinese People's Political Consultative Conference.

⁸⁴ Cheng Siwei, *The History and Status Quo of China's Venture Capital*, in CHENG SIWEI ON VENTURE CAPITAL (2008).

⁸⁵ In 1999, the Ministry of Science and Technology, the State Development Planning Commission, the State Economic and Trade Commission, the People's Bank of China, the Ministry of Finance, the State Administration of Taxation and the China Securities Regulatory Commission jointly issued the *Opinions on Establishing a Venture Investment Mechanism*.

⁸⁶ Such as the Technical Innovation Fund for Small and Medium Sized Enterprises 1999. See *The Glorious Growth of the Private Equity Investment Industry over 10 years* [Simu Guquan Touziye Shinian Huali Feiyue, 2014 Nian Kaiqi Zhongguo Guquan Touzi Shidai], PEDATA.CN (Apr 24, 2015), http://www.pedata.cn/main_do/news_detail/214294.

⁸⁷ Beijing Zhongguancun Technology Venture Capital Company was the first private venture capital firm in China. In 1992, the first foreign VC (IDG Capital), entered into China. In 1995, the *Administrative Measures on Foreign-Established Industry Investment Funds* [Sheli jingwai zhongguo chanye touzi jijin guanli banfa], State Council, People's Bank of China, was promulgated. The 1st Sino Foreign Joint Venture in the venture capital sector – Kezhao High Tech Co. Foreign PE invested in Sohu, Sina, 163, etc. and eventually got them listed on NASDAQ. See Steve Blank, *The Rise of Chinese Venture Capital (Part 3 of 5)* (Apr 12, 2013), <http://steveblank.com/2013/04/12/the-rise-of-chinese-venture-capital/>.

⁸⁸ Limited Partnership was not available in this period.

⁸⁹ Refer to Figure 2 below for a timeline of key developments since 2002.

participants, clear guidance and regulations were issued on matters pertaining to the establishment, management, supervision, taxation and foreign investment⁹⁰ of venture capital.⁹¹ To facilitate the exit of venture capital-backed companies, the Small and Medium-sized Enterprise Board (“SME Board”)⁹² was launched in 2004. As a result of these policy incentives, venture capital funds raised more than USD 4 billion in 2005, exceeding the cumulative amounts raised in the past three years (Figure 1 and Figure 2).

4. Deepening Structural Reforms (2006- 2013)

The adoption of the limited partnership in 2006 was essential to the Chinese venture capital market as it provided a new business vehicle for venture capitalists and investors to raise funds.⁹³ The introduction of the limited partnership was part of the government’s strategy to develop scientific innovation as articulated in its 11th Five-Year Plan (2006-2010),⁹⁴ which identified the promotion of venture capital investment as a critical element for achieving “independent innovation” and sustainable economic progress in China.⁹⁵

Although the number and volume of funds raised dipped in 2009 due to the global financial crisis, both the number of newly established venture funds and the amounts raised increased two-fold in 2011 (Figure 1). The major contributors to this venture capital boom included the launch of a new NASDAQ-like secondary board – ChiNext, new measures allowing insurance funds to make equity investments,⁹⁶ the launch of several Qualified Foreign Limited Partner (“QFLP”) schemes in Shanghai, Beijing, Tianjin and Chongqing which permitted foreign qualified institutional investors to make equity investments in Chinese markets, as well as the substantial increase in investments by the National Social Securities Fund (“NSSF”) in private equity (of more than RMB 6 billion).⁹⁷

As such, although the suspension of the IPO process by the China Securities Regulatory Commission (“CSRC”) from November 2012 to January 2014 negatively affected fund-

⁹⁰ The *Regulations on the Administration of Foreign Invested Venture Capital Enterprises*, Ministry of Foreign Trade and Economic Cooperation, Ministry of Science and Technology, State Administration for Industry and Commerce, State Administration of Taxation, State Administration of Foreign Exchange (2003) allowed foreigners intending to invest in the Chinese VC market to do so through setting up an FIVCIE which can take the form of an incorporated entity or a non-legal person entity.

⁹¹ *Interim Measures for Administration of Startup Investment Enterprises*, National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People's Bank of China, State Administration of Taxation, State Administration for Industry and Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission, and State Administration for Foreign Exchange [2005] Order No. 39.

⁹² In 2004, the Small and Medium-sized Enterprise Board was launched at Shenzhen, China.

⁹³ *Administrative Measures relating to the Establishment of Partnerships in China by Foreign Enterprises or Individuals*, State Council [2009] Order No. 567. In 2001, the *Interim Measure on the Establishment of Foreign-Invested Venture Capital Enterprises* [guanyu sheli waishang touzi chuangye qiye de zhanxing guiding] (2001) was issued. In 2002, the *Foreign Investment Industry Guidance Catalogue* was issued to attract more foreign investment. In 2005, the State Administration of Foreign Exchange issued the Circular 75, which greatly improved the foreign equity investment environment in China.

⁹⁴ See *The Eleventh Five Year Plan*, CENTRAL COMMITTEE OF THE CHINA COMMUNIST PARTY, passed on October 11, 2005 at the Fifth Meeting of the Sixteenth Central Committee of the China Communist Party.

⁹⁵ See *Reasons for revising Partnership Enterprise Law*, NATIONAL PEOPLE’S CONGRESS NEWS RELEASE (May 2006). Before the introduction of LPs, the only major legal structures generally available for venture capital firms in PRC were the Limited Liability Company, Joint Stock Company and General Partnership, but all of them were unattractive because of their inherent features.

⁹⁶ The *Interim Measures for Equity Investment with Insurance Funds*, China Insurance Regulatory Commission (2010), allowed insurance funds allowed to make equity investments.

⁹⁷ See Appendix 2.

raising in both 2012 and 2013, the reforms discussed in the previous paragraph accelerated the reboot of the venture capital market in 2014. This was further assisted by the 2013 nationwide expansion of the National Equities Exchange and Quotation (“NEEQ”) system (also known as the “New Third Board”), which has now become an important exit vehicle for venture capital-backed startup firms.⁹⁸

5. Towards a More Market-Oriented System (2014-present)

Since 2014, the Chinese central government seems to be moving towards a “Government Led + Market Operation” model in providing public funding,⁹⁹ instead of directly participating in the allocation of capital. The State Council announced in 2015 that China would be setting up the RMB 40 billion (USD 6.5 billion) State Venture Capital Investment Guidance Fund (“SVCIGF”) (*guojia xinxingchanye chuangyetouzi yindao jijin*) to support startups in emerging industries, foster innovation, and upgrade the industry.¹⁰⁰ Public tenders would be made to select qualified professional firms to manage the fund.¹⁰¹ Rather than setting up and directing the government-backed funds, the central government stated that it would instead be a limited participant by only providing funding.¹⁰² However, whether the new SVCIGF will be effective and whether local governments¹⁰³ will follow the central government’s approach towards government funds remains an open question.¹⁰⁴

In summary, although the Chinese venture capital market was dominated by state-owned venture capital firms and venture capital funds in the 1980s and 1990s, it has seen a rapid emergence of private firms and investors since 2006. As a result, private individual and families form the majority of investors in the venture capital and private equity market in terms of number.¹⁰⁵ Further, the majority of leading venture capital firms in China today are private firms and foreign firms.¹⁰⁶ Arguably, this has been achieved largely through the evolution of the central government’s role and approach to developing the venture capital market – from a direct participant in capital allocation (through establishing state-owned venture capital firms and funds) to a capital provider that intervenes less in the capital allocation process (focusing on the easing of regulatory barriers for the entry of foreign and private capital into the venture capital market).

Figure 1: New Venture Capital Commitments against New Venture Capital Funds

⁹⁸ According to Zero2IPO statistics, in the year 2015 alone, 929 venture capital-backed companies were listed on the NEEQ, accounting for 51.2% of the total exit vehicles in 2015. See further information on the correlation between the stock market and the venture capital market in Lin, *supra* note 62.

⁹⁹ Zero2IPO Research Center, *Report of the China Government Guidance Fund 2015* [2015 Nian Zhongguo Zhengfu Yindao Jijin Fazhan Baogao Jianban], ZERO2IPO PUBLISHER (Feb 28, 2015).

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² See *infra* text accompanying notes 158- 165 on further discussion of the new direction of the SVCIGF.

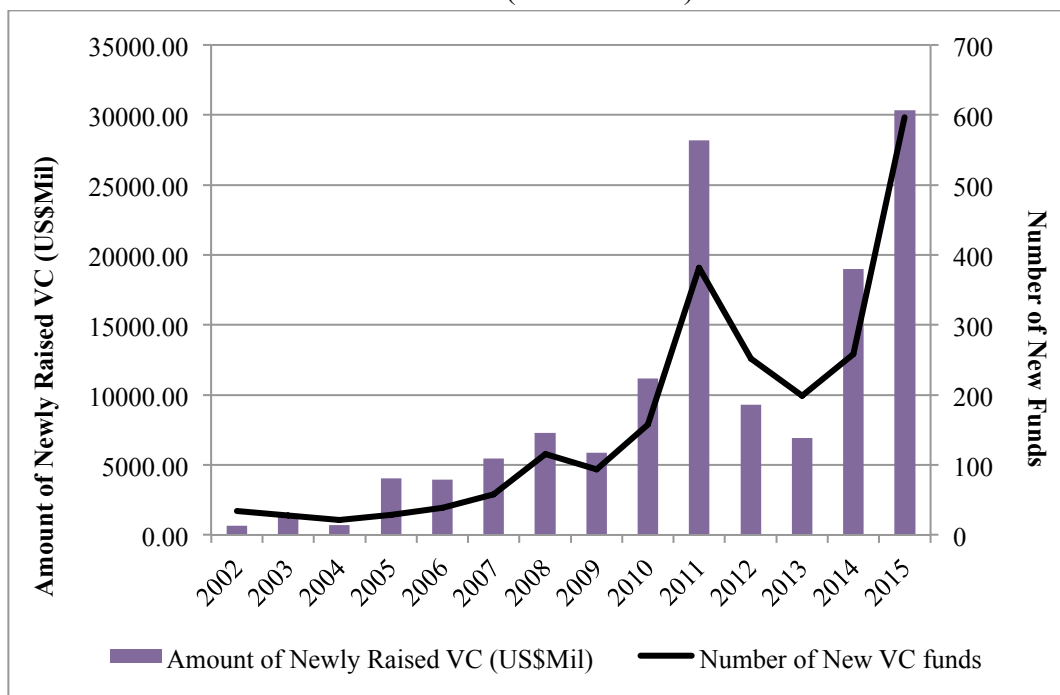
¹⁰³ In China, provincial and sub-provincial leaders on local level have a significant amount of autonomy. There are five practical (de facto) levels of local government: the provincial (province, autonomous region, municipality, and special administrative region), prefecture, county, township, and village.

¹⁰⁴ See *infra* text accompanying notes 158- 165 on further discussion of the new direction of the SVCIGF.

¹⁰⁵ See Table 2 & Table 3 in this article noting that government guidance funds only account for 2% of all investors on average.

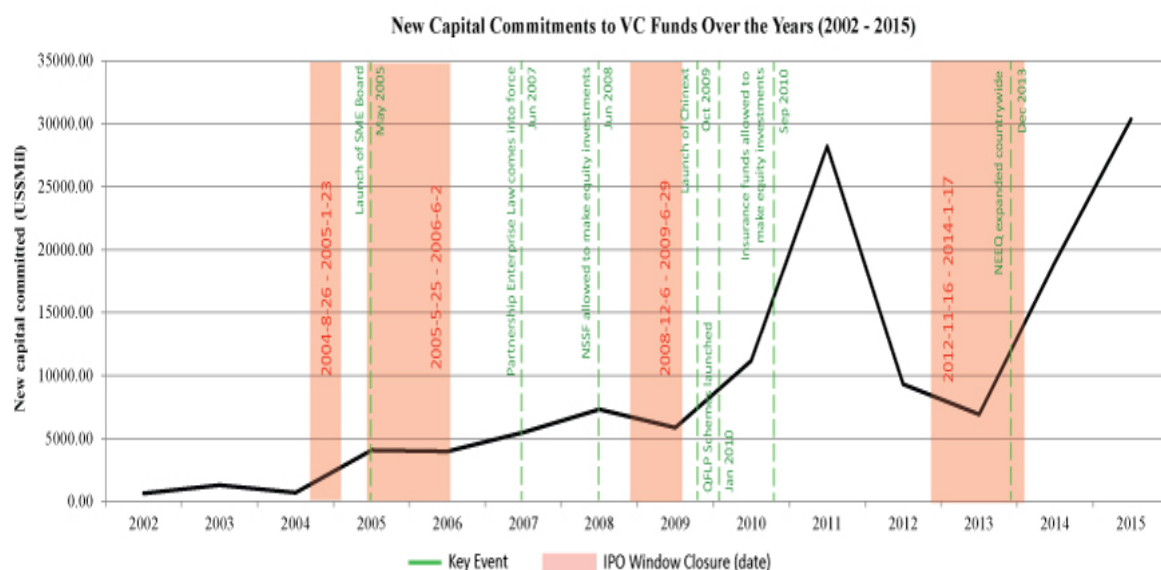
¹⁰⁶ See *The Top 50 VC Firms of the Year 2015* (ranked by Zero2ipo), PEDAILY.CN (Dec 4, 2015), <http://pe.pedaily.cn/201512/20151204391023.shtml>.

2002-2015 (USD Million)¹⁰⁷



¹⁰⁷ Source: China Venture Capital Annual Reports, published by Zero2IPO Research Center. Note that Zero2IPO Research is one of the most professional and authoritative research institutions in China.

Figure 2: New Venture Capital Commitments over the Years and the Major Policies and Legal Developments
2002-2015



III. Engineering Problems in China

This part will critically explore how the three-factor simultaneity problem has been gradually tackled in China, from a comparative and empirical perspective.¹⁰⁸

A. Capital

1. Public Capital

Funds for venture capital investment can be divided into two types depending on their source: government funding¹⁰⁹ and private funding. Government funding has been recognized as one of the most important sources of funding for fueling entrepreneurship across countries, after bank credit.¹¹⁰ Many countries have promulgated various kinds of government programs to support entrepreneurial businesses, typically through setting up government-sponsored funds to make investments in startups. Notable examples include Israel's Yozma Program,¹¹¹ Germany's Deutsche Wagnisfinanzierungsgesellschaft ("WFG"),¹¹² New Zealand's Venture

¹⁰⁸ See also Appendix 1 for a brief overview of the legislative efforts at tackling the simultaneity problem in China.

¹⁰⁹ In this article, government funding typically refers to capital provided by central and local governments from their budgets.

¹¹⁰ See *The EY G20 Entrepreneurship Barometer 2013*, ERNST & YOUNG (2013). See also *Adapting and Evolving: Global Venture Capital Insights and Trends 2014*, ERNST & YOUNG (2014) at 14, [http://www.ey.com/Publication/vwLUAssets/Global_venture_capital_insights_and_trends_2014/\\$FILE/EY_Global_VC_insights_and_trends_report_2014.pdf](http://www.ey.com/Publication/vwLUAssets/Global_venture_capital_insights_and_trends_2014/$FILE/EY_Global_VC_insights_and_trends_report_2014.pdf).

¹¹¹ Gilson, *supra* note 1, at 1097-1098.

¹¹² See Gilson, *supra* note 1.

