Engineering A Venture Capital Market: Lessons from China

Lin Lin, National University of Singapore
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Abstract

This is the first article that analyzes Professor Ronald Gilson’s theory of “simultaneity” in engineering a venture capital market in the context of China. Based on both quantitative and qualitative data collected by the author, this article analyzes how China has created the fastest developing and the largest engineered venture capital market in the world within three decades. It concludes that the rise of venture capital in China is attributable to (1) increasing capital supply through various governmental programs, easing regulatory barriers towards institutional and foreign investors, providing tax incentives and improving exit environment; (2) enhancing the availability of financial intermediaries by introducing the limited partnership that creates an efficient relationship between venture capitalists and investors; and (3) encouraging entrepreneurship by improving the regulatory environment for small businesses. Through these measures, China has facilitated the simultaneous availability of capital with the appetite for high-risk, long-term investments and the emergence of a class of entrepreneurs with the skills and incentives to put that capital to work. One key factor of the rapid development of the Chinese market has been its increased reliance on market forces in allocating capital. On the other hand, a residual degree of bureaucratic allocation prevents the Chinese regime from being fully efficient. China serves as an (imperfect) model for other governments seeking to engineer a venture capital market where enfettered market forces have failed to do so.
Table of Contents

Introduction ........................................................................................................................................ 4
I. Tackling the Simultaneity Problem in China .................................................................................. 9
   A. The Difficulty Overseas ............................................................................................................. 9
   B. Capital ....................................................................................................................................... 14
      1. The Need for Venture Capital in China .................................................................................. 14
      2. Increasing Capital Supply through Government Guidance Funds ....................................... 15
      3. Increasing Capital Supply from Institutional Investors ...................................................... 18
      4. Increasing Capital Supply from Foreign Investors ............................................................... 21
      5. Tax Incentives ....................................................................................................................... 22
      6. Improving Exit Environment ................................................................................................. 24
   C. Investment Vehicle .................................................................................................................... 25
      1. Adoption of the Limited Partnership and Its Popularity ...................................................... 26
      2. Introduction of Foreign-Invested Limited Partnership ......................................................... 29
   D. Entrepreneurs ........................................................................................................................... 30
      1. Strengthening Entrepreneurship by Policies and Tax Reliefs .............................................. 30
      2. Entrepreneur-friendly Company Law Reforms ..................................................................... 32
   E. The Venture Capital Response to Governmental Actions ....................................................... 34
II. Room for Improvement and Suggestions ..................................................................................... 38
   A. Problems with Public Funding ................................................................................................. 38
   B. Problems with Investment Vehicle .......................................................................................... 47
   C. Problems with Entrepreneurs .................................................................................................. 50
III. Lessons Learned ............................................................................................................................ 52
   A. Capital ....................................................................................................................................... 53
      1. Increased domestic and foreign capital supply ....................................................................... 53
      2. Tax Incentives ....................................................................................................................... 55
      3. Active Stock Market .............................................................................................................. 56
   B. Investment Vehicle .................................................................................................................... 57
   C. Entrepreneurship ...................................................................................................................... 58
Conclusion ......................................................................................................................................... 59
Introduction

Venture capital ("VC") is widely recognized as a powerful engine that can drive a nation’s innovation, job creation, knowledge economy, and macroeconomic growth.\(^1\) As such, governments from various jurisdictions around the world, including Germany,\(^2\) Australia,\(^3\) Japan,\(^4\) Israel,\(^5\) Chile,\(^6\) Taiwan\(^7\) and Singapore,\(^8\) have all tried to promote the development of VC markets. Generally, government programs have not been especially successful.\(^9\) However, China’s efforts seem to have borne fruit. Over three decades, China has created the world’s second largest VC market in terms of annual VC investment,\(^10\) second only to the United States (U.S.). This article will explore the elements of China’s experience in engineering a national VC market, as well as concerns about its continued growth of the market.

In a groundbreaking article, Professor Ronald Gilson explained that a VC market requires three key elements to thrive: (1) providers of capital with appetites for high-risk, high-return investments; (2) specialized financial intermediaries—VC firms—that properly incentivize all participants in the VC market; and (3) entrepreneurs.\(^11\) This much is straightforward, but

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2 See Gilson, supra note 1.
5 Gilson, supra note 1, at 1068; 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 42.
6 Id.
8 LERNER, supra note 5, at 42.
9 Gilson, supra note 1, at 1070. LERNER, supra note 5, at 192.
11 Gilson, supra note 1, at 1076-1078, 1093.
as he further explained, these three elements must emerge *simultaneously*. The simultaneous emergence of all three elements is difficult to envision with or without government involvement. For example, if there is no capital available in an economy for high-risk businesses, how will entrepreneurs emerge to form such businesses, and how will intermediaries emerge to identify the best of those entrepreneurs and channel investment funds to them? Gilson refers to this as the “simultaneity problem.” He attributes the success of the U.S. VC market in solving the simultaneity problem to private ordering, explaining that the “U.S. VC market developed organically, largely without government assistance and certainly without government design.” Instead, it was the “idiosyncratic” history of the U.S. VC market that encouraged the simultaneous emergence of entrepreneurs, investors, and the right vehicles that served as the “nexus of a set of sophisticated contracts”.

This raises the question of whether it is possible for governments to successfully engineer VC markets. Most governments have tried to address the simultaneity problem by creating government programs to provide capital, encourage entrepreneurship and attract knowledgeable financial intermediaries. For the most part, however, these programs failed because they could not adequately respond to the problems inherent in VC financing: uncertainty, information asymmetry and agency cost.

China offers a fascinating case study of how a VC market can be engineered – its VC market is one of the fastest developing and largest engineered markets in the world. Before 1985,

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12 Id., at 1069, 1093.
13 See Gilson, supra note 1, at 1070.
14 Id., at 1069, 1093.
15 Id., at 1070.
VC did not exist in China. But after three decades of development, China now receives the second largest annual VC investment in the world. In 2015, 597 new VC funds were set up in China, collectively raising more than USD 30 billion of fresh capital for investment. This represented a 57.89% increase over the previous year. Additionally, there were 3,445 VC investment deals closed in 2015, an increase of 79.9% from the previous year. Total VC investments in China was USD 48.9 billion, surpassing the entirety of Europe combined. Also, of the top five VC deals worldwide in 2015, three were made in China. While the U.S. dominates global VC activity by deal quantity and value in 2015 with 3916 deals of investment valuable amount to USD 72.3 billion, two out of three top deals were China-based. VC exits were also impressive, with the amount raised from exits via IPO and M&A reaching USD 8.2 billion and USD 11.5 billion, respectively, in 2015. For context, VC exits via IPO and M&A in the U.S. raised USD 6 billion and USD 54 billion respectively in the same period. As of end-2014, VC investments contributed directly and indirectly to 9.3% of China’s GDP. These figures underline the significance of the Chinese VC market and its influence on China’s economy.