Investment Fund (“NZVIF”),¹¹³ and Singapore’s Early Stage Venture Fund (“ESVF”) scheme.¹¹⁴ However, not all government programs have been successful.¹¹⁵

Many factors affect the effectiveness of government programs, including the duration of the programs,¹¹⁶ their size¹¹⁷ and flexibility,¹¹⁸ the presence of incentives for the financial intermediary to monitor portfolio companies,¹¹⁹ and the implementation process.¹²⁰ Empirical evidence indicates that a well-designed government-sponsored fund which sufficiently incentivizes fund managers and employs appropriate monitoring mechanisms to ensure maximum returns would increase the overall level of venture capital investment and fundraising,¹²¹ and *vice versa*.¹²² This is illustrated by Chile and Israel’s venture capital programs, which emphasize the need for market forces as opposed to Germany’s heavy governmental involvement in capital allocation during the venture capital investment process.¹²³

a) *The Rise of Government Guidance Funds*

In China, venture capital funding has been provided to tech startups through various government-sponsored programs, particularly through Government Guidance Funds (“GGF”) (*zhengfu yindao jijin*),¹²⁴ which are designed to increase the supply of venture capital to early-stage enterprises and implement national industrial policy by directing capital into government encouraged innovative industries.¹²⁵

The sizing of the government program is important to venture capital financing. A public program that is too small would hardly have any impact on a large and diverse economy, while a program that is too large might crowd out or discourage private funding.¹²⁶ Also, small firms typically face great difficulties in raising capital, due to the information asymmetry between the entrepreneurs and investors, resulting in reduced investor confidence.¹²⁷ Government funds are thus advantageous as they have an “add-on effect” in

¹¹³ For a detailed analysis of the program, see Josh Lerner, David Moore, Stuart Shepherd, *A Study of New Zealand Venture Capital and Private Equity Market and Implications for Public Policy*, LECG LIMITED (2005).

¹¹⁴ Terence Lee, *Singapore Government to Pump \$48 Million into Six Venture Capital Funds*, TECHINASIA (Apr 22, 2014).

¹¹⁵ See Gilson, *supra* note 1; LERNER, *supra* note 8.

¹¹⁶ LERNER, *supra* note 8, at 112-116 (arguing that encouraging entrepreneurship requires a long-term commitment on the part of public officials, and thus they should not have a short-term perspective or require quick returns under the government programs).

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

¹¹⁸ *Id.*, at 124-127 (suggesting that government officials must appreciate the need for the flexibility in venture capital investment and rely more on market forces in selecting the sectors, locations, and portfolio companies).

¹¹⁹ See Gilson, *supra* note 1.

¹²⁰ LERNER, *supra* note 8.

¹²¹ Armour & Cumming, *supra* note 3, at 601; Douglas J. Cumming & Jeffrey G. MacIntosh, *Crowding Out Private Equity: Canadian Evidence*, 21(5) JOURNAL OF BUSINESS VENTURING 569 (2006).

¹²² *Id.*

¹²³ See Gilson, *supra* note 1, at 1094-1099.

¹²⁴ The Industrial Investment Fund is a special type of government-backed fund whereby capital is raised from “specific institutional investors”, including the Social Security Fund, SOEs, commercial banks, insurance companies, securities companies, financial institutions and other institutional investors specified by the NDRC.

¹²⁵ See 2008 Venture Capital Fund Specifications and Operational Guide.

¹²⁶ LERNER, *supra* note 8, at 117-119.

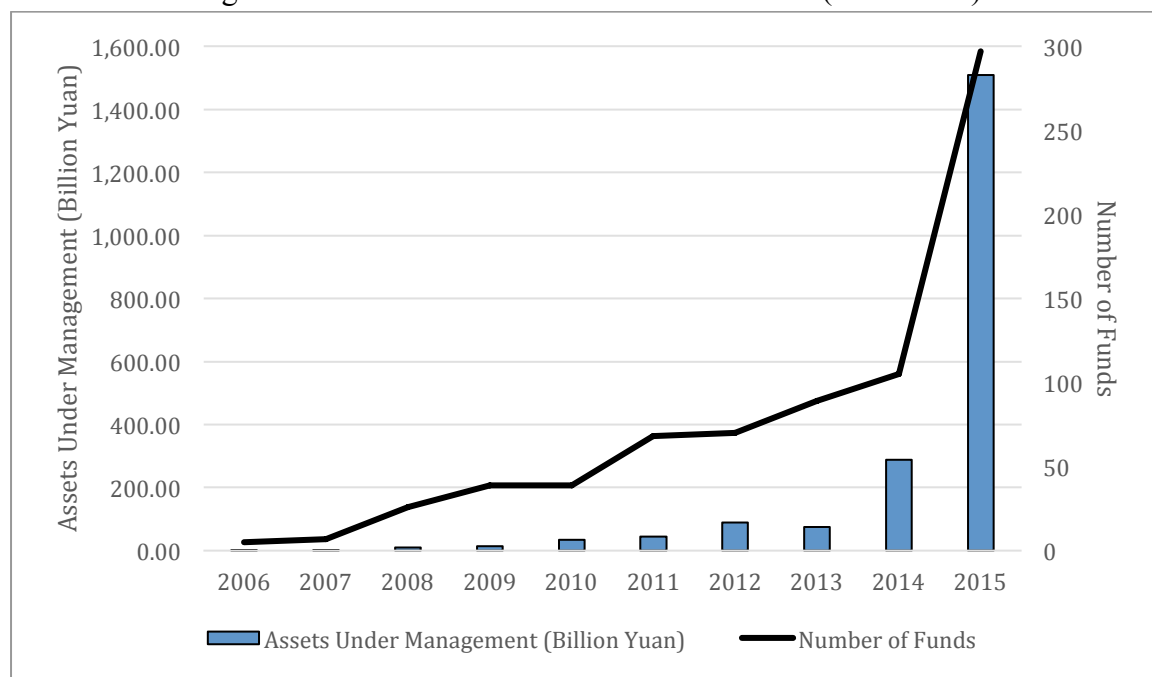
¹²⁷ LERNER, *supra* note 8, at 69.

raising capital,¹²⁸ such that investors would be more willing to invest in such funds once government investors have taken the lead.

As shown in Figure 3 and Table 2, the size of the Chinese GGF program arguably used to be too small – only 2% of the total investable amount was contributed by GGFs. This problem is more pronounced in rural areas, where GGFs are so lacking in size that they cannot play effective roles in guiding capital flow to startups.¹²⁹

To solve this problem, there has been a new wave of GGFs established at the central and local levels since 2015. As can be seen from Figure 3, in the year 2015 alone, 297 GGFs were established with a combined investment amount of RMB 1.5 trillion, which was 5.24 times the investment amount raised in 2014.¹³⁰ Arguably, the newly established RMB 40 billion (USD 6 billion) SVCIGF¹³¹ and the RMB 60 billion (USD 9 billion) National SME Development Funds,¹³² together with a number of local GGFs¹³³ are likely to leverage on government funding to attract private investors to participate in the funds.¹³⁴

Figure 3: Government Guidance Funds in China (2006-2015)¹³⁵



b) Problems with Government Guidance Funds

Nonetheless, despite positive progress and swift development, GGFs have not been

¹²⁸ *Id.*, at 70.

¹²⁹ Zero2IPO, *China Government Guidance Fund Annual Report 2015 [qingke zhongguo yindao jijin niandu baogao]*, ZERO2IPO PUBLISHER (Feb 28, 2015), <http://research.pedaily.cn/201601/20160128393065.shtml>.

¹³⁰ *Id.*

¹³¹ See *supra* note 99.

¹³² On 1 September 2015, the State Council decided to establish a National SME Development Fund (*guojia zhongxiao qiye fazhan jijin*) with 60 billion RMB to promote the development of SMEs in China.

¹³³ They are also termed as the local venture capital investment guidance funds (LVCIGF).

¹³⁴ See Zero2ipo, *supra* note 129.

¹³⁵ Source: China Government Guidance Fund Annual Reports, published by Zero2IPO, <http://research.pedaily.cn/201601/20160128393065.shtml>.

unproblematic.

First, government intervention in investment choice is prevalent within GGFs. Local governments often mandate the sectors, companies or locations which are to be funded through GGFs.¹³⁶ In particular, it is common for a local government to require GGF-backed venture capital firms to invest in certain companies within the region, instead of similar companies elsewhere that may have higher growth potential and are in need of capital.¹³⁷ This could lead to conflicts between the GGF and the venture capital firm, resulting in disincentives to the latter in finding promising projects and causing it to be less willing to receive funding from GGFs in future projects.

There are also problematic local regulations that unduly restrict the length of investments and size of the investee companies. For example, the Measures of Jiangsu Emerging Venture Capital Investment Guidance Fund specifies that the maximum length of the investment is five years,¹³⁸ which is inconsistent with the international practice of between 7 to 10 years.¹³⁹

Second, there exists a flawed governance structure and system for the selection of managers within local GGFs. For instance, under the Measures of the Shanghai Angel Investment Guidance Fund 2014 (“Shanghai AIGF Measures”), the manager of the Shanghai AIGF is not selected from the private sector, but is statutorily appointed. The manager currently appointed is a subsidiary of another government-backed fund – the Shanghai Technology Entrepreneurship Foundation for Graduates (“EFG”), who “shall exercise the rights as the investors of the Shanghai AIGF”.¹⁴⁰ Two questions naturally follow: first, how would the EFG “exercise the rights as an investor” effectively since it does not provide capital contribution to the fund and does not own any equity interests in the fund? Second, how would the EFG monitor the fund effectively and fairly when the fund is being operated by its subsidiary? Also, unlike the ordinary venture capital limited partnership model where a professional venture capital firm serves as the general partner and is subject to various legal and contractual constraints (e.g. unlimited liability for the debts of the fund, fiduciary duties of the general partner and the limited partners’ derivative action mechanism), there is no effective mechanism to constrain the behavior of the Shanghai AIGF’s statutorily mandated fund manager.

¹³⁶ For example, Article 6(5) of the *Implementation Rules of the Shanghai Angel Investment Guidance Fund* [Shanghaishi tianshi touzi yindao jijin guanli shishi xize], Shanghai Science and Technology Committee, Hukehe [2014] No. 49 states that the Shanghai Angel Investments Guidance Fund is to invest mainly in companies within Shanghai.

¹³⁷ Article 8 of the *Implementation Rules of the Shanghai Angel Investment Guidance Fund*, *supra* note 136, states that investments by the Shanghai Angel Investments Guidance Fund into each portfolio company shall be between RMB 5 million – 30 million RMB and that this amount shall not exceed 50% of the total subscribed capital of the portfolio company.

¹³⁸ Article 41 of the *Measures of the Jiangsu Emerging Industry Venture Capital Investment Guidance Fund* [Jiangsu sheng xinxing chanye chuangye touzi yindao jijin guanli banfa] states that the duration of investments made by the Jiangsu Emerging Industry Venture Capital Investment Guidance Fund shall not exceed 5 years unless approval is sought from the fund’s management committee

¹³⁹ LERNER, *supra* note 8,

¹⁴⁰ *Implementation Rules of the Shanghai Angel Investment Guidance Fund*, *supra* note 136, Article 3.

Moreover, under the Shanghai AIGF Measures,¹⁴¹ a steering committee comprising the deputy mayor of Shanghai and other government bureaucrats is in charge of the policy-making and supervision of the Shanghai AIGF.¹⁴² Given the lack of expertise and experience of government officials in making venture capital investments, it is uncertain whether they would be able to ensure the efficient and effective use of the Shanghai AIGF's assets in coordination with other key players.

Further, the Shanghai AIGF Measures mandate the establishment of a separate investment committee comprising external experts and government representatives to review and vote for investment proposals.¹⁴³ These government officials may intervene directly in the decision-making process of the Shanghai AIGF, thus causing internal conflicts. Also, while the general partner of an ordinary venture capital fund is constrained by fiduciary duties and potential personal liability, government officials in the investment committee of the Shanghai AIGF are neither penalized nor rewarded for decisions made by the committee. Consequently, ensuring that these officials do not misuse resources of the GGF to obtain personal benefits remains a difficult task.

Third, local governments or GGFs often guarantee investment losses suffered by venture capital firms, resulting in a lack of incentives on the part of the venture capital firm and the entrepreneurs. Examples include the GGFs of Beijing,¹⁴⁴ Jiangsu,¹⁴⁵ Guangzhou¹⁴⁶ and Shanghai.¹⁴⁷ Under the Shanghai AIGF Measures, the Shanghai government will guarantee and compensate venture capital firms for up to 60% of their actual losses caused by investments in scientific and technological enterprises at seed stage or up to 30% if at start-up stage,¹⁴⁸ as well as RMB 3 million of their actual losses for each investment project and RMB 6 million for annual investments by each investment firm.¹⁴⁹

¹⁴¹ *Id.* Article 3 states that the steering committee is the highest management institution for the Shanghai Angel Investments Guidance Fund and is responsible for the policymaking and supervision of the fund. Public information reveals that the steering committee includes the deputy mayor of the Shanghai city as the leader and bureaucrats from the 12 departments of the Shanghai government. See Liang Jialin, *The First Angel Investments Guidance Fund was set up in Shanghai*, JINGJI GUANCHAO (Dec 24, 2014), <http://www.eeo.com.cn/2014/1224/270637.shtml>.

¹⁴² *Id.*

¹⁴³ Article 12 of the *Implementation Rules of the Shanghai Angel Investment Guidance Fund*, *supra* note 136, states that the fund must set up an independent investment review committee to review investment proposals. The committee will comprise experts and representatives from relevant government agencies.

¹⁴⁴ *The Measures on the Zhongguancun Talent Attraction Investment Fund* [zhongguancun guojia zizhu chuangxin shifanqu youxiurencai zhichi zijin guanli banfa] Zhongkeyuanfa [2013] No. 40 also stipulates subsidies for venture capital investments within Zhongguancun.

¹⁴⁵ *The Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund* [Jiangsusheng xinxing chanye chuangye touzi yindao jijin guanli banfa], Jiangsu Development and Reform Committee, Sufagaiguifa [2011] No. 8 states that angel investment firms would be compensated for up to 50% of the losses they incur from investments into seed or early-stage technology-based enterprises, provided that these losses were incurred within three years from the time the relevant investments were made, up to a limit of RMB 3 million.

¹⁴⁶ *The Trial Measures for the Technology Enterprises Incubator Venture Capital and Credit Risk Compensation Fund* [guanyu keji qiye fuhuaqi chuangye touzi ji xindai fengxian buchang zijin shixing xize], Yuekeguicaizi [2015] No. 21 states that venture capital firms will be compensated for up to 50% of the losses they incur from investments made into early-stage enterprises in the Guangdong Province Technology Enterprises Incubator, up to a limit of RMB 2 million.

¹⁴⁷ *Shanghai Angel Investment Risk Compensation Interim Measures* [shanghaishi tianshi touzi fengxian buchang guanli zhanxing banfa], Shanghai Science and Technology Committee, Shanghai Finance Bureau and Shanghai Finance Bureau and Shanghai Development and Reform Commission, Hukehe [2015] No. 27.

¹⁴⁸ *Id.* Article 9.

¹⁴⁹ *Id.* Article 10.

Such venture capital firms would unfortunately be less incentivized to perform effectively and work for the best interests of the funds under their management. Guarantee schemes which are funded by taxpayers' money would also create public grievance towards the GGFs as the very nature of venture capital investments is high-risk. Guarantee schemes are also problematic because they are usually implemented by government officials who may not possess sufficient expertise in calculating the losses suffered, and who may prefer to compensate venture capital firms that are government-backed. For example, the Shanghai AIGF Measures state that a steering group comprising government officials is responsible for the implementation of the compensation scheme.¹⁵⁰ Statistics show that many of the venture capital firms in Shanghai that received compensation for their investment losses were indeed government-backed firms.¹⁵¹

Fourth, GGFs often negotiate for a smaller compensation package for GGF-backed venture capital firms, resulting in lower incentives for the latter. Typically, the most popular distribution of the GP's compensation is the so-called "2/20 Rule".¹⁵² The GP's compensation comprises two parts: an annual management fee for its services comprising 2 to 2.5 % of the committed capital, and a carried interest of 20 to 25 % of the profits realized by the fund.¹⁵³ This is however not always the case for GGF-backed venture capital firms. Local governments are often overly protective of the taxpayer's money while negotiating profit allocation, resulting in the venture capital firm being paid less than a 20% carried interest,¹⁵⁴ or in the GGFs being given priority in the distribution of profits over the venture capital firm.¹⁵⁵

Meanwhile, numerous GGFs have not set up a comprehensive appraisal system to measure the performance of the GGF and the GGF's manager,¹⁵⁶ resulting in a lack of clear and detailed rules on the evaluation of the GGF.¹⁵⁷

c) *New Directions and Ways Forward for Regulating GGFs*

Cognizant of the problems within the local GGFs as discussed above, the Chinese central government has begun to move towards a market-oriented approach in the provision of

¹⁵⁰ *Id.* Article 11.

¹⁵¹ *Id.* Article 8 specifies that applicants for compensation shall make a filing with the relevant registrar in charge of venture capital investments. Statistics show that out of more than 110 venture capital firms which had made filings for compensation as of January 2016, most were state-owned venture capital firms; see *Why is the Government Subsidizing Venture Capital Investment Failures* [fengxian touzi shibai, pingshenme zhengfu lai tieqian], INTOUCH TODAY (Jan 27, 2016), <http://view.news.qq.com/original/intouchtoday/n3417.html>.

¹⁵² Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3 (2008).

¹⁵³ Kate Litvak, *Venture Capital Partnership Agreements: Understanding Compensation Arrangements*, 76 UNIVERSITY OF CHICAGO LAW REVIEW 161 (2009).

¹⁵⁴ Zero2IPO, *supra* note 129.

¹⁵⁵ *Four Problems Faced by Government Guidance Funds* [qidi zhengfu yindao jijin: sida wenti lanlu], PEDAILY (May 12, 2016), <http://pedaily.baijia.baidu.com/article/449928>.

¹⁵⁶ Article 24 of the *Implementation Rules of the Shanghai Angel Investment Guidance Fund*, *supra* note 136 states generally that the steering committee and its office are responsible for the supervision and evaluation of government guidance funds, but provides no specific evaluation criteria.

¹⁵⁷ Article 30 of the *Interim Measures of the Government Investment Fund* [zhengfu touzi jijin zhanxing guanli banfa], Ministry of Finance, Caiyu [2015] No. 210, simply specifies that the GGF should set up an evaluation system for the fund, but provides no detailed rules on how the assessment should be made.

funding for venture capital.¹⁵⁸ This involves attracting more private investors into the venture capital market (which will be discussed in the next section) and reducing government intervention in the operation of the GGFs, which is largely reflected in the newly established SVCIGF 2015¹⁵⁹ and the Interim Measures of the Government Investment Fund 2015 which specify that the GGFs should operate based on market forces.¹⁶⁰

Several observations and suggestions may be made. First, according to Gilson, the ceding of control to market forces would mitigate operational inefficiencies arising from the incompetence and lack of professional experience on the part of government authorities. It also helps to tackle agency problems caused by the divergence of interests between governments and venture capital firms. The local government should avoid participation in the selection of portfolio companies and not seek to direct venture capital towards later-stage government-linked companies within their regions. Funding should be provided to early-stage startups that are in high demand of capital, instead of later-stage companies that allow the generation of quick returns. Also, as noted by Cumming and Johan, the impact of government-sponsored VC funds depends not only on the design of the program but also on the selection of the VC managers.¹⁶¹ Instead of appointing government-linked companies, governments should select experienced, professional and independent venture capital firms to manage the funds on a commercial basis.¹⁶² The SVCIGF is a positive step forward on both points (Diagram 1).

Further, requiring matching funds to be raised from the private sector would help to reduce the dangers of uninformed decisions and political interference.¹⁶³ The SVCIGF takes a step in the right direction – it will comprise RMB 40 billion of capital funding, with RMB 10-15 billion coming from the government and the remainder coming from other investors such as private enterprises and large institutional investors.¹⁶⁴ Arguably, by allowing more than half of the funding to originate from the private sector, government interference is mitigated and the fund's managers can make more informed commercial decisions on capital allocation.

Second, the structure of the GGFs should be simplified to reduce bureaucracy and transaction costs, and to increase professionalism. A “fund of funds” (FOF) approach taken by the SVCIGF seems more desirable for GGFs (Diagram 1). Under the FOF model, the consolidated fund will make investments in a number of other funds and each of these funds will invest into a portfolio of companies. By doing so, the consolidated fund enjoys broader exposure to the industry and diversification of the risks associated with a single investment.

¹⁵⁸ See Zero2IPO, *supra* note 129.

¹⁵⁹ See Zero2IPO, *supra* note 129.

¹⁶⁰ See e.g. *Interim Measures of the Government Investment Fund* [zhengfu touzi jijin zhanxing guanli banfa], *supra* note 157, Article 11.

¹⁶¹ Douglas Cumming & Sofia Johan, *Pre-seed government venture capital funds*, 7(1) J INT ENTREP 26 (2009).

¹⁶² The third key feature of the SVCIGF is that the government does not participate in fund management, and instead relies on incentivized financial intermediaries. Further, the SVCIGF will invite public tenders from professional fund managers for investment decisions.

¹⁶³ LERNER, *supra* note 8, at 128-133.

¹⁶⁴ 400 yi guojia chuangtou jijin dingceng fangan sheji yi jiben wancheng [The Design of the 40 billion State Venture Capital Investment Fund has been completed], SINA FINANCE (Mar 30, 2015), <http://finance.sina.com.cn/china/20150330/155021844627.shtml>.

The fund's managers would be incentivized to take a more active approach with the fund's investments and achieve appropriate asset allocation, in contrast to GGFs of old whereby a local fund is usually restricted to only one project.¹⁶⁵

Third, a well-designed appraisal and compensation system should be established within the fund to reduce bureaucracy and provide incentives to the fund's manager. The universal 2/20 compensation rule should be followed to incentivize the fund's manager. The reward and penalty package of the fund's manager and the investment committee should be specified in the regulations governing the GGFs. Also, more detailed rules should be provided on the evaluation, supervision and auditing of the GGFs to fill the legislative gap in the existing regulations on GGFs.¹⁶⁶ Regular reporting and external auditing on the operation of the fund should be required.

Fourth, there are no detailed rules governing the stage wherein investments are made into portfolio companies under the various local regulations.¹⁶⁷ As noted by Gilson, giving the venture capital fund disproportionate representation or even control of the portfolio company's board of directors could help to reduce agency costs at the financing stage.¹⁶⁸ It is suggested that the GGF should appoint a representative to serve as a director in the board of the portfolio company to restrict the entrepreneur's discretion and behavior in using the fund. The GGFs may also require veto rights in important matters or the power to replace the entrepreneur as the portfolio company's chief executive officer.

Last but not the least, in light of the public nature of the GGFs, the unique party-state system of China, the administrative appointment system for officials in charge of the GGFs and protectionism at the local level, the most significant task is for local governments to follow the central government's approach in allowing local GGFs to operate based on market forces, while concurrently pursuing the local government's policy goals. It is recommended that local regulations be revised according to the central government's regulation and directives. Measures for the continuous education of local governments should also be implemented to deepen their understanding of the venture capital industry, especially on the negative implication of government intervention in the capital allocation process and the importance of market forces in the development of venture capital.

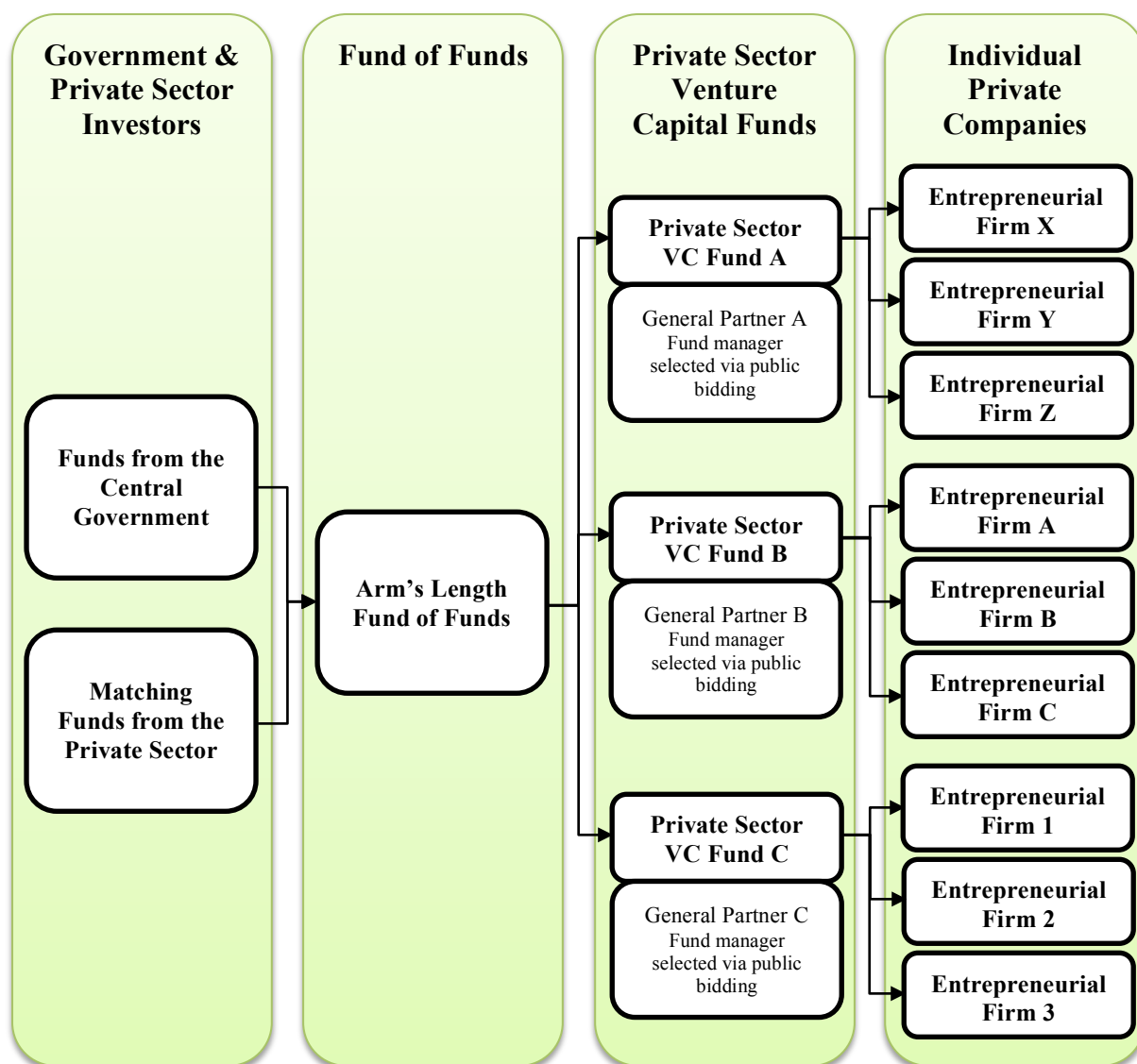
Diagram 1: State Venture Capital Investment Guidance Fund (SVCIGF) 2015

¹⁶⁵ *Id.*

¹⁶⁶ Various local regulations governing GGFs do not provide rules on these issues. See e.g. *Implementation Rules of the Shanghai Angel Investment Guidance Fund*, *supra* note 136; *Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund*, *supra* note 145.

¹⁶⁷ *Id.*

¹⁶⁸ Gilson, *supra* note 1, at 1082.



2. Private Capital

a) Predominance of Wealthy Individuals and Families

The second major type of funding is private capital. With continuous economic growth after the open-door policy and economic reform, the number of high-net-worth individuals and families is increasing in China, generating large amounts of available capital for the venture capital industry. As of 2014, China had the largest population of high-net-worth individuals in Asia (890,000) holding a combined wealth of USD 4.5 trillion, a 19.3% increase from the previous year.¹⁶⁹

Moreover, a favorable tax environment is also a relevant “push” factor that would increase the supply of private capital in a venture capital market.¹⁷⁰ Many local Chinese governments have implemented various preferential tax policies for venture capital firms which serve as

¹⁶⁹ *Annual World Wealth Report*, CAPGEMINI & RBC WEALTH MANAGEMENT (2015), <http://www.worldwealthreport.com/>.

¹⁷⁰ Armour & Cumming, *supra* note 3, at section 4.

the general partners (GP) in venture capital funds, and for their investors who serve as the limited partner (LP) in the fund (see Table 1), to increase the supply of private capital in their regions and boost the regional economy.¹⁷¹

As seen from the comparison between Table 2 & Table 4, the current composition of investors (LPs) differs starkly in China and the U.S. respectively – large institutional investors contribute much less to Chinese venture capital funding. As of 2015, 53% of the number of LPs in China are wealthy individuals and families, 14.6% are private enterprises and 9.4% are investment companies (Table 2). In particular, there is a growing number of wealthy companies with their own venture capital funds that primarily focus on consumer and internet-related enterprises.¹⁷²

Table 1: Tax Rules For Private Equity Funds At Selected Locations In China¹⁷³

Region	Tax Regulations on Private Equity Funds ¹⁷⁴
Beijing	GPs and LPs pay individual income tax at a rate of 20%.
Tianjin	Individual partners (GPs and LPs) pay individual income tax at a rate of 20%. Within the Tianjin Economic-Technological Development Area, individual partners receive 100% subsidies for tax on income beyond the 20% individual income tax of individual partners.
Shanghai	Individual GPs pay individual income tax at a rate of 35% for income above RMB 50,000; LPs pay individual income tax at a rate of 20% for equity investment income.
Chongqing	Individual GPs pay individual income tax at progressive tax rates ranging from 5-35%; LPs pay individual income tax at a rate of 20%. Pursuant to China's Western Development program, funds organized as companies are subject to corporate income tax at a rate of 15%.
Shenzhen	Individual GPs pay individual income tax at a progressive tax rate ranging from 5-35%; LPs pay individual income tax at a rate of 20%.

b) Increasing Capital Supply from Institutional Investors

Institutional investors such as commercial banks, the NSSF and insurance companies were prohibited from making equity investments in the past due to policy constraints under previous regulations.¹⁷⁵ This has contributed to the predominance of wealthy individuals and families in the venture capital market as discussed above. Recognizing the importance of institutional investors as a major and suitable source of investable capital in long-term and high-risk investments, and in light of recent success stories such as Israel and Singapore

¹⁷¹ Gui Jieying, *Cancellation of PE Tax Incentives Causes a Stir amid the Trend of Market Innovation and Mass Entrepreneurship*, PEDAILY.CN (Apr 10, 2015), <http://en.pedaily.cn/Item.aspx?id=220259>.

¹⁷² See Ernst & Young, *supra* note 110, at 20.

¹⁷³ Gui Jieying, *supra* note 171, <http://en.pedaily.cn/Item.aspx?id=220259>.

¹⁷⁴ The private equity funds in this table also include venture capital funds.