The growth of the VC market in China over the past decade is without historical precedent. In the U.K., VC investments peaked in 2007 and have remained relatively stagnant, totaling USD 4.8 billion in 2015 (0.168% of U.K.’s 2015 GDP). The value of VC investments in Germany and France amounted to USD 2.9 billion (0.086% GDP) and USD 1.9 billion

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17 See text accompanying infra note 56.
18 See Back to Reality, supra note 10, at 3, 10-12.
20 See Id.
21 See Back to Reality, supra note 10, at 3, 10-12.
22 Id., at 10.
23 Id., at 3.
24 Id., at 10.
25 Id. at 6.
28 Back to Reality, supra note 10, at 3, 10-12.
respectively in 2015.\footnote{Id., at 9.} In stark contrast, China’s VC market has maintained rapid growth since 2002, with fund raising, investments and exits reaching a record high in 2015 (0.450% GDP), as highlighted above.

In contrast to the U.S., China’s VC market did not emerge as a result of market forces alone, but was instead consciously and strategically designed by the state from the outset. Specifically, governmental policies and actions facilitated the development of the VC market in order to encourage innovation and technological development, and to stimulate structural reforms of the economy. China’s fascinating experience challenges the orthodox view that top-down governmental efforts to promote VC are likely to be unsuccessful. Moreover, China succeeded in building a VC market despite what commentators have considered weak investor protection\footnote{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).} and a lack of judicial independence,\footnote{See generally JIANFU CHEN, LEGAL INSTITUTIONS IN CHINESE LAW: CONTEXT AND TRANSFORMATION (2008), ch 4. 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).} all of which have led to doubt regarding the effectiveness of private ordering in China.\footnote{The empirical study consists of: (I) a study on a sample of fifty VC agreements. These agreements are obtained from leading law firms and VC firms, i.e. Gaorong Capital, Jieyi Capital, Shiyue Capital, Songhe Yuanwang Capital, Chengwei Capital, Hualin Securities, Beijing Fangda Law Firm, Beijing Global Law Firm, Beijing Jincheng Tongda Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm, Shenzhen Deheng Law Firm and Shenzhen Huashang Law Firm; (II) the interviews with sixty venture capitalists, legal counsels, representatives of institutional investors and entrepreneurs. The interviewees come from the six cities that are the major places of VC in China, i.e. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, and Guangzhou; (III) the study of official data published by the leading service providers, i.e. the annual reports published by the Zero2IPO Research Center, the China Venture Capital Yearbook published by China Venture Capital Research Institution, and the annual reports published by the VentureChina.cn.} The pivotal question is: How has China managed to create the second largest VC market in the world despite its immature legal infrastructure?

Based on quantitative and qualitative data,\footnote{The empirical study consists of: (I) a study on a sample of fifty VC agreements. These agreements are obtained from leading law firms and VC firms, i.e. Gaorong Capital, Jieyi Capital, Shiyue Capital, Songhe Yuanwang Capital, Chengwei Capital, Hualin Securities, Beijing Fangda Law Firm, Beijing Global Law Firm, Beijing Jincheng Tongda Law Firm, Chongqing Zhonghao Law Firm, Shanghai Yuantai Law Firm, Shenzhen Deheng Law Firm and Shenzhen Huashang Law Firm; (II) the interviews with sixty venture capitalists, legal counsels, representatives of institutional investors and entrepreneurs. The interviewees come from the six cities that are the major places of VC in China, i.e. Beijing, Shanghai, Tianjin, Shenzhen, Chongqing, and Guangzhou; (III) the study of official data published by the leading service providers, i.e. the annual reports published by the Zero2IPO Research Center, the China Venture Capital Yearbook published by China Venture Capital Research Institution, and the annual reports published by the VentureChina.cn.} this article analyzes how China has addressed the simultaneity problem. The Chinese government has helped solve the problem by laying
down the necessary legal and institutional infrastructure for a VC market, including: (1) providing public capital through various government programs, increasing private capital by easing regulatory barriers towards institutional investors and providing tax incentives and improving the exit environment; (2) enhancing the availability of financial intermediaries and fund raising by introducing the limited partnership, a new and popular business vehicle that creates an efficient relationship between venture capitalists and investors; and (3) encouraging entrepreneurship by revising the country’s corporate and securities laws and streamlining of the process of setting up a business and doing business in the nation.

The Chinese government’s role in allocating capital, however, is not without flaws. Its relative success stemmed largely from the fact that the central government has laid down the institutional and legislative infrastructure to increase the role of market force in capital allocation process. But there are institutional obstacles, including the flawed cadre appointment system and the flawed incentive mechanisms of government officials, that prevent local governments from achieving the delicate balance of allowing local government funding to operate based on market forces while concurrently pursuing the governments’ policy goals.

The lesson to be learned from the Chinese experience is that the optimal role of a government in engineering a VC market should be to provide the necessary enablers, while playing only a limited role in the capital allocation process by simply providing seed funding, while leaving specific capital allocation decisions such as selection of portfolio companies and designing investment strategies to private VC firms with the right incentives. This is a lesson that could be valuable to other countries, such as Japan\(^{34}\) and Germany\(^{35}\) that have attempted to

\(^{34}\) See Shishido, *supra* note 4.
promote the development of a VC market without significant success so far, and to other countries that are attempting to promote the formation and growth of a VC sector.

The remaining parts of this article are structured as follows. Part I examines the Chinese experience of engineering a VC market. Part II identifies the institutional impediments in China and suggests rooms for future reforms. Part III critically discusses the lessons learned from China for other jurisdictions. The last part concludes.

I. Tackling the Simultaneity Problem in China

A. The Difficulty Overseas

The key challenge for governments seeking to engineer a VC market is in ensuring the simultaneous availability of three factors—a challenge that Gilson termed the “simultaneity problem.” The first factor is investment capital. Venture capitalists provide a special type of capital for early-stage, high-growth, high-risk, often high-technology firms that need equity capital to finance product development or growth.\(^{36}\) Because of venture capitalists’ appetite for high-risk, high-return investments, and because of their managerial skills and industrial connections, venture capital plays an important role in commercializing cutting-edge science and innovation.\(^{37}\)

The second factor is the availability of specialized financial intermediaries that serve as the “nexus of a set of sophisticated contracts” and that implement an effective incentive structure in a VC cycle.\(^{38}\) There are two main contracts that place financial intermediaries at the center between sources of capital and innovative businesses. The first contract arises at the fund-
raising stage between the investor and the VC 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.\textsuperscript{39} The second contract arises between the VC fund and the portfolio company. This contract addresses the uncertainty, information asymmetry and agency costs between the VC 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.\textsuperscript{40} The interaction, or “braiding”, of the two contracts enhances the efficiency of each in terms of incentivizing exit and constraining opportunistic behavior by the VC fund against entrepreneurs.\textsuperscript{41}

The last essential factor for creating a national VC 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 \textit{funding} through the right contractual \textit{vehicle}, government can encourage a supply of \textit{entrepreneurs}.\textsuperscript{42}

International experience reveals that resolving the simultaneity problem is not an easy task. Over recent years, many governments have sought to engineer a VC market but have encountered difficulties to varying extents.

\textsuperscript{39} \textit{Id.}, at 1087-1090.
\textsuperscript{40} \textit{Id.}, at 1078-1087.
\textsuperscript{41} \textit{Id.}, at 1091-1092.
\textsuperscript{42} \textit{Id.}, at 1102-1103.
In Germany, funding remains the major issue for startups, and governmental efforts at resolving the issue have not been sufficient. Germany’s Deutsche Wagnisfinanzierungsgesellschaft (“WFG”) proved a failure due to the interference by the government – the capital allocation was determined by WFG’s board committee. It also failed to incentivize venture capitalists to choose portfolio companies as the government provided a guarantee and insured up to 75% of WFG’s losses and profits were limited by the entrepreneur’s call option. Further, WFG personnel were not incentivized to provide technological or management assistance to portfolio companies due to the restriction of profits placed on WFG. The program was also wholly funded by public funds and the lack of private participation amplified bureaucratic hubris.

The Indian government has faced challenges in ensuring the availability of capital and specialized financial intermediaries. Although VC fund regulations were enacted in India to encourage the funding of early-stage companies, this goal has been compromised as VC funds have primarily been used as a vehicle for more mature companies, rather than startup companies. Further, VC funds in India are typically organized as trusts because the limited partnership vehicle is not available. Participants in the Indian VC market are thus unable to take advantage of the efficient contracting structure for specialized financial intermediaries that is prevalent in the U.S.

43 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 VC 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.
44 See Gilson, supra note 1, at 1094-1097.
45 Id.
47 Siddharth Raja & Chitra Raghavan, India, in PRIVATE EQUITY IN 32 JURISDICTIONS WORLDWIDE (Casey Cogut ed., 2012), at 77.
48 Id., at 74.
While the Singapore government has enhanced the availability of funding for startups through various programs 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. The imposition of various eligibility requirements on the entrepreneurs, types of portfolio companies and industries may dampen incentives for participants in the VC market. ⁴⁹ There is also a “lack of a large base of entrepreneurs” due to the perceived high opportunity costs of becoming an entrepreneur in Singapore. ⁵⁰

Nevertheless, some government programs have achieved success to a certain degree, such as the Israeli Yozma ⁵¹ Program and the Chilean Corporation for the Incentive of Production (“CORFU”) Program. ⁵² These successes highlight the shortcomings of others and are consistent with the success of the Chinese government’s efforts. For example, the Israeli Yozma program did not make investment decisions and provided no guarantee against loss. ⁵³ These investments were made by highly incentivized private fund managers who bore the investment’s risk and possessed the control rights to directly monitor the portfolio companies. ⁵⁴

VC has had a much shorter history in China than in the U.S. ⁵⁵ The concept of VC was first officially introduced in China in the central government’s “Decision to Reform the Science

⁵¹ Gilson, supra note 1, at 1097-1098.
⁵² Id., at 1097-1099.
⁵³ Id., at 1097.
⁵⁴ Id.
⁵⁵ See LERNER, supra note 5, at 8. The U.S. has over 70 years of experience in VC since the 1940s.
The industry only began to emerge in the same year when the first VC firm, the China New Technology Venture Capital Company (zhongguo xinjishu chuangye touzi gongsi) was set up as a government-initiated project. Prior to that, and before the launch of the open-door policy and economic reform (gaige kaifang) in 1978, there were no private enterprises, let alone startups or VC. The Chinese VC market developed slowly and was dominated by state-owned VC firms and VC funds in the 1980s and 1990s due to the lack of a developed stock market and unfamiliarity with the new concept, as well as the limited choices of business vehicles available at that time. The market began to develop rapidly only after 1998 when Mr. Cheng Siwei, the then vice chairman of the National People’s Congress Standing Committee presented a groundbreaking “No.1 Proposal” urging the development of a VC market. After the proposal, a series of policies and laws were promulgated, including the Strategy of Invigorating China through Science and Education (kejiao xingguo) and the Law on Promoting the Transformation of Scientific and Technological Achievements.

As will be discussed below, the Chinese government has helped to tackle the simultaneity problem effectively within two decades.

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59 Limited Partnership was not available under Chinese law in this period.
61 Appendix 2 in this article.
62 Section B-E of Part I in this article.
B. Capital

1. The Need for Venture Capital in China

Today, there is a strong demand for high-risk, high return VC in China, with the increased number of small businesses and the improved innovation and IT infrastructure. In the first 9 months of 2015, over 3 million small businesses were registered, accounting for 96.62% in the total number of new registered businesses. 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. Beijing has become Asia's largest hub for entrepreneurship.

However, the growth of startups and small and medium size firms (“SME”) 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 meeting the stringent listing requirements set by the two Main Boards.

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. Statistics show that among 56 million micro and small enterprises in China’s industrial and commercial areas, only 11.9% are able

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63 State Administration of Industry and Commerce Statistics 2015.
64 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.
66 Supra note 58, at 17.
67 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).
to obtain loans from banks.\textsuperscript{68} Further, they receive less than 25% of the loans extended by state-owned commercial banks.\textsuperscript{69} Such problems with securing debt financing are exacerbated for startups, which typically have insufficient collateral to offer as security. This inadvertently contributed to a high demand for VC as an important means of startup financing.

In addition, China’s Gross Domestic Product (\textquotedblleft GDP\textquotedblright) growth rate fell from 10.4\% in 2010 to 7.3\% in 2014,\textsuperscript{70} with traditional economic sectors such as manufacturing and real estate showing signs of weakening.\textsuperscript{71} 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.\textsuperscript{72} 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. Developing a national VC market is therefore high on the agenda of the Chinese government.

2. Increasing Capital Supply through Government Guidance Funds

Funds for VC investment can be divided into two types depending on their source: government funding\textsuperscript{73} and private funding. Government funding has been recognized as one of the most important sources of funding for fueling entrepreneurship across countries, after


\textsuperscript{69} Id.

\textsuperscript{70} GDP Growth (Annual %), \textit{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.


\textsuperscript{73} In this article, government funding typically refers to the capital provided by central and local governments from their budgets.
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. Recent examples include New Zealand’s Venture Investment Fund (“NZVIF”), and Singapore’s Early Stage Venture Fund (“ESVF”) program.

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

The size of the government program is important to VC 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 private funding and obstruct market forces in the allocation of start-up financing. Also, small firms typically face great difficulties in raising capital, due to information asymmetry between entrepreneurs and investors. Government funds are advantageous as they have an “add-on effect” in raising capital. With proper structuring, investors are willing to invest in such funds once government investors have taken the lead.