¹⁷⁵ For example, insurance companies were explicitly prevented from investing in venture capital funds until 2014 when the Chinese Insurance Regulatory Commission issued the *Notice of Venture Capital Investments by Insurance Capital* [*guanyu baoxian zijin touzi chuangye touzi jijin youguan shixiang de tongzhi*], Baojianfa [2014] No. 101 to allow insurance capital to be invested in venture capital funds.

which have had their venture capital industries greatly boosted by global investors,¹⁷⁶ China's regulators have made positive efforts at changing the existing composition of the investor base, thus allowing more qualified institutional investors and foreign investors to engage in venture capital investments.

Regulators, notably the CSRC, China Insurance Regulatory Commission ("CIRC") and China Banking Regulatory Commission ("CBRC"), have since 2008 begun to remove restrictions preventing the NSSF, insurance companies, commercial banks, investment funds¹⁷⁷ and trust companies¹⁷⁸ from making equity investments. For example, after the CIRC issued a set of investment guidelines allowing insurance companies to engage in venture capital investments, insurance companies have quickly built up substantial assets in the venture capital industry, reaching RMB 10 billion at end 2014.¹⁷⁹

Additionally, foreign investors were also progressively permitted to raise funds and make investments in China's venture capital market through the government's promulgation of various foreign-related laws, including the Provisions Concerning the Administration of Foreign-funded Business-starting Investment Enterprises¹⁸⁰ which provides a new business vehicle for foreigners to raise funds; as well as the Measures for the Administration of Confirmation and Recordation of Overseas Investment Projects,¹⁸¹ which specify the areas and procedures for foreign investments. In recent years, the QFLP¹⁸² schemes and Renminbi Qualified Foreign Limited Partner ("RQFLP") program¹⁸³ were launched to broaden the scope of foreign investors eligible to make venture capital investments in China. With the easing of regulatory barriers for institutional investors, the distribution of investors is shifting. Major institutional investors such as public pension funds and investment companies and insurance companies are gradually becoming important players in the market.¹⁸⁴

¹⁷⁶ LERNER, *supra* note 8, at 101.

¹⁷⁷ In 2013, the China Securities Regulatory Commission promulgated the *Interim Provisions on the Management of Securities Investment Funds by Asset Management Institutions*.

¹⁷⁸ Since 2008, the National Social Security Fund has been permitted to make equity investments in certain industrial funds. Since 2010, insurance companies were allowed to make equity investments under the *Interim Measures on Equity Investment by Insurance Capital* [baoxian jijin guquan zhanxing banfa]. In 2014, insurance companies were permitted to make investments in venture capital funds under the *Notice of the China Insurance Regulatory Commission on Matters concerning the Investment of Insurance Funds in Venture Capital Funds*.

¹⁷⁹ Gui Jieying, *The Size of Insurance Companies and Government Guidance Funds in 2015* [2015 nian yi jidu huoyue LP zengzhijia, xianzi, yindao jijin qianzai guimo pangda], ZHONGGUANCUN INVESTMENT AND FINANCING NETWORK [zhongguancun touzi rongzi wang] (Apr 29, 2015), <http://www.zgctrz.com.cn/shownews-29840.html>.

¹⁸⁰ *Provisions Concerning the Administration of Foreign-funded Business-starting Investment Enterprises* [waishang touzi chuangye touzi qiye guanli guiding], Ministry of Foreign Economic Liaison (replaced), Ministry of Science & Technology, State Administration for Industry & Commerce, State Administration of Taxation, State Administration of Foreign Exchange (issued in 2003 and amended in 2015).

¹⁸¹ *Measures for the Administration of Confirmation and Recordation of Overseas Investment Projects*, [jing wai touzi xiangmu hezhun he beian guanli banfa], State Development & Reform Commission (incl. former State Development Planning Commission) (first issued in 2004 and amended in 2014).

¹⁸² Under the QFLP, foreign-invested private equity funds and fund management companies are permitted to convert their foreign currency capital into RMB in order to invest into RMB funds. Since 2011, Shanghai, Beijing, Tianjin, Chongqing and Shenzhen have promulgated regional QFLP schemes to attract foreign institutional investors to make equity investments in their regions.

¹⁸³ The 2012 Renminbi Qualified Foreign Limited Partner Program ("RQFLP") permits offshore-raised RMB to be invested in PRC companies by PRC private equity funds and managers.

¹⁸⁴ See Table 2. Although the relaxation of policies since 2008 has opened up more investment channels for institutional investors, investment restrictions are still in place for the purpose of investor protection in this high-risk industry.

Table 2: Percentage Of Types of Limited Partners in China's Venture Capital and Private Equity Market (By Number) (2011-2015)¹⁸⁵

China	2011(%)	2012(%)	2013(%)	2014(%)	2015(%)
Wealthy families and individuals	46.1	50.2	50.8	54.4	53.0
Enterprises ¹⁸⁶	19.5	17.2	16.6	14.9	14.6
VC/PE institutions	7.0	6.3	6.3	6.2	6.2
Investment companies	4.7	5.9	6.1	8.5	9.4
Government-guided funds	3.7	2.8	2.7	2.0	2.1
Listed companies	3.0	4.3	4.2	3.9	4.7
Asset management companies	3.1	2.3	2.1	1.7	1.7
Governmental agencies	3.0	3.2	3.9	3.1	3.0
Trusts	3.6	0.6	0.7	0.5	0.5
Banks		1.3	1.1	0.8	0.7
Public pension funds	1.9	1.3	1.1	0.8	0.7
Fund of funds	1.8	1.5	1.5	1.3	1.5
University endowment funds	1.0	0.5	0.4	0.3	0.3
Insurance institutions	0.6	0.6	0.6	0.4	0.4
Private family funds	0.5	0.3	0.3	0.2	0.2
Sovereign wealth funds	0.4	0.3	0.3	0.2	0.1
Enterprise annuity fund	0.1	0.1	0.1	0.1	0.1
Endowment funds	--	0.3	0.3	0.2	0.2
Others	--	1.0	1.0	0.9	0.8
Total	100.0	100.0	100.0	100.0	100.0

Table 3: Percentage Of Capital Raised By Limited Partners in China's Venture Capital and Private Equity Market (By Investable Amount) (2011-2015)¹⁸⁷

China	2011(%)	2012(%)	2013(%)	2014(%)	2015(%)
Listed companies	28.7	26.3	26.3	25.0	24.5
Public pension funds	20.4	20.7	20.3	19.2	17.8
Sovereign wealth funds	19.0	19.1	18.7	17.5	16.0
Enterprises ¹⁸⁸	3.5	3.4	3.6	4.5	4.5
Fund of funds	5.9	6.4	6.3	6.1	5.6
Investment companies	2.8	4.0	4.1	4.5	4.7
VC/PE institutions	3.7	3.2	3.3	3.8	3.8
Enterprise annuity fund	4.3	4.1	4.0	3.7	3.4

¹⁸⁵ Source: Zero2IPO Research Center, Annual Reports of Limited Partners in China.

¹⁸⁶ Enterprises exclude listed companies.

¹⁸⁷ Source: Zero2IPO Research Center, Annual Reports of Limited Partners in China.

¹⁸⁸ *Id.*

Governmental agencies	0.4	0.9	1.0	3.4	5.9
Wealthy families and individuals	0.7	1.1	1.3	1.5	1.6
Private family funds	1.4	1.4	1.3	1.2	1.1
Trusts	3.8	0.2	0.3	0.4	0.5
Banks		3.0	2.9	2.8	4.0
Asset management companies	1.7	2.3	2.3	2.3	2.4
Government-guided funds	1.8	2.1	2.1	2.0	2.0
Endowment funds	--	0.1	0.1	0.1	0.1
Insurance institutions	1.1	1.0	1.1	1.1	1.1
University endowment funds	0.8	0.7	0.7	0.7	0.6
Others	--	0.2	0.2	0.2	0.3
Total	100.0	100.0	100.0	100.0	100.0

Table 4: Percentage Of Capital Raised in the U.S. Venture Capital Market¹⁸⁹
(By Amount)

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

B. Financial Intermediaries

The second factor under Gilson's simultaneity theory is the availability of specialized financial intermediaries which serve as the "nexus of a set of sophisticated contracts" and which get the incentives right in a venture capital cycle.¹⁹⁰ There are two main contracts which financial intermediaries serve as the nexus of. The first arises at the fund-raising stage between the investor and the venture capital fund, which is typically organized in the U.S. as a limited partnership. This contract alleviates the agency costs between the investor and fund manager and incentivizes the latter through mechanisms such as a fixed term, mandatory distributions, and structuring of the fund manager's compensation.¹⁹¹ The second contract arises between the venture capital fund and the portfolio company. This contract addresses

¹⁸⁹ Source: National Venture Capital Association.

¹⁹⁰ Gilson, *supra* note 1, at 1069, 1093.

¹⁹¹ *Id.*, at 1087-1090.

the uncertainty, information asymmetry and agency costs between the venture capital fund and entrepreneurs and incentivizes both participants through mechanisms such as staged financing, allocation of control to the fund, structuring of the entrepreneur's compensation and incentivizing exit.¹⁹² The interaction, or "braiding", of the two contracts enhances the efficiency of each in terms of incentivizing exit and constraining opportunistic behavior by the venture capital fund against entrepreneurs.¹⁹³

Therefore, the term "specialized financial intermediaries", as conceptualized by Gilson, refers to the venture capitalists and venture capital firms which are "interpos[ed]... between passive investors and the portfolio company".¹⁹⁴ This chapter focuses on the role of the Chinese government in providing the right business vehicle for such intermediaries through the promulgation of laws and regulations. By providing the right business vehicle, a government can attract specialized financial intermediaries that get the incentives right in the venture capital cycle.

Many jurisdictions have introduced various kinds of business vehicles in a bid to enhance the attractiveness of their venture capital markets, although the business vehicle preferred by venture capitalists and investors varies from jurisdiction to jurisdiction. The limited partnership has been the predominant vehicle for fund-raising in the U.S. since the 1970s.¹⁹⁵ In recent years, a number of jurisdictions such as Singapore,¹⁹⁶ New Zealand,¹⁹⁷ Taiwan,¹⁹⁸ Japan¹⁹⁹ and Switzerland²⁰⁰ have introduced the limited partnership into their business menus to attract more equity investment in their regions. Other jurisdictions that already have the limited partnership vehicle, such as the United Kingdom²⁰¹ and Australia,²⁰² have also recently amended their limited partnership regimes in order to encourage the growth of venture capital investment.

¹⁹² *Id.*, at 1078-1087.

¹⁹³ *Id.*, at 1091-1092.

¹⁹⁴ *Id.*, at 1097.

¹⁹⁵ See LERNER, *supra* note 8, at 10.

¹⁹⁶ Singapore has passed the Limited Partnership Bill on 18 November 2008. The Singapore Limited Partnerships Act 2008 (Cap 163B) came into operation on May 4, 2009.

¹⁹⁷ The Limited Partnerships Act 2008 (2008/1) came into force on 2 May 2008 in New Zealand. See *Introducing Limited Partnerships*, NEW ZEALAND COMPANIES OFFICE NEWS RELEASE (3 Dec 2008), <https://www.business.govt.nz/companies/learn-about/other-registers/limited-partnerships/introduction>.

¹⁹⁸ Taiwan Executive Yuan passed the Limited Partnership Law on 27 June 2007. See *Council Passed the Limited Partnership Bill*, TAIWAN COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT NEWS RELEASE (Aug 10, 2007).

¹⁹⁹ In 1999, the National Diet of Japan passed the Limited Partnership for Investment Act (投資事業有限責任組合契約に関する法律) to enable the formation of the Limited Partnership for Investment.

²⁰⁰ A special form of limited partnership which was designed for collective investments in the area of alternative investment was introduced into Swiss law in 2007. See Remy Bärlocher, *The Swiss Limited Partnership - An Attractive Structuring Alternative for Private Equity in Europe*, EUROPEAN LAWYER 77 (Dec 2007 / Jan 2008).

²⁰¹ The British Government announced in 2006 that it would reform the Limited Partnership Act 1907 to clarify and modernize the law relating to limited partnerships. Certain changes based on these recommendations were brought forward in a Legislative Reform Order (LRO) laid before Parliament in June 2009.

²⁰² In 2007, a Tax Laws Amendment (2007 Measures No. 2) Bill was introduced to Australia in order to relax the eligibility requirements for foreign residents investing in venture capital LPs and Australian venture capital funds. See *Government to Make Further Improvements to the Tax System*, MINISTER FOR REVENUE AND THE ASSISTANT TREASURER MEDIA RELEASE (Mar 29, 2007).

Recognizing the importance of limited partnerships to venture capital, the Chinese legislature has also introduced the vehicle in China to facilitate the development of venture capital.²⁰³ This chapter focuses only on the regulations governing this new business vehicle, which significantly helps to facilitate fund raising in China.²⁰⁴

1. Adoption of the Limited Partnership: A Venture Capital Oriented Business Vehicle

The limited partnership is a new business vehicle created by the revised Partnership Enterprise Law of the People's Republic of China ("PEL") on June 1, 2007.²⁰⁵ Before 2006, there was only one type of partnership enterprise under Chinese law, i.e. the general partnership under which partners are liable personally for the debts and obligations of the partnership. Shortly after the enactment of the revised PEL, the very first Chinese limited partnership (*Nanhai Chengzhang Venture Investment Limited Partnership*)²⁰⁶ was set up on 27 June 2007.²⁰⁷ To allow foreign investors to use this new business vehicle in raising funds, the State Council issued the Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals in 2009.

Depending on the organizational form of the fund, Chinese venture capital funds can be categorized into three major types: (1) company-type funds, (2) trust-type funds,²⁰⁸ and (3) limited partnership-type funds. Today, the limited partnership has become the most popular business vehicle among newly raised venture capital funds in China (Table 5).

The popularity of the limited partnership in China can be attributed to several factors. Firstly, it offers a new business option for venture capitalists and investors. Prior to that, the major business forms for venture capitalists were the Limited Liability Company ("LLC"), the Joint Stock Company ("JSC") and the general partnership. Each of these business vehicles had its own limitations. LLCs and JSCs faced double tax treatment, substantial formation costs and substantial financial disclosure requirements,²⁰⁹ while general partnerships gave rise to unlimited liability for all partners and a similarly harsh tax burden.²¹⁰

²⁰³ Yan Yixun, *Reasons of Revising the Partnership Enterprise Law*, NATIONAL PEOPLE'S CONGRESS NEWS RELEASE (May 8, 2006), http://www.npc.gov.cn/npc/bmzz/caizheng/2006-05/08/content_1383740.htm.

²⁰⁴ The private ordering issue will be addressed in another paper of the author.

²⁰⁵ The law was promulgated in 2006 and came into effect in 2007.

²⁰⁶ *The First Venture Capital Limited Partnership was Established*, SHANGHAI SECURITIES NEWS (Jun 29, 2007).

²⁰⁷ *The First Limited Partnership in China*, FIRST FINANCIAL DAILY [diycailing] (Mar 17, 2009).

²⁰⁸ The trust-type private equity fund emerged in China in 2008. The trust-type fund is regulated by the *PRC Operational Guidelines for Private Equity Investment Trust Business of Trust Companies*, The China Banking Regulatory Commission, Yinjianfa [2008] No. 45. In a typical trust-type fund, a trust company acts as the trustee of a fund and is responsible for fund raising and investments. Capital is pooled from investors via a trust plan. A trust company would either employ a professional investment company (normally a private equity firm or investment bank) as the investment consultant of the fund, or conduct investments on its own. It is also common for a trust company to set up an investment committee to select portfolio companies and make investments. Investors participate in the management of the trust plan through beneficiary meetings and share in profits according to the trust plan. There is no taxation of trust profits. Instead, income tax or enterprise tax is levied at the beneficiary level. Nonetheless, due to the structure's complexity, insufficient protection to investors and beneficiaries, as well as the lack of a registration regime, the trust-type fund has not been a popular business form for fund raising in China.