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75 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).

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

77 See 2008 Venture Capital Fund Specifications and Operational Guide.

78 LERNER, supra note 5, at 117-119.

79 Id., at 69.

80 Id., at 70.
As shown in Figure 1 and Table 1, 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 was more pronounced in rural areas, where GGFs were so lacking in size that they could not play effective roles in guiding capital flow to startups.\textsuperscript{81}

To resolve this problem, there has been a new wave of GGFs established at both the central and local levels since 2015. As can be seen from Figure 1, 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 amount raised in 2014.\textsuperscript{82} As of the end of 2015, there were 780 GGFs in China, managing RMB 2183.447 billion.\textsuperscript{83}

Significantly, at the central government level, 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”) (\textit{guojia xinxingchanye chuangyetouzi yindao jijin}) to support startups in emerging industries and foster innovation.\textsuperscript{84} The State Council also announced the establishment of a National SME Development Fund (\textit{guojia zhongxiao qiye fazhan jijin}) with 60 billion RMB to promote the development of SMEs. These two national funds, together with a number of local GGFs are likely to leverage on government funding to attract private investors to participate in the funds.\textsuperscript{85}

\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Id.
\textsuperscript{85} See Zero2ipo, supra note 81.
3. Increasing Capital Supply from Institutional Investors

Institutional investors such as commercial banks, insurance companies, trust companies and pension funds have long been prohibited from making equity investments due to policy constraints under previous regulations. This has contributed to a predominance of wealthy individuals and families in the VC market, as discussed below.

Recognizing the importance of institutional investors as a source of investable capital in long-term and high-risk investments, and in light of recent success stories in Israel and Singapore, which have had attracted global investors to their VC industries, China’s regulators have made efforts to promote VC investment from qualified institutional investors and foreign investors.

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87 See Appendix 2 of this article.
88 LERNER, supra note 5, at 101.
Regulators, notably the China Securities Regulatory Commission ("CSRC"), China Insurance Regulatory Commission ("CIRC") and China Banking Regulatory Commission ("CBRC"), have since 2008 begun to remove restrictions preventing the National Social Security Fund ("NSSF"), insurance companies, commercial banks, investment funds and trust companies from making equity investments.\(^8\) For example, after the CIRC issued a set of guidelines allowing insurance companies to engage in VC investments, insurance companies have quickly built up substantial assets in the VC industry, reaching RMB 10 billion at end 2014.\(^9\) There is also a substantial increase in investments by the NSSF. As of the end of 2015, NSSF managed RMB1508.592 billion (USD 226.94 billion) and recorded a 15.14% return with RMB 228.704 billion (USD 34.40 billion) on investment in 2015.\(^1\) According to the Regulations on NSSF, 10% of the total managed asset of NSSF can be used in private equity (including VC) investments.\(^2\)

With the easing of regulatory barriers for institutional investors, the distribution of investors is shifting. Major institutional investors such as public pension funds, investment companies and insurance companies are gradually becoming important limited partners (LPs) in the market.

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8 Since 2008, the NSSF has been permitted to make equity investments in certain funds. Since 2010, insurance companies were allowed to make equity. Since 2014, insurance companies were permitted to make investments in VC funds. See Appendix 2 of this article.
Table 1: Percentage Of Capital Raised By LPs in China’s Venture Capital and Private Equity Market (By Investable Amount) (2011-2015)  

<table>
<thead>
<tr>
<th></th>
<th>2011(%)</th>
<th>2012(%)</th>
<th>2013(%)</th>
<th>2014(%)</th>
<th>2015(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed companies</td>
<td>28.7</td>
<td>26.3</td>
<td>26.3</td>
<td>25.0</td>
<td>24.5</td>
</tr>
<tr>
<td>Public pension funds</td>
<td>20.4</td>
<td>20.7</td>
<td>20.3</td>
<td>19.2</td>
<td>17.8</td>
</tr>
<tr>
<td>Sovereign wealth funds</td>
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<td>19.1</td>
<td>18.7</td>
<td>17.5</td>
<td>16.0</td>
</tr>
<tr>
<td>Enterprises</td>
<td>3.5</td>
<td>3.4</td>
<td>3.6</td>
<td>4.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>5.9</td>
<td>6.4</td>
<td>6.3</td>
<td>6.1</td>
<td>5.6</td>
</tr>
<tr>
<td>Investment companies</td>
<td>2.8</td>
<td>4.0</td>
<td>4.1</td>
<td>4.5</td>
<td>4.7</td>
</tr>
<tr>
<td>VC/PE institutions</td>
<td>3.7</td>
<td>3.2</td>
<td>3.3</td>
<td>3.8</td>
<td>3.8</td>
</tr>
<tr>
<td>Enterprise annuity fund</td>
<td>4.3</td>
<td>4.1</td>
<td>4.0</td>
<td>3.7</td>
<td>3.4</td>
</tr>
<tr>
<td>Governmental agencies</td>
<td>0.4</td>
<td>0.9</td>
<td>1.0</td>
<td>3.4</td>
<td>5.9</td>
</tr>
<tr>
<td>Wealthy families and individuals</td>
<td>0.7</td>
<td>1.1</td>
<td>1.3</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>Private family funds</td>
<td>1.4</td>
<td>1.4</td>
<td>1.3</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Trusts</td>
<td>3.8</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Banks</td>
<td>3.0</td>
<td>2.9</td>
<td>2.8</td>
<td>4.0</td>
<td></td>
</tr>
<tr>
<td>Asset management companies</td>
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<td>2.3</td>
<td>2.3</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Government-guided funds</td>
<td>1.8</td>
<td>2.1</td>
<td>2.1</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
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<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Insurance institutions</td>
<td>1.1</td>
<td>1.0</td>
<td>1.1</td>
<td>1.1</td>
<td>1.1</td>
</tr>
<tr>
<td>University endowment funds</td>
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<td>0.7</td>
<td>0.7</td>
<td>0.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Others</td>
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<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
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<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>2011(%)</th>
<th>2012(%)</th>
<th>2013(%)</th>
<th>2014(%)</th>
<th>2015(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wealthy families and individuals</td>
<td>46.1</td>
<td>50.2</td>
<td>50.8</td>
<td>54.4</td>
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<tr>
<td>Enterprises</td>
<td>19.5</td>
<td>17.2</td>
<td>16.6</td>
<td>14.9</td>
<td>14.6</td>
</tr>
<tr>
<td>VC/PE institutions</td>
<td>7.0</td>
<td>6.3</td>
<td>6.3</td>
<td>6.2</td>
<td>6.2</td>
</tr>
<tr>
<td>Investment companies</td>
<td>4.7</td>
<td>5.9</td>
<td>6.1</td>
<td>8.5</td>
<td>9.4</td>
</tr>
<tr>
<td>Government-guided funds</td>
<td>3.7</td>
<td>2.8</td>
<td>2.7</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Listed companies</td>
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<td>4.3</td>
<td>4.2</td>
<td>3.9</td>
<td>4.7</td>
</tr>
</tbody>
</table>