²⁰⁹ Before the revision of the *PRC Company Law* 2005, *supra* note 64, it was not easy to incorporate a company in China as the minimum capital required for the Limited Liability Company and the Joint Stock Company was RMB 30,000 and RMB 5 million respectively.

²¹⁰ Before 2000, the PRC partnership enterprise was subject to taxation both at the enterprise level and upon distribution. Since 2000, the partnership enterprise has become tax transparent.

Secondly, like partnerships in most parts of the world, the Chinese limited partnership is governed by the partnership agreement. Partners can enter into covenants that align the interests of the investors and the venture capitalists particularly in the areas of compensation and management. Moreover, as compared to companies, limited partnerships enjoy a greater degree of confidentiality over their financial information – an attractive feature for investors who do not wish to disclose their investment in the funds. Limited partnerships also enjoy considerably lower formality costs as compared to companies. Further, the combination of limited liability and personal liability meets the needs of the key players in a venture capital market, especially those of the investors, who prefer to entrust their capital to experienced venture capitalists and would not want to bear unlimited liability for the debts of the partnership.

Additionally, limited partnerships enjoy tax transparency at the entity level in China. There are also a number of preferential tax policies on LPs and GPs in venture capital funds at the local level (Table 1).

Table 5: Proportion of Different Types of Business Forms used for Newly Raised Venture Capital Funds (2008-2013)²¹¹

	Limited Partnership	Company	Trust	Others	Total
2013	68.96%	24.14%	0.00%	6.90%	100%
2012	57.50%	35.00%	5.00%	2.50%	100%
2011	69.64%	28.57%	0.00%	1.79%	100%
2010	46.56%	45.80%	1.53%	6.11%	100%
2009	25.20%	67.48%	3.25%	4.07%	100%
2008	51.19%	39.29%	4.76%	4.76%	100%

In 2009, the State Council issued the Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals (Foreign Invested Partnerships, FIP) so as to allow foreign investors to use the limited partnership for the purpose of fundraising.²¹² Under this new measure, foreign venture capitalists and investors can choose to set up a foreign-invested limited partnership (“FILP”).

Prior to this, one of the popular business vehicles used by foreign venture capitalists and investors to raise funds was the Foreign-invested Venture Capital Investment Enterprise under the Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises (“FIVCIE”) 2003. Compared to the FIVCIE, the foreign invested limited partnership is subject to less procedural requirements in its establishment and operation. For

²¹¹ Source: China Venture Capital Annual Reports, published by the China Construction Pres. The sample size for the years from 2008 to 2013 is 84, 123, 131, 112, 40 and 29 respectively. The figures are collected from Zero2IPO Research Center, *China Venture Capital Annual Report*, ZERO2IPO PUBLISHER (2008 – 2013), <http://zero2ipo.com.cn/en/Research/ReportList2.aspx?ReportCategoryID=c70dc7e8-c7ca-4e11-81dc-bbfa2b2b3323>.

²¹² *Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals* [waiguo qiye huozhe geren zai zhongguo jingnei sheli hehuo qiye guanli banfa], State Council, Guowuyuanling [2009] No. 567.

example, unlike the FIVCIE which requires the fund's manager²¹³ to satisfy certain capital and experience requirements,²¹⁴ there is no such requirement under the FILP. Further, unlike the FIVCIE regime which requires the fund manager to contribute at least 1% of the total capital,²¹⁵ the fund's manager under the FILP is not required to make a minimum contribution and is allowed to contribute in the form of services. Also, FILPs can be registered and may reduce their capital without obtaining governmental approval. They are not required to make up for accumulated losses or to allocate part of their profits to a reserve fund. They enjoy flexibility in the structuring of profit distributions without reference to capital contribution. In the FILP, the Chinese partners may be designated as limited partners, while foreign investors may serve as general partners which gives them greater control over the fund.

2. Special Features of the Chinese Limited Partnership

The Chinese limited partnership model possesses the basic features of a modern limited partnership regime.²¹⁶ It is deemed to be valid from the date of issue of the partnership enterprise business license.²¹⁷ It has the right to hold assets,²¹⁸ to sue and be sued²¹⁹ and is not dissolved upon the dissociation of partners.²²⁰ There are two types of partners: general partners who are jointly and severally liable for the debts and liabilities of the firm, and limited partners who are only liable to the extent of their capital contributions.²²¹ In addition, there must be at least one expressly identified general partner who bears unlimited liability for the debts of the firm,²²² and partners can be individuals or legal persons.²²³ The Chinese limited partnership also provides the fundamental default rule on the management of the firm – a limited partner shall not “carry out partnership affairs”, while general partners have the right to conduct the day-to-day management of the firm.²²⁴

In the Chinese venture capital market, a typical venture capital fund is a fixed-life fund organized as a limited partnership, raised and managed by a professional venture capital firm comprising investment professionals. These funds are usually termed venture capital limited partnerships, and the limited partnership agreement settles issues such as the rights and obligations of partners, governance, and compensation. The venture capital firm typically

²¹³ *Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises* [waishang touzi chuangye touzi qiye guanli guiding], State Administration of Foreign Exchange (2002), Article 7.

²¹⁴ For example, under Article 7(2) of the *Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises*, *supra* note 213, the mandatory investor (i.e. the fund manager) must have managed assets to the value of at least USD 100m in the most recent 3 years before the application.

²¹⁵ *Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises*, *supra* note 213, Article 7(6).

²¹⁶ See generally ZHU & GE, *supra* note 80. The Chinese limited partnership was not intended to model any specific foreign limited partnership regime. Instead, it adopted different legal institutions and provisions from existing limited partnership regimes around the world.

²¹⁷ See *Partnership Enterprise Law of the People's Republic of China*, National People's Congress [2006] No. 55, Article 11.

²¹⁸ *Id.*, Articles 20, 21 and 22.

²¹⁹ See *Civil Procedure Law of the People's Republic of China*, National People's Congress [2007] No. 59, Article 49.

²²⁰ *Partnership Enterprise Law of the PRC*, *supra* note 217, Article 48.

²²¹ See *id.*, Article 2.

²²² *Id.*, Article 61.

²²³ *Id.*, Article 2.

²²⁴ See *id.*, Articles 2, 67 and 68.

serves as the GP and carries out the day-to-day operations of the fund's business, such as raising new funds, selecting portfolio companies, and managing and monitoring the fund's investments. Investors usually act as LPs and provide capital to the fund, and although LPs are expected to be passive in the management of the fund, the reality is very different in China (as will be discussed later).²²⁵

Beyond the above general rules regarding limited partners, the Chinese limited partnership also possesses some special features which deserve critical examination.

First, the PEL does not allow wholly state-owned companies, state-owned enterprises ("SOEs"),²²⁶ listed companies,²²⁷ charitable institutions²²⁸ and social organizations to serve as general partners in a limited partnership.²²⁹ The legislative concern is that general partners assume unlimited liability for the debts of the partnership, and allowing such entities to serve as general partners may place national assets and public funds at risk.²³⁰ There is also a great degree of uncertainty here as the PEL is silent on whether the subsidiary or branches of the listed companies or SOEs can serve as general partners,²³¹ and further complicating matters are the different regulations on the types of companies that can be considered "SOEs".²³²

Second, unlike other jurisdictions such as US-Delaware,²³³ the United Kingdom,²³⁴ and Singapore²³⁵ which do not impose an upper limit on the number of partners in the limited partnership, the Chinese limited partnership has a requirement of at least two and a maximum

²²⁵ See Part III(B)(3) in this article

²²⁶ The National People's Congress has defended this proposition on the basis that allowing state-owned companies to be general partners may trigger the stripping of state-owned assets and that allowing listed companies to be general partners may also unduly prejudice the interests of shareholders. The latter's investment in the company may then be exposed to 'double risks' in that the company will have to bear unlimited liability not only for the debts incurred by the limited partnership but also liability for its own corporate debts. See LI FEI, INTERPRETATION OF PARTNERSHIP ENTERPRISE LAW OF THE PEOPLE'S REPUBLIC OF CHINA 4 (2006).

²²⁷ However, it is arguable that the PRC's company and securities laws already provide sufficient mechanisms to protect shareholder interests. Moreover, the requirement that partners must be registered will in principle provide the means for any third party who deals with the LP to easily identify whether the listed company is a general partner in the firm. There is hence arguably no need to prevent the listed company from being a general partner.

²²⁸ The preclusion of charitable institutions and social organizations from being general partners has been justified by the National People's Congress on the ground of protecting the 'public interest'. As many activities of these organizations involve the public and publicly donated funds, it may be inappropriate to expose such organizations to potential unlimited liability.

²²⁹ *Partnership Enterprise Law of the PRC*, *supra* note 217, Article 4.

²³⁰ LI FEI, *supra* note 226 at 6.

²³¹ The practical view is that subsidiaries of a listed company can serve as general partner of a limited partnership as the listed company is only liable for its contribution in its subsidiary but does not need to bear unlimited liability for the debts of the partnership.

²³² These relevant regulations include: *Guanyu shishi shangshigongsi guoyougudong biao zhiguanli zhanxingguiding youguanwentide han* [Notice of the State-owned Assets Supervision and Administration Commission of the State Council and China Securities Regulatory Commission on Issuing the Interim Provisions on the Administration of the Marks of Listed Companies' State-owned Shareholders], Guozitingchanquan [2008] No. 80; *Guanyu huafen qiye zhuce leixing de youguan guiding* [Provisions for the Classification of Types of Enterprise Registration], Guotongzi [2011] No. 86.

²³³ See *Delaware Revised Uniform Limited Partnership Act* § 17-101.

²³⁴ Although the UK used to impose an upper limit on the number of partners, there is no longer such a limit for all types of partnerships since 2001. See *Report of the Study Team on Limited Partnerships*, ATTORNEY-GENERAL'S CHAMBERS SINGAPORE (2007),

http://www.agc.gov.sg/DATA/0/Docs/PublicationFiles/Report_of_the_Study_Team_on_Limited_Partnerships_.pdf, at para. 8.4.1.

²³⁵ *Id.*, at para. 8.4.

of fifty partners.²³⁶ The major concern of the drafters is that investors may engage in illegal fundraising if there is no upper limit on the number of investor-partners.²³⁷ However, the maximum number of partners may unduly constrain the size of the fund and is inconsistent with international practice. As such, it is suggested that the restriction on the number of partners be removed from the PEL.

Third, in contrast to the DRULPA²³⁸ that allows limited partners to contribute in kind by rendering services, limited partners of a Chinese limited partnership can only contribute in cash, tangible goods, intellectual property, land use rights or other property rights.²³⁹ The drafter of the PEL asserts that firstly, limited partners do not participate in the management of the fund and enjoy limited liability to the extent of their contribution to the firm, and hence there is no need for limited partners to contribute in services. Moreover, allowing limited partners to make contributions in kind may create difficulties in evaluating the value of their partnership shares.²⁴⁰ However, in the context of venture capital funds, the expertise and industrial experience of the limited partners are invaluable assets to the success of the fund. Indeed, valuing a service is not much more difficult (and, in fact, could be easier) than valuing an intangible like intellectual property. Therefore, practical difficulties provide an unsatisfactory rationale for a blanket rule against contributions in kind from limited partners. It is recommended that the PEL should be amended to allow limited partners to make contributions in the form of services.²⁴¹

Fourth, under the Chinese limited partnership, partners are allowed to transfer their partnership shares to outsiders (subject to various requirements).²⁴² An assignee of a general partner will become a general partner himself, and be subject to the rights and obligations in accordance with the amended agreement and the PEL.²⁴³ This stands in stark contrast to the assignee's position under U.S. law, whereby a transfer in whole or in part of a partner's transferable interest in the partnership does not entitle the transferee to participate in the management of the partnership business.²⁴⁴ Arguably, any change in general partner is likely to result in serious consequences for a limited partnership-type venture capital fund, particularly with regard to the limited partners' interests since they rely on the personal liability of the general partner when deciding to invest in the fund. Therefore, it is submitted that the PEL should not entitle the transferee, during the continuance of the partnership, to participate in the fund's management.

²³⁶ *Partnership Enterprise Law of the PRC*, *supra* note 217, Article 61.

²³⁷ See LI FEI, *supra* note 226 at 100.

²³⁸ *Delaware Revised Uniform Limited Partnership Act* §17-501.

²³⁹ *Partnership Enterprise Law of the PRC*, *supra* note 217, Article 64 read with Article 16.

²⁴⁰ LI FEI, *supra* note 226 at 105-106.

²⁴¹ Where capital contribution that takes the form of in-kind benefits, intellectual property, land use rights or any other form of property rights requires valuation, the *Partnership Enterprise Law of the PRC*, *supra* note 217, Article 16 additionally provides that all the partners may determine the value of the contribution or appoint a statutory organization to conduct the valuation.

²⁴² *Partnership Enterprise Law of the PRC*, *supra* note 217, Articles 22 and 73. A general partner must obtain the consent of all the partners before the transfer (unless otherwise provided by the partnership). A limited partner may transfer his partnership shares according to the partnership agreement; however, he is required to give 30 days' notice to the other partners before transferring his partnership shares.

²⁴³ *Partnership Enterprise Law of the PRC*, *supra* note 217, Article 24. See also LI FEI, *supra* note 226 at 37.

²⁴⁴ *Uniform Partnership Act* §503 (1997).

Fifth, the U.S. does not require newly admitted partners, whether general or limited, to be personally liable for the prior obligations of the partnership.²⁴⁵ Logically, the newly-admitted partner ought not to bear any liability for the prior debts of the firm since he was not a partner then and was not involved in any form of management of the firm. However, similar to the position in Germany²⁴⁶ and Japan,²⁴⁷ a general partner in a Chinese limited partnership will assume joint liability with the existing partners for debts incurred by the firm before he joined the firm. Correspondingly, a new limited partner will bear liability to the extent of his capital contribution even if the partnership's debts were incurred before he joined the firm.²⁴⁸ Arguably, this restriction would reduce the attractiveness of the limited partnership vehicle to the venture capitalists and investors.

Sixth, unlike the U.S.-Delaware code, the PEL does not provide any rules specifying how an existing company or partnership may convert into a limited partnership or *vice versa*. Nevertheless, there is a real practical need for venture capital limited partnerships to be able to convert into companies, because portfolio companies backed by limited partnership-type funds are not allowed to list on the stock exchange under current Chinese law.²⁴⁹ Consequently, funds must deregister as limited partnerships and re-establish themselves as companies in order to realize their exits. It is suggested that the Chinese legislature should provide a seamless process for the conversion of limited partnerships to companies.²⁵⁰ At the same time, the restrictions relating to the listing of companies backed by limited partnerships should be removed so as to provide these firms with access to the capital markets.

Lastly, another distinctive feature of the PEL is the requirement that limited partnerships must be dissolved and be converted into a general partnership in the event that the firm is left with only limited partners after the departure of all general partners.²⁵¹ Equivalent provisions are not found in its German, French and U.S. counterparts.²⁵² In view of this, it is suggested that a Chinese limited partnership with only limited partners should be allowed to continue operating as a limited partnership over a grace period so as to explore possible options and attract incoming general partners. Also, as a typical venture capital fund usually lasts for ten

²⁴⁵ See *Delaware Revised Uniform Partnership Act* §15-306 (b); *Uniform Partnership Act* §306 (1997).

²⁴⁶ *German Commercial Code* §130 provides that a new partner is liable as the other partners for partnership obligations incurred before he joined. *German Commercial Code* §173 also provides that a new limited partner shall be liable for partnership obligations incurred before he joined.

²⁴⁷ *Japanese Commercial Code*, Article 82 provides that in a corporate partnership (*Gomei Kaisha*), "a corporate member which joined the corporation after its establishment is also liable for the obligations of the corporation arising before the corporate member joined the corporation."

²⁴⁸ *Partnership Enterprise Law of the PRC*, *supra* note 217, Articles 44 and 77.

²⁴⁹ Yang Guang, *RMB Funds Change Face: A Trend of Converting Back to Companies through Increasing Capital Contributions by GP*, CHINESE VENTURE (Jun 2, 2009).

²⁵⁰ It is suggested that the draftsmen may consider Delaware's rules for the conversion process: before a certificate for 'conversion' to limited partnership can be filed with the Secretary of State, the proposal for conversion should be approved internally by the company or partnership and there should be a partnership agreement that includes seeking the approval of those who have agreed to be the general partners of the limited partnership after the conversion process. See *Delaware Revised Uniform Limited Partnership Act* §17-217.

²⁵¹ *Partnership Enterprise Law of the PRC*, *supra* note 217, Articles 24 and 75; See also LI FEI, *supra* note 226, at 122.

²⁵² For example, under the *Delaware Revised Uniform Limited Partnership Act* § 17-801, the LP will not be automatically dissolved if the sole remaining partner is either a limited partner or a general partner; instead, the Delaware LP is allowed to appoint another limited or general partner within a grace period of 90 days (or such other period as provided for in the partnership agreement).

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

3. Concluding Remarks

In summary, there is little doubt that the adoption of the limited partnership in China has contributed to a more favorable regulatory environment for the venture capital industry. However, the earlier discussion has also highlighted some special features within the Chinese limited partnership which require further legislative attention.

Moreover, empirical studies also indicate a mismatch between global standards and Chinese practices in relation to elements of private ordering, such as the prevalence of LP-activism in the control of Chinese funds and the deviation from the 2/20 compensation rule of GPs among Chinese funds²⁵³. Typically, while venture capital LPs²⁵⁴ in the U.S. are passive and do not participate in the control of the fund, LPs in Chinese funds are more active and eager to take part in the management of the fund, especially in the selection of portfolio companies.²⁵⁵ Chinese LPs participate in the management of the fund through various kinds of internal committees, and this is markedly different from a typical U.S. fund where only the GPs make decisions pertaining to the daily operation of the fund.²⁵⁶

Nonetheless, while the activism of LPs used to be prominent in Chinese funds, this phenomenon is likely to be temporary. Firstly, China's limited partnership is a relatively new business vehicle, and further, the Chinese venture capital market is young and does not possess the rich entrepreneurial experience that the U.S. market has. Many domestic funds' managers come from investment banking backgrounds without experience in the venture capital industry.²⁵⁷ There is also a shortage of experienced venture capitalists with a good track record.²⁵⁸ As such, activism by Chinese limited partners is likely to be a manifestation of their unfamiliarity with the business vehicle and the venture capitalists' unsatisfactory levels of experience. Secondly, as shown in Tables 2 & 3, institutional investors are increasingly forming a greater proportion of LPs in China. Unlike individual investors, institutional investors are more sophisticated and less risk averse, and accordingly less likely or willing to participate in the management of the fund. Arguably, the increased sophistication of the investors and the increasing number of experienced professionals who are able to advise on the negotiation of venture capital contracts will help to further align China's venture capital practice with international standards, especially in terms of contractual design and enforcement of contracts by the venture capital practitioners.

²⁵³ Lin, *The Private Equity Limited Partnership*, *supra* note 52, at 187.

²⁵⁴ In this article, the abbreviations "LP" and "GP" are used in the context of the discussion on venture capital, while the full terms "limited partner" and "general partner" are used in the context of the discussion on partnership law.

²⁵⁵ See Lin, *The Private Equity Limited Partnership*, *supra* note 52.

²⁵⁶ See *id.*

²⁵⁷ Interview with Ms K, Lawyer of the Beijing Global Law Firm, October 2015 (on file with author); see also Yang Yong Xiang & Xu Xiaocheng, *Investment and Cooperation [Touzi yu Hezuo]*, CHINA LP (Aug 6, 2008).

²⁵⁸ Interviews with Ms K, Lawyer of the Beijing Global Law Firm and Ms S, legal counsel of the Gaorong Capital, October 2015 (on file with author) and observations from the limited partnership agreements.

C. Entrepreneurs

The last essential factor for creating a national venture capital market is the availability of entrepreneurs. Gilson assumes that the supply of entrepreneurs is the “sole function” of the availability of capital and specialized financial intermediaries. On this view, by providing *funding* through the right contractual *vehicle*, government can encourage a supply of *entrepreneurs*.²⁵⁹

1. Strengthening Entrepreneurship by Policies and Tax Reliefs

First, as indicated in Appendix 2, since 1978, a large number of substantive laws were promulgated to serve the mission of the “Four Modernizations” Policy and the Strategy of Invigorating China through Science and Education. Significantly, since May 2013, the central government has issued at least 22 documents, including two fundamental opinions issued by the State Council in March 2015 to embark on the “*Mass Entrepreneurship and Innovation*” reform.²⁶⁰ This was followed by several specific measures that aimed to improve institutional mechanisms to facilitate entrepreneurship and innovation, for instance, by creating a better environment for fair competition, deepening business system reforms, strengthening intellectual property protection and establishing a mechanism for the training and hiring of talented professionals.²⁶¹ These policies resulted in the emergence of young entrepreneurs in China’s venture capital market.²⁶² It is reported that 2.3% of the university graduates of 2013 have chosen to start businesses.²⁶³ There is also an increasing number of overseas returnees (*haigui*) who start businesses with their technological knowhow, expertise and valuable overseas resources and connections. As of 2014, the number of overseas returnees stood at 1.8 million, accounting for 51.4% of China’s total overseas graduates.²⁶⁴ In an interview conducted with 913 overseas returnees, 78.4% of whom had returned after 2010,²⁶⁵ more than half of them indicated that their decision to return to China was largely based on the attractive entrepreneurial and regulatory environment,²⁶⁶ reflecting the positive effect of government policies in encouraging entrepreneurship.

Second, various tax reliefs are also provided to national scientific parts and incubators to encourage innovation.²⁶⁷ For example, under the “Notice on Issues concerning the Taxation Policy of the National University Science Park”, qualified incubators would be exempted

²⁵⁹ Gilson, *supra* note 1 at 1102-1103.

²⁶⁰ *Opinions of the State Council on Several Policies and Measures for Vigorously Advancing the Popular Entrepreneurship and Innovation*, State Council [2015] No. 32.

²⁶¹ *Id.*

²⁶² The State Council has encouraged the interest of young entrepreneurs in venture capital by promulgating the *Guidelines on Mass Entrepreneurship and Innovation*, State Council (Mar 11, 2015) and the *Opinions of the State Council on Several Policies and Measures for Vigorously Advancing the Popular Entrepreneurship and Innovation*, *id.*

²⁶³ Chen Zhengfei, *Post-90s Entrepreneurs*, JUECE.NET.CN (May 4, 2015), <http://www.juece.net.cn/content-7-1009-1.html>.

²⁶⁴ *China Overseas Returnees Entrepreneurship Report 2015 [Zhongguo Haigui Chuangye Diaocha Baogao 2015]*, CENTER FOR CHINA & GLOBALIZATION (2015). The number of overseas returnees in 2014 is 3.2% more than the number in 2013, and almost 10% more than that in 2012.

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ The 2006 *Outline of the National Program for Long- and Medium-Term Scientific and Technological Development* mentioned that “qualified science and tech incubators and National University Science Parks will be exempt from corporate tax, income tax, property tax, and urban land use tax for a specified period of time”.

from paying real estate taxes and taxes on using urban land.²⁶⁸ They would also be exempted from paying business taxes for income from renting sites and housing as well as providing incubation services to incubated companies.²⁶⁹ Such developments have caused a nationwide surge in the number of incubators, from 534 in 2005 to 896 in 2010, and then to 1500 in 2015. The number of national-level incubators has increased from 135 to 500.²⁷⁰

2. Entrepreneur-friendly Company Law Reforms

Various company law reforms to promote entrepreneurship have been recently carried out in a number of jurisdictions, including several EU states,²⁷¹ Taiwan²⁷² and Singapore.²⁷³ These reforms typically focus on updating existing corporate forms, introducing new types of private companies, reducing capital requirements and procedures for setting up companies, as well as providing more flexibility in share transfer and corporate governance.

While some may argue that company law reforms alone may not strengthen enterprises and entrepreneurship, empirical studies have found that fine-tuning regulations on companies can have a positive effect on entrepreneurship,²⁷⁴ in particular reducing the minimum capital requirement.²⁷⁵

The limited liability company is a prominent business form for portfolio companies (i.e. startup firms) in the Chinese venture capital market. In recent years, important amendments have been made to the PRC Company Law to modernize the corporate regime. Common law rules and institutions that protect investors such as piercing the corporate veil, the derivative action and fiduciary duties have been introduced in China during the comprehensive review of the Company Law in 2005.²⁷⁶

Arguably, one of the most significant company law reforms promoting entrepreneurship is the abolition of certain registered capital requirements for domestic and foreign companies in 2013.²⁷⁷ Prior to this revision, limited liability companies were required to have a minimum

²⁶⁸ Ministry of Finance and the State Administration of Taxation jointly issued a circular and notice in 2007 to the effect that real estate and land could be used for itself or offered to incubated companies for free or for a rent.

²⁶⁹ In 2013, the Ministry of Finance and the State Administration of Taxation extended the abovementioned policy to 31 December 2015. See MOF, *SAT Issue Circulars on Preferential Tax Policies for Incubators and University Science Parks 2014*, STATE ADMINISTRATION OF TAXATION NEWS RELEASE (Mar 13, 2013).

²⁷⁰ *Problems of Incubators in China* [Guonei Fuhuaqi Fazhan Shitou Xunmeng, Zijin Yali cheng Zhuyao Pingjing], CHINVENTURE (Jan 27, 2014).

²⁷¹ Mette Neville & Karsten Engsig Sorensen, *Promoting Entrepreneurship - The New Company Law Agenda*, 15(4) EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 545 (2014).

²⁷² In 2015, Taiwan introduced a new corporate form, the Closely-Held Company Limited by Shares, to provide flexibility for fund-raising for startups. See Joseph Tseng & Jacqueline Fu, *Amendment to Taiwan's Company Act Establishes 'Closely-Held Company Limited by Shares' to Provide Flexibility on Fund-Raising for Startups*, K&L GATES (Jul 27, 2015), <http://www.klgates.com/amendment-to-taiwans-company-act-establishes-closely-held-company-limited-by-shares-to-provide-flexibility-on-fund-raising-for-start-ups-07-27-2015/>.

²⁷³ Lin Lin & Michael Ewing-Chow, *The Doing Business Indicators in Minority Investor Protection: The Case of Singapore*, SINGAPORE JOURNAL OF LEGAL STUDIES (forthcoming, 2016).

²⁷⁴ See Neville & Sorensen, *supra* note 271 (there is little doubt that legislation on companies can contribute to promoting entrepreneurship).

²⁷⁵ *Id.*

²⁷⁶ Article 148 of the PRC Company Law 2005, *supra* note 64, imposes the duties of loyalty and due diligence on directors, supervisors and senior executives of a company. Article 152 of the same regulates the derivative action.

²⁷⁷ On December 28, 2013, the Standing Committee of the National People's Congress passed certain amendments to the PRC Company Law 2005, *supra* note 64, effective as of March 1, 2014.

registered capital of at least RMB 30,000 (USD 4,800).²⁷⁸ Also, domestic and foreign investors were required to contribute the first installment of registered capital within 90 days from the date of incorporation, and the remainder within two years. The amendment removes this statutory threshold. Since March 1, 2014, investors have been free to decide the amount of registered capital in their companies. Companies are no longer required to appoint an accounting firm to verify mandatory capital contributions and register the paid-in capital amount with the company registration agency, such as the local Administration of Industry and Commerce.

The newly introduced "three-in-one" business registration reform, (i.e., a "three-in-one licence and single identification number" for new enterprise), is another noteworthy improvement in the ease of starting business in China. Starting from October 1, 2015, there is no need for different government agencies to issue business certificates separately for enterprises applying for registration. The Organisation Code Certificate and Tax Registration Certificate will no longer be issued. Unified registration procedures, numbering and coding rules will be put into practice national wide.²⁷⁹

An additional important reform is the launch of a new annual reporting system in 2014.²⁸⁰ Under the new system, companies are no longer required to submit annual reports. Instead, the State Administration of Industry and Commerce or its local branches will conduct random reviews of the contents of a company's public reports. This has greatly reduced the cost and the procedures involved in setting up and doing business in China.

Lastly, the introduction of preference shares under Chinese law provides an important tool for venture capital financing as it offers venture capitalists preference in the distribution of profits and/or liquidation during the exit process from this high-risk venture capital industry.²⁸¹ Preference shares were not available in China until the State Council of China issued the Guiding Opinions on the Pilot Launch of Preference Shares on November 30, 2013.²⁸² Thereafter, the "Interim Measures for the Administration of Startup Investment Enterprises" was issued, in which Article 15 explicitly stipulates that "venture capital may make investments by way of shares, preferred shares and convertible preferred shares when provided in the agreement with venture enterprises".²⁸³ The introduction of preference shares represents an important improvement in meeting the needs of venture capitalists.

As of October 2015, there are on average 116,000 companies registered daily in China.²⁸⁴ In the first 9 months of 2015, over 3 million small businesses were registered (with a registered

²⁷⁸ PRC Company Law 2005, *supra* note 64, Article 26.

²⁷⁹ State Administration of Taxation News Release, *supra* note 269.

²⁸⁰ On February 14, 2014, the SAIC published the *Notice on Ceasing the Annual Inspection of Enterprises*, confirming the revocation of the annual inspection system of companies in China.

²⁸¹ See e.g. Andreas Bascha and Uwe Walz, *Convertible Securities and Optimal Exit Decisions in Venture Capital Finance*, 7(3) JOURNAL OF CORPORATE FINANCE 285 (2001).

²⁸² *China Launches Landmark Preference Share Pilot Program*, HOGAN LOVELLS (Jan 2014), http://www.hoganlovells.com/files/Uploads/Documents/China_Preference_Share_Pilot.pdf.

²⁸³ See ZHANG LIN, CHINA'S VENTURE CAPITAL MARKET: CURRENT LEGAL PROBLEMS AND PROSPECTIVE REFORMS 50 (2015).

²⁸⁴ Guangdong Administration of Industry and Commerce Statistics 2015 and Shenzhen Administration of Industry and Commerce Statistics 2015.

capital of RMB 20 million or below), accounting for 96.62% in the total number of new registered businesses.²⁸⁵ This increasing number of registered business in China can be attributed, to a certain extent, to fundamental changes in the domestic business environment.