93 Source: Zero2IPO Research Center, Annual Reports of LPs in China.
94 Id.
95 Source: Zero2IPO Research Center, Annual Reports of LPs in China.
96 Enterprises exclude listed companies.
<table>
<thead>
<tr>
<th>Asset management companies</th>
<th>3.1</th>
<th>2.3</th>
<th>2.1</th>
<th>1.7</th>
<th>1.7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governmental agencies</td>
<td>3.0</td>
<td>3.2</td>
<td>3.9</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>Trusts</td>
<td>3.6</td>
<td>0.6</td>
<td>0.7</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Banks</td>
<td>1.3</td>
<td>1.1</td>
<td>0.8</td>
<td>0.7</td>
<td></td>
</tr>
<tr>
<td>Public pension funds</td>
<td>1.9</td>
<td>1.3</td>
<td>1.1</td>
<td>0.8</td>
<td>0.7</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>1.8</td>
<td>1.5</td>
<td>1.5</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>University endowment funds</td>
<td>1.0</td>
<td>0.5</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Insurance institutions</td>
<td>0.6</td>
<td>0.6</td>
<td>0.6</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Private family funds</td>
<td>0.5</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Sovereign wealth funds</td>
<td>0.4</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Enterprise annuity fund</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Endowment funds</td>
<td>--</td>
<td>0.3</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Others</td>
<td>--</td>
<td>1.0</td>
<td>1.0</td>
<td>0.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Table 3: Percentage Of Capital Raised in the U.S. Venture Capital Market

(By Amount)

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

4. Increasing Capital Supply from Foreign Investors

Since 1995, China has promulgated regulations aimed at promoting the establishment of foreign funds. For example, the *Administrative Measures on Foreign-Established Industry Investment Funds* allows Chinese firms to raise funding overseas together with foreign investors.

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firms, \textsuperscript{98} and the \textit{Regulations on the Administration of Foreign Invested Venture Capital Enterprises} allowed foreigners intending to invest in the Chinese market to do so by setting up a Foreign Invested Venture Capital Enterprise ("FIVCIE").

Since 2011, Shanghai, Beijing, Tianjin, Chongqing and Shenzhen have promulgated regional Qualified Foreign Limited Partner ("QFLP") programs to attract foreign qualified institutional investors to make equity investments in their regions. Under the QFLP, foreign-invested funds and fund management companies are permitted to convert their foreign currency capital into RMB in order to invest into RMB funds. In 2012, the Renminbi Qualified Foreign Limited Partner ("RQFLP") program was launched by Shanghai to broaden the scope of foreign investors eligible to make VC investments. Under RQFLP, qualified foreign fund managers are permitted to raise offshore RMB from offshore investors to invest in RMB funds set up in Shanghai.

5. Tax Incentives

A favorable tax environment is an important factor in increasing the supply of private capital in a VC market.\textsuperscript{99} Many local Chinese governments have implemented preferential tax policies for VC firms that serve as the general partners (GPs), and for their investors who serve as the limited partners (LPs) in VC funds (see Table 4).\textsuperscript{100}

Today, individuals and families form the majority of LPs (by number) in the market. As of 2015, 53\% of the number of LPs in China are wealthy individuals and families,\textsuperscript{101} 14.6\% are private enterprises and 9.4\% are investment companies (Table 2). As of 2014, China had the

\textsuperscript{98} Promulgated on September 6, 1995, People’s Bank of China.
\textsuperscript{99} John Armour & Douglas Cumming, \textit{The Legislative Road to Silicon Valley}, 58 OX. ECON. PAPERS 598 (2006), at section 4, 5.2.
\textsuperscript{101} The number of wealthy individual and families is big while the fund size they raise is small (1.6\% in year 2015, see Table 2).
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. Further, the majority of leading VC firms are also private firms and foreign firms. There is also a growing number of VC funds set up by non-state owned companies, including Chinese internet giants Tencent and Alibaba. Interviewees have stated that these tax incentives have greatly increased their interests in making VC investments.

Table 4: Tax Rules For Private Equity/VC Funds At Selected Locations In China

<table>
<thead>
<tr>
<th>Region</th>
<th>Tax Regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beijing</td>
<td>GPs and LPs pay individual income tax at a rate of 20%.</td>
</tr>
<tr>
<td>Tianjin</td>
<td>Individual 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.</td>
</tr>
<tr>
<td>Shanghai</td>
<td>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.</td>
</tr>
<tr>
<td>Chongqing</td>
<td>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%.</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>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%.</td>
</tr>
</tbody>
</table>

104 See Ernst & Young, supra note 74, at 20.
105 Tentent and Alibaba are two top Chinese e-commerce companies.
106 Interview with Ms. S (anonymity requested), Vice President, Beijing X Capital Co, July 13 2016 (on file with author).
107 Gui Jieying, supra note 100.
108 The private equity funds in this table also include VC funds.
6. Improving Exit Environment

The establishment of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) in 1990 offered new exit channels for VC investments. Before that, VC-backed firms were unable to exit via IPOs. In October 2009, the exit environment was further improved by the launch of a new NASDAQ-like secondary board – ChiNext. The ChiNext provides more relaxed listing requirements as compared to the two main boards, i.e. the SSE and SZSE. The launch of ChiNext has indeed facilitated VC-backed exits. In the five-year span after ChiNext’s launch, 519 exits were made via ChiNext, with a market return of RMB 743.4 billion. As of October 23, 2014, 519 companies that were backed by VC/private equity were listed on ChiNext.

In 2013, the nation-wide expansion of the National Equities Exchange and Quotation (“NEEQ”) system (also known as the “New Third Board”) also provided an important exit vehicle for VC-backed firms. Unlike the Main Boards and ChiNext, all of which employ the merits-based approval system for IPOs, the NEEQ uses the filing system, under which board listings are not subject to CSRC approvals. Such a filing system involves largely reduced listing costs for the applicants. Moreover, the relatively low listing requirements and shorter listing timelines have greatly expedited financing for SMEs and startups, especially for the companies that were unable to meet the listing standards of the Main Board or ChiNext. In the year 2015 alone, 929 VC-backed companies were quoted on the NEEQ, accounting for 51.2% of the total exit vehicles in 2015.