3. Concluding Remarks

With supportive governmental policies and an improving regulatory environment for doing business, China's entrepreneurial culture is also evolving. A new generation of entrepreneurs – the “post-90s” generation of entrepreneurs has emerged. Unlike their parents, these second-generation entrepreneurs are more inclined to pursue their dreams through setting up their own businesses.²⁸⁶ Further, having received a good education and having grown up in the age of the Internet and the rise of China, they tend to be less afraid of failure. These young entrepreneurs are also able to adapt quickly to changes in the environment, better meeting the needs of young consumers.²⁸⁷

Nevertheless, as these second-generation entrepreneurs are still relatively new and inexperienced in the venture capital market, the future challenge would be to attract skilled venture capitalists and experienced mentors who have the necessary startup management expertise and the willingness to nurture young entrepreneurs. Indeed, interviewees have reflected that there is and will remain a gap between China and U.S. in terms of entrepreneurial culture.²⁸⁸

Despite the positive changes to the corporate regime, it is admitted that many more legislative gaps must be filled to promote the growth of entrepreneurs and entrepreneurial firms, such as enhancing the protection of intellectual property rights. Also, there is a lack of personal bankruptcy laws in China. As noted by Armour and Cumming, a liberal personal bankruptcy regime has a positive impact on the success of a venture capital market.²⁸⁹ Conversely, a stricter bankruptcy regime discourages potential entrepreneurs from taking risks and failed entrepreneurs from re-engaging in business.²⁹⁰ Given the high-risk nature of venture capital, it is crucial to provide an appropriate exit mechanism for individuals who have failed in their entrepreneurial venture. Personal bankruptcy laws should allow them to start afresh, while at the same time ensuring that creditors can obtain a fair share of the bankrupt's assets.

IV. The Role of Law and Government

The manner and extent to which a government should intervene in the market and guide economic development has been fiercely debated by state-interventionist economists and their laissez-faire counterparts. The former favors government intervention for the purpose of

²⁸⁵ State Administration of Industry and Commerce Statistics 2015.

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ See *We Are 90-Post, We Are Entrepreneur*, TENCENT INTERNET AND SOCIETY RESEARCH CENTER (2015) (exploring the entrepreneurial experience of 17 post-90s entrepreneurs).

²⁸⁹ Armour & Cumming, *supra* note 3, at subsections 5.2 and 5.4. John Armour, *Personal Insolvency Law and the Demand for Venture Capital*, 5(1) EBOR 87 (2004) (this paper argues that a nation's personal insolvency law may have an important impact on the demand for venture capital finance, with the more severe treatment of insolvents tending to reduce demand).

²⁹⁰ Armour & Cumming, *supra* note 3, at subsection 3.3.

correcting market failures and promoting the general welfare of society,²⁹¹ while the latter suggests that transactions between private parties should be free from government interference.²⁹² Nonetheless, many twentieth century law and development experts believe that neither state planners nor markets can work alone in promoting the economic development of a nation.²⁹³ Rather, “strategies must evolve and investment choices must be made through public-private partnerships and processes of iterative experimentation.”²⁹⁴

In the context of venture capital, economic theory suggests two main rationales for public intervention favoring startups and SMEs: one is the spillover hypothesis and the other is the existence of market failures.²⁹⁵ The spillover hypothesis argues that public intervention should subsidize young, entrepreneurial firms that have to spend substantial research and development (R&D) expenditure but only receive limited private returns in the early stage of their life cycles.²⁹⁶ The market failure hypothesis explains that government can rectify the market imperfections by creating and improving legal and fiscal environments to make it easier for private investors and entrepreneurs to operate (e.g. tax relief, bankruptcy process facilitating the reorganization, a stock market that facilitates SME exits).²⁹⁷

As for China and many other countries²⁹⁸ that are seeking to develop national venture capital markets, it is impossible to rely only on private ordering. It is also impossible to follow the exact path that the U.S. took due to vastly different national conditions, historical contexts, and economic environments. As acknowledged by Gilson, the government is the “natural engineer to confront the venture capital simultaneity problem” in countries other than the U.S., especially when market forces are unlikely to solve the simultaneity problem.²⁹⁹ Lerner also notes that public intervention played a crucial role in accelerating early growth in the venture capital industry.³⁰⁰ The need for active government involvement in entrepreneurship is premised on the assumed problem that the private sector provides insufficient capital to new firms and the assumed resolution to this problem that the government can identify investments with high social and/or private returns and can encourage financial intermediaries to make such investments³⁰¹. On this view, the strategic challenge for creating a venture capital market is to craft a role for the government that solves the three-factor

²⁹¹ See e.g. LUDWIG VON MISES & BETTINA BIEN GREAVES, *INTERVENTIONISM: AN ECONOMIC ANALYSIS* (2011).

²⁹² See e.g. SIDNEY FINE, *LAISSEZ FAIRE AND THE GENERAL-WELFARE STATE* (1964).

²⁹³ David M. Trubek, *Law and Development in the Twenty-first Century* in *LAW AND DEVELOPMENT IN ASIA* (Gerald Paul MacAlinn & Caslav Pejovic eds., 2012), at 2-3.

²⁹⁴ *Id.*

²⁹⁵ Marina di Giacomo, *Public Support to Entrepreneurial Firms: An Assessment of the Role of Venture Capital in the European Experience*, *The Journal of Private Equity*, Vol. 8, No. 1 (Winter 2004), pp. 22-38 at 25.

²⁹⁶ Zvi Griliches, *The Search for R&D Spillover*, *Scandinavian Journal of Economics*, 94 (1992) pp 29-47; cited in *id.*, at 25.

²⁹⁷ Lerner, Josh, *When Bureaucrats Meet Entrepreneurs: The Design of Effective Public Venture Capital Programmes*, *Economic Journal* 112 (2002), pp. F73-F84; cited in *id.*, at 25.

²⁹⁸ See Gilson, *supra* note 1, at 1097-1099. Newly-established venture capital markets, such as Israel and Chile, are consciously designed by the state and usually have a nationally-strategic role from the outset, i.e. to develop a nation's venture capital market.

²⁹⁹ *Id.*, at 1094.

³⁰⁰ LERNER, *supra* note 8, at 33-42.

³⁰¹ Josh Lerner, *When Bureaucrats Meet Entrepreneurs: the Design of Effective 'Public Venture Capital' Programs*, 112(477) *The Economic Journal* F73 (2002).

simultaneity problem while facilitating the creation of a market premised on private contracting rather than government participation in the capital allocation process.³⁰²

International experiences reveal that resolving the simultaneity problem is not an easy task. Over recent years, many governments have specifically sought to engineer a venture capital market but have encountered difficulties to varying extents. For example, the Indian government has faced challenges in ensuring the availability of capital and specialized financial intermediaries. Although venture capital fund regulations were enacted in India to encourage the funding of early-stage companies, this goal has been compromised as venture capital funds have primarily been used “as a vehicle for many other funds such as PE, real estate and private investments in public entities (PIPE)”.³⁰³ As such, the bulk of available financing goes to late stage, rather than startup companies.³⁰⁴ Further, venture capital funds in India are typically organized as trusts because the limited partnership vehicle is not available.³⁰⁵ Participants in the Indian venture capital market are thus unable to take advantage of the efficient contracting structure for specialized financial intermediaries prevalent in the U.S.

In Germany, funding remains the major issue for startups, and governmental efforts at resolving the issue have not been sufficient.³⁰⁶ Germany’s Deutsche Wagnisfinanzierungsgesellschaft (“WFG”) also proved a failure due to the heavy role of the government in the management of WFG and insufficient incentives for financial intermediaries to monitor portfolio companies.³⁰⁷

While the Singapore government has enhanced the availability of funding for startups through various schemes and introduced the limited partnership to provide a new business vehicle for venture capitalists and investors, concerns have been raised about the government’s significant role in the capital allocation process which may dampen incentives for participants in the venture capital market.³⁰⁸ There is also a “lack of a large base of entrepreneurs” due to the perceived high opportunity costs of becoming an entrepreneur in Singapore.³⁰⁹

In the context of China, as indicated in Appendix 1 and Appendix 2 and as discussed above,

³⁰² Gilson, *supra* note 1, at 1100.

³⁰³ Siddharth Raja & Chitra Raghavan, *India* in PRIVATE EQUITY IN 32 JURISDICTIONS WORLDWIDE (Casey Cogut ed., 2012), at 77.

³⁰⁴ V.R. Jyotsna Kumari, *An Analysis of Trends of Venture Capital and Private Equity Investments in India*, 12 INDIAN JOURNAL OF ECONOMICS & BUSINESS 73, 80 (2013).

³⁰⁵ Raja & Raghavan, *supra* note 298 at 74.

³⁰⁶ Martin Selter & Thomas Pruever, *Liquidity Meets Perspective: Venture Capital and Start-ups in Germany* (VC Trends Initiative by EY, 2015), at 36. See Gilson, *supra* note 1, at 1094-1097. It has been noted that the average venture capital investment in Germany stands at merely €780,000, compared to €6m in America as of 2013; see *A Slow Climb*, THE ECONOMIST (Oct 15, 2013), <http://www.economist.com/news/business/21587209-vigorous-start-up-scene-has-yet-produce-its-first-big-breakthrough-slow-climb>.

³⁰⁷ See Gilson, *supra* note 1.

³⁰⁸ Newley Purnell, *Singapore Aims to Become Southeast Asia's Silicon Valley*, THE WALL STREET JOURNAL (Feb 26, 2014), <http://www.wsj.com/articles/SB10001424052702304071004579406393779804868>.

³⁰⁹ Winston T.H. Koh, *The Venture Capital Industry in Singapore: A Comparative Study with Taiwan and Israel on the Government's Role*, NUS ENTREPRENEURSHIP CENTRE WORKING PAPERS (2005), at 25.

the government at both the central and local levels has helped to tackle the simultaneity problem in creating the venture capital market. Some success has been achieved through the following legislation and policies: (1) providing public funding through GGFs and increasing private funding through the easing of regulatory barriers towards institutional investors; (2) enhancing the availability of financial intermediaries through introducing a new and popular business vehicle – the limited partnership – for venture capital fund raising; and (3) facilitating the establishment and operation of entrepreneurial firms through supportive industrial policies, tax reliefs and revisions to the corporate regime.

Today, an underlying legal and regulatory environment conducive to venture capital development has been established. A great deal of legislation has been promulgated to facilitate the different stages in a venture capital cycle, including fund raising, investment, and exit. Based on the hierarchy of laws in China, there are: (1) national laws³¹⁰ ranging from the PRC Company Law 2005 to the PRC Partnership Enterprise Law 2006,³¹¹ (2) administrative regulations³¹² ranging from the Interim Measures for Administration of Startup Investment Enterprises 2005 (“Startup Measures”)³¹³ to the Provisions Concerning The Administration Of Foreign-Funded Venture Investment Enterprises,³¹⁴ and (3) various kinds of local regulations governing issues such as establishment of funds and tax.

In addition, the regulatory framework governing venture capital in China is evolving from one that is more stringent to one that is more liberal. The newly promulgated Interim Measures for Supervision and Administration of Private Investment Funds (“CSRC Interim Measures”) 2014³¹⁵ clarifies the regulatory responsibilities of different government agencies: the CSRC remains the key regulator of venture capital funds,³¹⁶ but certain regulatory powers of the CSRC are delegated to a self-regulatory organization – the Asset Management Association of China (“AMAC”).³¹⁷ The CSRC Interim Measures are designed to improve processes relating to the registration of fund managers and the qualified investor regime. The current stance of the CSRC on the regulation of the venture capital industry is similar to the

³¹⁰ National laws are promulgated by the National People’s Congress and its Standing Committee.

³¹¹ On 28 October 2003, the *Securities Investment Funds Law of the People’s Republic of China*, National People’s Congress [2003] Order No. 9 was promulgated, effective as of 1 June 2004.

³¹² Administrative regulations are promulgated by the State Council and the ministries under the State Council.

³¹³ *Interim Measures for Administration of Startup Investment Enterprises* [Chuangye touzi qiye guanli zhanxing banfa], National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People’s Bank of China, State Administration of Taxation, State Administration for Industry and Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission, State Administration for Foreign Exchange [2005] Order No. 39.

³¹⁴ *The Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises*, Ministry of Foreign Trade and Economic Cooperation, Ministry of Science and Technology, State Administration for Industry and Commerce, State Administration of Taxation, State Administration of Foreign Exchange [2003] No. 2 came into force on March 1, 2003.

³¹⁵ See the *Circular on Further Regulating the Development and the Administration on Filings of Equity Investment Enterprises in Pilot Regions* (2011); see also the *Circular on Promoting Regulation and Development of Equity Investment Enterprises* (2011); and the *Measures on the Registration of Private Investment Fund Managers and Filing of Private Investment Funds (for Trial Implementation)*, Asset Management Association of China (2014). The CSRC Interim Measures set forth the regulatory regime for private funds under five key topics: (i) registration and filing; (ii) qualified investors; (iii) fund raising; (iv) fund operation; and (v) special rules for venture capital funds.

³¹⁶ In June 2013, the Central Government issued the *Notice on the Division of Responsibilities of Private Equity Fund Management* [guanyu simu guquan jijin guanli zhizhe fengong de tongzhi], Zhongyang Bianbanfa [2013] No. 22, specifying that CSRC will be responsible for the supervision and administration of private equity funds.

³¹⁷ Since 2013, the NDRC has been empowered to compile policies for the development of the private equity and venture capital industry.

U.S., in the sense that the market should not be burdened by substantial mandatory regulations, but should instead be guided by voluntary guidelines and self-regulatory measures set by the industry itself.

It is expected that if local governmental authorities in China follow the guidance of the central government, China would be able to successfully solve the simultaneity problem and facilitate the creation of a venture capital market premised on private contracting rather than government participation in the capital allocation process.

V. Conclusion

China, as an experimentalist in law and development, offers an important and paradigmatic example of the engineering of a national venture capital market. While pointing out the mistakes of the government in building a market may not be difficult, it is however much less straightforward to conclusively identify and prove what has been done right. This article finds that the Chinese government has played an important role in helping the nation establish a market that has not developed on its own and has tackled the simultaneity problem with a degree of success. This finding reinforces Gilson's theory by proving that a government can indeed help to address the simultaneity problem of engineering a venture capital market.

This article has also shown that while China's venture capital market is established and led by the central government, a key reason for its relative success is the central government's efforts at adopting a more market-oriented approach towards capital allocation. This is reflected in the newly established SVCIGF, the new regulations governing the GGF, and the changing role of the central government: from a direct financial intermediary that decides how exactly capital is to be allocated to a mere facilitator and provider of capital. Other factors also evidence an increasingly market-oriented approach: the fact that private capital is the major source of venture capital (Table 2 & Table 3), the evolving regulatory framework governing the venture capital market, the predominance of the limited partnership, and the increased number of private venture capital firms, startups and entrepreneurs. By providing the legislative and institutional infrastructure of the venture capital market, the government has facilitated the increased role of market forces especially in the area of capital allocation.

Nevertheless, there is substantial room for improvement in relation to facilitating the sustainable growth of venture capital in China. Various institutional impediments within each factor, as highlighted above, may prevent the venture capital industry from realizing its true potential. Moreover, in light of China's unique party-state system and the problematic central and local government conflicts, it is difficult to ensure that local governments do not intervene in the capital allocation process at all. It is suggested that the design of the government programs should be perfected to keep such intervention to a minimum, while ensuring that the government's policy goals are still realized.

Additionally, in order to realize the full potential of the venture capital market, the next big challenge for the government is to further develop a venture capital market premised on private contracting. In this regard, one key task is to ensure the effective enforcement of the various contracts covering the entire venture capital cycle, ranging from fund raising, to the venture capital fund's investment in a portfolio company, and to the exit by which the venture capital fund's investment is realized. As the effect of private ordering in China may not be known for years to come, considerable future research will be required before meaningful suggestions can be offered.

Lastly, on top of capital, specialized financial intermediaries and entrepreneurs, an effective venture capital market also requires a wide range of complex social, legal, and economic institutions: robust stock markets, sophisticated auditing and legal professions, competent courts, effective judicial enforcement, as well as an effective reputation market. Further research must be done in these particular areas for there to be a comprehensive examination of how the relationship between the government and the free market should be balanced and how the effectiveness of contractual design should be maximized. Ultimately, it remains to be seen whether the Chinese venture capital market can replicate the success of the U.S. market in the long run.