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109 Supra note 66.
110 Ibid.
112 See further information on the correlation between the stock market and the VC market in China, supra note 66. The regulatory environment driven by an efficient stock market has a significant impact on the VC market, particularly when it comes to VC availability.
C. Investment Vehicle

In order to create the right incentives for investment in attractive technologies and businesses, a business vehicle that appropriately allocates legal rights and obligations must be available. The limited partnership has been the predominant vehicle for collecting investment funds in the U.S. since the 1970s. The limited partnership, managed by a venture capital firm, collects and holds funds for future investment and the shares of startups in which it has invested. In recent years, a number of jurisdictions such as Singapore, New Zealand, Taiwan, Japan and Switzerland 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 Kingdom and Australia, have also recently amended their limited partnership regimes in order to encourage the growth of VC investment.

The central concept characterizing the limited partnership is that there are two types of partners. LPs who make capital contributions to the firm enjoy a limited liability shield and have no right to participate in its management. GPs have the right to manage the firm and bear unlimited liability for the debts and obligation of the firm. The combination of limited liability and general liability, and the prohibition of LPs to take part in the management of the firm, is particularly attractive to investors who want to delegate management of their funds to

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113 See LERNER, supra note 5, at 10.
114 The Singapore Limited Partnerships Act 2008 (Cap 163B) came into operation on May 4, 2009.
116 Taiwan Limited Partnership Law was passed on 27 June 2007.
117 In 1999, the National Diet of Japan passed the Limited Partnership for Investment Act.
119 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) in June 2009.
120 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 VC LPs and Australian VC funds. See Government to Make Further Improvements to the Tax System, MINISTER FOR REVENUE AND THE ASSISTANT TREASURER MEDIA RELEASE (Mar 29, 2007).
professional venture capitalists. The limited partnership is governed by a partnership agreement that offers flexibility for the partners to customize terms to align the interests of the investors and the venture capitalists.

Further, 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. Limited partnerships also generally enjoy considerably lower formality costs as compared to corporations, as well as pass-through tax treatment.

1. Adoption of the Limited Partnership and Its Popularity

Recognizing the importance of limited partnerships to venture capital, the Chinese legislature has also introduced this new business vehicle in China under the revised Partnership Enterprise Law (“PEL”). The adoption 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), which identified the promotion of VC investment as a critical element for achieving “independent innovation” and sustainable economic progress.

Shortly after the enactment of the revised PEL, the first Chinese limited partnership was set up on 27 June 2007. Today, the limited partnership has become the most popular business vehicle among newly raised VC funds in China (see Table 5 below).

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122 It must be noted that when the GP is organized as a corporation, the issue of unlimited liability has effectively been sidestepped.
124 The law was promulgated in 2006 and came into effect on June 1, 2007.
125 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.
126 See supra note 123.
127 The First Venture Capital Limited Partnership was Established, SHANGHAI SECURITIES NEWS (Jun 29, 2007).
Consistent with the benefits of limited partnerships elsewhere in the world, Chinese limited partnership regime also have two types of partners: GPs who are jointly and severally liable for the debts and liabilities of the firm, and LPs who are only liable to the extent of their capital contributions. LPs are not permitted to “carry out partnership affairs”, while GPs have the right to conduct the day-to-day management of the firm. The PEL also provides a “safe-harbor” list of the activities in which LPs may engage without being viewed as “carrying out the partnership affairs”, in order to assist LPs in demarcating the legitimate scope of their participation in the firm’s activities.

In addition, the Chinese limited partnership provides an efficient contract between the GP and the LPs. First, in contrast to England and Singapore which adopt the aggregate approach towards limited partnership and do not consider the limited partnership as a separate legal entity, the Chinese regime does possess entity features and have certain attributes which are consistent with separate legal personality such as the right to hold assets, to sue and be sued. Furthermore, the limited partnership is not dissolved upon the dissociation of partners, and a creditor’s recourse against the GP is postponed until he has exhausted his remedies against partnership assets. The entity approach adopted by the Chinese law helps to facilitate the continuity of the limited partnership. Second, apart from allowing limited partnerships to enjoy pass-through tax treatment at the entity level in China, there are also a number of preferential tax policies for LPs and GPs in VC funds provided by the local governments (Table 4).

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128 See Partnership Enterprise Law of the PRC, Article 2.
129 See id., Articles 2, 67 and 68.
130 See id., Article 68.
131 See generally ZHU & GE supra note 57.
133 Supra at note 128, Articles 20, 21 and 22.
Prior to the introduction of limited partnership, the major business forms for domestic venture capitalists to raise funds were the Limited Liability Company (“LLC”), the Joint Stock Company (“JSC”), the general partnership and trust. These types of entities had disadvantages that discouraged investment. LLCs and JSCs faced double tax treatment, substantial formation costs and substantial financial disclosure requirements, while general partnerships gave rise to unlimited liability for all partners and a similarly harsh tax burden. As to the trust-type fund, although it also enjoys pass-through tax treatment, due to the complex structure, insufficient protection to investors, as well as the lack of registration regime, it has not been a popular business form for fund raising in China.

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

<table>
<thead>
<tr>
<th></th>
<th>Limited Partnership</th>
<th>Company</th>
<th>Trust</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>68.96%</td>
<td>24.14%</td>
<td>0.00%</td>
<td>6.90%</td>
<td>100%</td>
</tr>
<tr>
<td>2012</td>
<td>57.50%</td>
<td>35.00%</td>
<td>5.00%</td>
<td>2.50%</td>
<td>100%</td>
</tr>
<tr>
<td>2011</td>
<td>69.64%</td>
<td>28.57%</td>
<td>0.00%</td>
<td>1.79%</td>
<td>100%</td>
</tr>
<tr>
<td>2010</td>
<td>46.56%</td>
<td>45.80%</td>
<td>1.53%</td>
<td>6.11%</td>
<td>100%</td>
</tr>
<tr>
<td>2009</td>
<td>25.20%</td>
<td>67.48%</td>
<td>3.25%</td>
<td>4.07%</td>
<td>100%</td>
</tr>
</tbody>
</table>

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

137 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.


139 For example, in contrast with GPs, trustee companies do not bear unlimited liability. It only bears limited liability in specific situations, such as illegal activities or breach of the trust agreement, while bearing no liability for any failures under ordinary operating situations. As such, the accountability of the trustee company towards the fund is limited.

140 For example, under Article 27 of the Trustee Company Management Guideline, trustee company does not need to engage in the registration of the trust. As the trust regime lacks a compulsory public registry, the identity of the beneficiaries cannot be determined and this becomes an obstacle when the portfolio company of the trust-type VC fund wants to conduct an IPO in China.


142 “Others” mainly refer to the contractual type - VC funds.
2. Introduction of Foreign-Invested Limited Partnership

To allow foreign investors to use the limited partnership in raising funds, the State Council issued a new measure to allow foreign venture capitalists and investors to set up a foreign invested limited partnership (FILP). It offers a new business vehicle for foreigners to raise VC funds in China.

Prior to this, one of the popular business vehicles used by foreigners to raise funds was the FIVCIE. As stated above, the FIVCIE was an important legal innovation in its time, but it had flaws. Compared to the FIVCIE, the FILP is subject to fewer procedural requirements in its establishment and operation. For example, unlike the FIVCIE which requires the fund’s manager to satisfy certain capital and experience requirements, 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, 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 LPs, while foreign investors may serve as GPs, giving them greater control over the fund.

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143 Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals, St. Council Gaz. 2009 No. 567.
144 The Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises, [2003] No. 2.
145 See text accompanying supra note 98.
146 Id., Article 7.
147 Id., Article 7(2) provides that 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.
148 Id., Article 7(6).
D. Entrepreneurs

The last essential factor for creating a VC market is the availability of entrepreneurs. This presents a “chicken and egg” challenge. Without entrepreneurs there will be no capital to fund them, and without capital to fund them, there will be no entrepreneurs — even if individuals with the requisite qualities are available.

1. Strengthening Entrepreneurship by Policies and Tax Reliefs

First, as indicated in Appendix 2, since 1978, a large number of substantive laws and policies were promulgated to serve the mission of the “Four Modernizations” Policy and the “Strategy of Invigorating China through Science and Education” (ke jiao xing guo). Since May 2013, the central government has issued at least 22 documents, including two fundamental opinions issued by the State Council to embark on the “Mass Entrepreneurship and Innovation” reform. This was followed by several specific measures that aimed to improve institutional mechanisms to facilitate entrepreneurship and innovation, for instance, by deepening business system reforms, strengthening intellectual property protection and establishing a mechanism for the training and hiring of talented professionals.

These policies resulted in the emergence of young entrepreneurs in China’s VC market. It is reported that 2.3% of the university graduates of 2013 have chosen to start businesses. There are also an increasing number of overseas returnees (haigui) who have started businesses with their technological knowhow and overseas resources. As of 2014, the number

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


151 Id.

152 The State Council has encouraged young entrepreneurs 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.

153 Chen Zhengfei, Post-90s Entrepreneurs, JUECE.NET.CN (May 4, 2015), http://www.juece.net.cn/content-7-1009-1.html.
of overseas returnees stood at 1.8 million, accounting for 51.4% of total overseas graduates. In an interview conducted with 913 overseas returnees, 78.4% of whom had returned after 2010, and more than half of them indicated that their decisions to return to China was largely based on the attractive entrepreneurial environment, reflecting the positive effect of government policies in encouraging entrepreneurship.

Second, various forms of tax relief have been provided to national scientific parks and incubators to encourage innovation. For example, qualified incubators are exempted from paying real estate taxes and taxes on using urban land. They are also exempted from business taxes for income received from renting work sites, housing, and incubation services provided to incubated companies. 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. As of March 2015, there were more than 1,600 incubators supporting more than 80,000 startups. 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 authorized.

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154 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.
155 Id.
156 Id.
157 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”.
158 Under the Notice on Issues concerning the Taxation Policy of the National University Science Park 2007, real estate and land could be used for itself or offered to incubated companies for free or for a rent.
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,\(^{163}\) Taiwan\(^ {164}\) and Singapore.\(^ {165}\) 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,\(^ {166}\) in particular reducing the minimum capital requirement.\(^ {167}\)

The LLC is a prominent business form for portfolio companies (i.e. startup firms) in the Chinese VC market. In recent years, important amendments have been made to the PRC Company Law to modernize the corporate regime, to reduce the costs in setting up a business, and to facilitate the development of VC.

First, one of the most significant company law reforms is the abolition of certain registered capital requirements for domestic and foreign companies in 2013.\(^ {168}\) Prior to this revision, LLCs were required to have a minimum registered capital of at least RMB 30,000 (USD


\(^{166}\) See Neville & Sorensen, *supra* note 163 (there is little doubt that legislation on companies can contribute to promoting entrepreneurship).

\(^{167}\) *Id.*

\(^{168}\) On December 28, 2013, the Standing Committee of the National People's Congress passed certain amendments to the PRC Company Law 2005, effective as of March 1, 2014.
4,800). 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.

Second, the newly introduced “three-in-one” business registration reform 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. Unified registration procedures, numbering and coding rules have been put into practice national wide.

Third, an additional important reform is the launch of a new annual reporting system in 2014. Under the new system, companies are no longer required to submit annual reports. Instead, the regulator will conduct random reviews of the contents of a company's public reports.

These initiatives have greatly reduced the cost and the procedures involved in setting up and doing business. China’s ranking on the World Bank’s Ease of Doing Business Index has also been gradually increased from No. 99 in 2013 to No. 84 in 2016.

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170 State Administration of Taxation News Release, supra note 159.  
171 On February 14, 2014, the SAIC published the Notice on Ceasing the Annual Inspection of Enterprises.  
As of October 2015, there are on average 116,000 companies registered daily in China. From January to September 2015, 3.16 million new companies were registered, a 19.3% rise from the same period the previous year. This increasing number of registered business can be attributed, to a certain extent, to fundamental changes in the domestic business regulatory environment.

E. The Venture Capital Response to Governmental Actions

As discussed in this part, the Chinese government at both the central and local levels has helped to tackle the simultaneity problem by establishing legislative and institutional infrastructure conducive to VC development. A significant amount of legislation has been promulgated to facilitate the different stages of the VC cycle, including fund raising, investment, and exit. Specifically, and with reference to the hierarchy of laws, there have been: (1) national laws ranging from the Company Law to the Partnership Enterprise Law; (2) administrative regulations ranging from the Interim Measures for Administration of Startup Investment Enterprises to the newly promulgated Interim Measures for Supervision and Administration of Private Investment Funds; and (3) various kinds of local regulations governing issues such as establishment of funds and tax.

In particular, the above legislation and policies have contributed to the effective engineering

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175 See also Appendix 1 and Appendix 2 in this article.
176 National laws are promulgated by the National People’s Congress and its Standing Committee.
178 Administrative regulations are promulgated by the State Council and the ministries under the State Council.
179 Interim Measures for Administration of Startup Investment Enterprises [Chuangye touzi qiye guanli zhanxing banfa], 2005 ST. COUNCIL GAZ. 39.
180 See the Circular on Further Regulating the Development and the Administration on Filings of Equity Investment Enterprises in Pilot Regions (2011); 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) (2014).
of China’s VC framework: (1) providing public funding through GGFs and increasing private funding through the easing of regulatory barriers towards institutional investors and foreign investors; (2) enhancing the availability of financial intermediaries through introducing a new and popular business vehicle – the limited partnership – for VC fund raising; and (3) facilitating the establishment and operation of entrepreneurial firms through supportive industrial policies, tax reliefs and revisions to the corporate regime.