Appendix 1: Overview of Legislative Efforts at Tackling the Simultaneity Problem in China

	Legislative efforts	Existing/Potential Problems	Suggestions
Capital	<p><u>Private capital:</u></p> <p>(1) Regulatory restrictions that prevented certain institutional investors from investing in VC funds have been gradually eased, thus broadening the investor base;</p> <p>(2) Tax incentives to attract private capital in venture capital investments;</p> <p>(3) Foreign investors were progressively permitted to make equity investments in China through various special schemes.</p> <p><u>Public capital:</u></p> <p>(1) A large number of GGFs have been set up to inject capital into the VC market, with the intention of attracting additional matching capital from the private sector;</p> <p>(2) The central government's SVCIGF scheme supports a market-oriented approach to capital allocation.</p>	<p><u>Public capital:</u></p> <p>(1) Agency problems exist in local GGFs;</p> <p>(2) Local governments' intervention in the management of the fund and allocation of capital;</p> <p>(3) Governmental guarantees of investment losses;</p> <p>(4) Complicated and problematic internal structure of local GGFs.</p>	<p><u>Public capital:</u></p> <p>(1) Regulations governing GGFs should be revised to abolish governmental guarantees of investment losses and to restrain governmental intervention in the selection of portfolio companies and funds' managers;</p> <p>(2) A well-designed appraisal and compensation system should be established to provide incentives to the fund's manager;</p> <p>(3) Continuous education of government officials on the nature and features of the VC industry.</p>

Special ized Financi al interme diaries	<p>(1) The limited partnership business vehicle was introduced to facilitate the development of the VC market;</p> <p>(2) Various foreign investment vehicles were introduced through law to attract foreign capital in venture capital investments, especially the Foreign-invested Venture Capital Investment Company, the (non-legal person) Foreign-invested Venture Capital Investment Enterprise, and foreign invested partnership.</p>	<p>(1) Regulatory problems concerning the limited partnership vehicle;</p> <p>(2) Private ordering problems for limited partnerships: LP activism and internal conflicts.</p>	<p>Addressing regulatory problems concerning the limited partnership vehicle such as by removing the maximum number of partners and providing more detailed statutory rules on partners' duties and limited partners' derivative action.</p>
Entrepr eneurs hip	<p>(1) The government has embarked on a policy of encouraging mass entrepreneurship and mass innovation through institutional measures;</p> <p>(2) The company law and securities law were revised to increase investor protection, facilitate investments, reduce the costs and improve the administrative ease of setting up new businesses and doing business;</p> <p>(3) A large number of substantive laws were promulgated or revised to facilitate the shaping of national IT and infrastructure.</p>	<p>(1) Excessive tax preference treatment is given at the local level;</p> <p>(2) There is a lack of personal bankruptcy law and a lack of dual class structure.</p> <p>(3) There is a lack of dual-class stock structure under Chinese law</p> <p>(4) IP rights are insufficiently protected</p>	<p>(1) Tax treatment at the local level should be more transparent;</p> <p>(2) A mentorship system should be put in place to guide and protect young entrepreneurs;</p> <p>(3) Personal bankruptcy law should be promulgated to ensure that honest failed entrepreneurs are protected and given a fresh start.</p> <p>(4) Considering adopting the dual-class stock structure</p> <p>(5) IP rights protection should be enhanced.</p>

**Appendix 2: Legal Developments and the Government's Role in
Developing the Venture Capital Market of China
1978-2015³¹⁸**

Dates	Law/policy	Implications for the VC market
Capital		
November 15, 2005	"Interim Measures for the Administration of Venture Capital Enterprises"(<i>chuangye touzi qiye guanli zhanxing banfa</i>) promulgated.	National and local governments could set up government-guided funds to support the establishment and development of venture capital enterprises.
February 9, 2006	"Outline of the National Medium and Long-Term Science and Technology Development Plan" (<i>guojia zhongchangqi kexue he jishu fazhan guihua gangyao</i>) (2006-2020) published.	Encouraged relevant departments and local governments to set up guidance funds to guide the venture capital fund's portfolio companies which were in the seed stage.
July 6, 2007	"Interim Measures for the Management of Venture Capital Guidance Funds which support Science and Technology-based Small and Medium Enterprises" (<i>kejixing zhongxiao qiye chuangye touzi yindao jijin guanli zhanxing banfa</i>) published.	Introduced concepts such as staged equity investment, follow-up investment, risk allowance and investment security to support independent innovation by science and technology-based SMEs.
June 5, 2008	National Social Security Fund Council officially announced that the PRC Ministry of Finance and Ministry of Human Resources and Social Security have allowed it to invest in industry funds and equity investment funds approved by the National Development and Reform Commission. The overall investment ratio will not be more than 10% of the assets of the	The National Social Security Fund Council sparked a large-scale growth in investment in equity funds, bringing about a significant increase in financing channels for local institutions and a strong rise of RMB funds.

³¹⁸ This table is not intended to be an exhaustive survey of all the legislations or policies issued since the launch of the economic reform and open-door policy of China in 1978. It only seeks to highlight the most important legal developments in relation to the development of the venture capital market in China.

	National Social Security Fund (according to the cost).	
October 18, 2008	“Guidance on the Establishment and Operation of the Venture Capital Guidance Funds” (<i>guanyu chuangye touzi yindao jijin guifan sheli yu yunzuo de zhidao yijian</i>) published.	Promoted the establishment and operation of venture capital guidance funds.
September, 2010	China Insurance Regulatory Commission issued the “Interim Measures for Equity Investment with Insurance Funds” (<i>baoxian zijin touzi guquan zhanxing banfa</i>).	Insurance funds were allowed to invest in private equity funds for the first time. The Interim Measures made provisions regarding the qualification requirements, investment targets, risk management, supervision and management of domestic equity investments by insurance funds. In August 2011, China Life Insurance became the first insurance company to obtain a license to make equity investments.
January, 2011	Shanghai City published the “Implementation Measures on the Pilot Program for Development of Foreign-invested Equity Investment Enterprises” (<i>guanyu benshi kaizhan waishang touzi guquan touzi qiye shidian gongzuo de shishi banfa</i>).	Under the pilot program, foreign-limited partners are permitted to convert their foreign currency capital into RMB in order to invest into RMB funds, i.e. funds that are raised in RMB.
February 28, 2011	Beijing Municipal People's Government published the “Interim Measures on the Administration of Equity Investment Funds and their Management Companies to make use of Foreign Investment” (<i>guanyu benshi kaizhan guquan touzi jijin jiqi guanli qiye zuohao liyong waizi gongzuo shidian de zhanxing banfa</i>).	Encouraged foreign high-quality capital to make equity investments in Beijing.
May, 2011	First batch of Qualified Foreign Limited Partner (QFLP) funds	Encouraged foreign high-quality capital to make equity investments in Chongqing.

	successfully set up under Chongqing QFLP Pilot Program.	
November 15, 2011	Tianjin City publishes “Provisional Measures on the Pilot Program for Foreign Investment Enterprises and their Management Agencies” (<i>guanyu benshi kaizhan waishang touzi guquan touzi qiye jiqi guanli jigou shidian gongzuo de zhanxing banfa</i>).	Encouraged foreign high-quality capital to make equity investments in Tianjing.
2012	Shanghai launched a new pilot program, RMB Qualified Foreign Limited Partner (RQFLP).	Permitted qualified foreign fund managers and asset management companies to raise offshore RMB from offshore investors to invest in RMB private equity funds set up in Shanghai.
July 25, 2012	China Insurance Regulatory Commission issued the “Notice on Issues Relating to Equity and Real Estate Investments by Insurance Funds”.	Expanded the scope of permissible equity investments by insurance funds to include investments in M&A funds, growth funds, and emerging strategic industry funds, but did not allow investment in angel and venture capital funds.
February, 2013	Shenzhen city issued "Operation Procedures of Pilot Program for Shenzhen Foreign Investment in Equity Investment Enterprises" (<i>shenzhenshi waishang touzi guquan touzi qiye shidian gongzuo caozuo guicheng</i>).	Encouraged high-quality foreign capital to make domestic equity investments.
February 18, 2013	China Securities Regulatory Commission promulgated the "Interim Provisions on the Management of Securities Investment Funds by Asset Management Institutions" (<i>zichan guanli jigou kaizhan gongmu zhengquan touzi jijin guanli yewu zhanxing guiding</i>).	More institutions, such as social security funds, insurance funds, and fund companies were now able to enter the equity investment industry as limited partners in Limited Partnerships. This led to continuous growth in the number of institutional investors.
August 13,	The State Council issued “Several	Clearly expanded the permissible industries

2014	Opinions of the State Council on Accelerating the Development of Modern Investment Service Industry” (<i>guowuyuan guanyu jiakuai fazhan xiandai baoxian fuwuye de ruogan yijian</i>).	for insurance companies to make equity investments.
December 15, 2014	China Insurance Regulatory Commission issued the “Notice on Issues Concerning the Investment in Venture Capital Funds by Insurance Funds” (<i>zhongguo baojianhui guanyu baoxian zijin touzi chuangye touzi jijin youguan shixiang de tongzhi</i>).	Investments by insurance companies in venture capital funds are not to exceed 2% of their total assets at the end of the previous investment season.
January 14, 2015	The State Council announced that China will be setting up the RMB 40 billion (USD 6.5 billion) State Venture Capital Investment Guidance Fund.	Provided substantial public funding and attracted private funding to the venture capital industry.
Financial Intermediaries		
July, 1994	Enactment of the first Company Law of PRC.	Provided a legal basis for the portfolio companies.
December 29, 1998	Enactment of the first Securities Law of PRC.	Provided a legal basis for the exit of private equity investors through the listing of portfolio companies on the stock exchange.
October 31, 2002	“Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises” (<i>waishang touzi chuangye touzi qiye guanli guiding</i>) was passed.	Regulated the establishment, organization and management of foreign invested enterprises.
October 27, 2005	PRC Company Law was revised.	Introduced the one-person company and revised the registration requirements for setting up a company.
October 27, 2005	PRC Securities Law was revised.	Improved investor protection.

November 15, 2005	“Interim Measures for the Administration of Venture Capital Enterprises” (<i>chuangye touzi qiye guanli zhanxing banfa</i>) was passed.	Regulated domestic venture capital enterprises and also provided tax incentives to foreign invested venture capital enterprises.
March 1, 2006	“Interim Measures for Administration of Startup Investment Enterprises 2005” (<i>chuangye touzi qiye zhanxing guiding</i>) came into force.	Regulated startup firms backed by venture capital.
May 17, 2006	“Administration of Initial Public Offerings and Listing of Shares” (<i>shouci gongkai faxing gupiao bing shangshi guanli banfa</i>) was passed.	Stipulated how portfolio companies should complete their initial public offering.
August 27, 2006	The first PRC Enterprise Bankruptcy Law was passed.	Provided a legal basis for bankrupted portfolio companies.
August 27, 2006	PRC Partnership Enterprise Law was passed on 27 August 2006, and came into force on 1 June 2007.	A significant milestone as it introduced a new business vehicle – the limited partnership. Provided the legal basis for setting up limited partnership-type funds.
March 1, 2007	Guideline Of The Trust Company Collective Funds Trust Scheme Management came into force.	Provided the legal basis for setting up a trust-type fund.
June 1, 2007	Minister of Finance and State Administration of Taxation Circular on Tax Policies Promoting Development of Venture Capital Enterprises 2007 (<i>guanyu cujin chuangye touzi qiye fazhan youguan shuishou zhengce de tongzhi</i>) came into force.	Provided tax incentives to Venture Capital Invested Enterprises (<i>chuangye touzi qiye</i>).
July 6, 2007	“Interim Measures for the Management of Scientific and Technological Small and Medium-sized Enterprise Venture Capital Guidance Funds” (<i>kejixing zhongxiao qiye chuangye touzi yindao jijin guanli zhanxing banfa</i>) came into force.	Established government-guided funds, and provided clear guidance to the fund's sources of funding, guidance, support and regulatory approach.

June 25, 2008	“Operational Guidelines for the Private Equity Investment Trust Business of Trust Companies 2008” (The China Banking Regulatory Commission, Yinjianfa 2008 No. 45) (<i>xintuo gongsi jihe zijin xintuo jihe guanli banfa</i>) came into force.	Regulated trust-type funds.
October 18, 2008	Notice Transmitted by the General Office of the State Council on the “Guiding Opinions on the Normalized Establishment and Operation of the Venture Capital Guiding Fund Made by the Departments Including the Development Reform Commission” (<i>xintuo gongsi siren guquan touzi xintuo yewu caozuo zhiyin</i>) was issued.	Provided clearer policy guidance on the operation of the funds.
November 25, 2009	Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals	Provided a new foreign-invested vehicle for foreigners
December 28, 2013	The Standing Committee of the National People’s Congress passed certain amendments to the PRC Company Law, effective on March 1 2014. These amendments relaxed registered capital requirements for domestic and foreign companies in China.	Abolished the requirement of minimum registered capital for establishing an enterprise in China.
February 7, 2014	Registration of Private Investment Fund Managers and Filing of Private Investment Funds (for Trial Implementation) 2014 by the Asset Management Association of China (“AMAC”) came into force.	Clarified the regulatory regime of the private equity industry.
September, 2015	China’s business registration system reform on integrating “three certificates into one” with unified credit codes.	Enabled a smoother registration of legal persons and organizations by integrating the registration processes for business licenses, certificates of organization codes and certificates of taxation. Also introduced a new social credit code for enterprises.
Entrepreneurship		

March, 1986	Launch and implementation of National High Technology Research and Development Program of China (863 Program).	Aimed to improve the country's independent innovation ability and to strengthen its strategic, cutting-edge and forward-looking ability, focusing on the research and development of cutting-edge technology.
August, 1988	The Torch Plan was launched.	A guiding plan for the development of China's high tech industry.
May, 1995	Decision to implement the “Strategy of Developing the Country through Science and Education” (<i>kejiao xingguo</i>).	Official recognition of the importance of science, technology and education in driving productivity.
May 4, 1998	Launch of “Project 985”.	Aimed to found world-class universities and colleges in China.
November 20, 2014	“Opinions of the State Council on Supporting the Sound Development of Micro and Small Enterprises” (<i>guowuyuan fuchi xiaoxing weixing qiye jiankang fazhan de yijian</i>) introduced.	Introduced a series of policy measures to support small and micro enterprise development through financial support, tax incentives, and the building up of an entrepreneurial system.
November 27, 2014	The State Council officially announced the “Notice of the State Council on Reviewing and Regulating Preferential Policies for Taxation and Other Aspects” (<i>guowuyuan guanyu qingli guifan shuishou deng youhui zhengce de tongzhi</i>).	Aimed to comprehensively clean up local taxes, financial subsidies and other related preferential policies to enable the market to play a decisive role in the allocation of resources.
March 2, 2015	“Opinions of the State Council on the Expansion of the Space for Mass Entrepreneurship and the Promotion of Mass Entrepreneurship” (<i>guowuyuan guanyu fazhan zhongchuang kongjian tuijin dazhong chuangxin chuangye de zhidao yijian</i>) issued.	Promoted market-orientated mass innovation.
March 23, 2015	“Several Opinions of the CPC Central Committee and the State Council on Deepening the Reform of Systems and Mechanisms to Accelerate the	Deepened reform of systems and mechanisms, and accelerated the implementation of innovation-

	Implementation of Innovation-driven Development Strategies” (<i>guanyu shenhua tizhi jizhi gaige jiakuai shishi chuangxin qudong fazhan zhuanlue de ruogan yijian</i>) issued.	driven development strategies.
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