As Figure 2 and Figure 3 demonstrate, from 2002 to 2015, China’s VC market has experienced steady growth in the total amount of funds raised. Figure 2 provides a timeline for the development of the market and illustrates how the development of the VC market is largely influenced by regulatory policies and laws. For example, 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. As explained above, this VC boom can be attributed to the launch of a new NASDAQ-like secondary board – ChiNext, new measures allowing more institutional investors and foreign investors to make equity investments,\(^{181}\) as well as the substantial increase in investments by the NSSF (of more than RMB 6 billion). Also, although the suspension of the IPO process by CSRC from November 2012 to January 2014 negatively affected fund-raising in both 2012 and 2013, the 2013 nation-wide expansion of the NEEQ system, which offered a new exit channel of the VC-backed companies, was followed by a sharp increase in new VC commitments.

Further, with regard to investor composition, although the Chinese market was dominated by state-owned VC firms and funds in the 1980s and 1990s, it has also seen a rapid emergence

\(^{181}\) See Appendix 2 in this article.
of private firms and funds. Today the majority of leading VC firms in China are private and foreign ones.\textsuperscript{182} Private funding coming primarily from listed companies and investment companies has become a major source capital to the VC market in China (see Table 1). Although their average investment is smaller, private individual and families form the majority of investors.\textsuperscript{183}

Finally, with supportive policies and an improving regulatory environment, China’s entrepreneurial culture is also evolving. A new generation of entrepreneurs – the “post-90s” generation of entrepreneurs has emerged.\textsuperscript{184} Unlike their parents, these second-generation entrepreneurs are more inclined to pursue their dreams through setting up their own businesses.\textsuperscript{185} 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. They are also able to adapt quickly to changes in the business environment.\textsuperscript{186}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{182} See The Top 50 VC Firms of the Year 2015 (ranked by Zero2ipo), PE\textsc{daily.c}n (Dec 4, 2015), http://pe.pedaily.cn/201512/20151204391023.shtml.
\item \textsuperscript{183} See Table 1 in this article noting that government guidance funds only account for 2\% of all investors on average.
\item \textsuperscript{184} Interview with Ms S, Vice President, Gaorong Capital, Beijing, October, 2015 (on file with author).
\item \textsuperscript{185} \textit{Id.}
\item \textsuperscript{186} \textit{Id.}
\end{itemize}
\end{footnotesize}
Figure 2: New Venture Capital Commitments over the Years and Major Legislative and Policy Changes (2002-2015)\textsuperscript{187}

Figure 3: New Venture Capital Commitments against New Venture Capital Funds

2002-2015 (USD Million)\textsuperscript{188}

\textsuperscript{187} Full figures for 2015 are not available as of the date of this article, thus the data for the year 2015 is not reflected in this table.

\textsuperscript{188} 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.
II. Room for Improvement and Suggestions

Although China has solved the simultaneity problem with a degree of success, institutional impediments may nonetheless prevent the Chinese VC industry from realizing its full potential. This part discusses how the Chinese government can improve on what it has done to facilitate even greater growth of VC.

A. Problems with Public Funding

Despite positive progress and swift development, GGFs have not been unproblematic. There are GGFs at both the central and local levels. National GGFs are set up by the central government, while local GGFs are set up by local governments at different levels (i.e. province, city, and county). As of December 2015, 417 GGFs were city-level GGFs, and they managed an investment amount of RMB 824.3 billion, while there were only 9 national-level GGFs managing RMB 274.85 billion.\(^{189}\) While most of these GGFs were recently established and it is still too early to test their roles in the VC market empirically, there are several flaws in the structure of the local GGFs and the rules by which they operate.

First, local government intervention is prevalent within local GGFs. Local governments often mandate the sectors, companies or locations to be funded.\(^{190}\) In particular, it is common for a local government to require a VC firm to inject GGF funding in certain companies within the region.\(^{191}\) This could lead to conflicts between the GGF and the VC 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 duration of investments.

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\(^{189}\) *Supra* note 81.

\(^{190}\) For example, Article 6(5) of the Implementation Rules of the Shanghai Angel Investment Guidance Fund, 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.

\(^{191}\) Article 8 of the Implementation Rules of the Shanghai Angel Investment Guidance Fund, *supra* note 190, 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.
and size of the portfolio companies. For example, Jiangsu province specifies that the maximum duration of the GGF investment is five years, which is inconsistent with the international practice of between 7 to 10 years.

Second, the selection of managers in some local GGFs is flawed. For instance, the manager of the Shanghai Angel Investment Guidance Fund (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”), that “shall exercise the rights as the investors of the Shanghai AIGF”. Two questions naturally follow: first, how would EFG “exercise the rights as an investor” and operate the fund effectively since it does not hold any equity interests in the fund? Second, how would the EFG monitor the fund effectively when the fund is being operated by its subsidiary? Also, unlike the ordinary VC limited partnership model where a professional VC firm serves as the GP and is subject to various legal and contractual constraints (e.g. unlimited liability for the debts of the fund, fiduciary duties of the GP and the LPs’ derivative action mechanism), there is no effective mechanism to constrain the behavior of the Shanghai AIGF’s statutorily mandated fund manager.

Moreover, under the Shanghai AIGF Measures, a steering committee comprising the deputy mayor of Shanghai and other government bureaucrats is in charge of the policy-

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192 Article 41 of the Measures of the Jiangsu Emerging Industry Venture Capital Investment Guidance Fund 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.

193 LERNER, supra note 5.

194 Shanghai Venture Capital Jieli Technology Financing Group (shanghai chuangye jieli keji jinrong jituan).

195 It was set up by the Shanghai government as a non-for profit organization in 2006.

196 Implementation Rules of the Shanghai Angel Investment Guidance Fund, supra note 190, Article 3.

197 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 GUANCHA BAO (Dec 24, 2014), http://www.eeo.com.cn/2014/1224/270637.shtml.
making and supervision of the fund. The lack of open selection mechanism for local cadres in charge of the GGFs may lead to problems including bureaucratic red-tape, paternalistic system and lack of expertise and professionalism with the GGFs.

Further, the Shanghai AIGF Measures mandate the establishment of a separate investment committee comprising of external experts and government representatives to review and vote for investment proposals. These officials may intervene directly in the decision-making process of the fund, thus causing internal conflicts. Also, while the GP of an ordinary VC fund is constrained by fiduciary duties and potential personal liability, officials in this committee are not penalized for decisions made by the committee. Consequently, ensuring that these officials do not misuse resources of the fund to obtain personal benefits remains a difficult task.

Third, local governments or GGFs often guarantee investment losses suffered by VC firms, resulting in a lack of incentives on the part of the VC firm and the entrepreneurs. Examples include the GGFs of Beijing, Jiangsu, Guangzhou and Shanghai. For example, the Shanghai government guarantees and compensates VC firms for up to 60% of their actual losses caused by investments in scientific and technological enterprises at seed stage or up to

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198 Id.
199 Article 12 of the Implementation Rules of the Shanghai Angel Investment Guidance Fund, supra note 190, 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.
201 The Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund, 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.
202 The Trial Measures for the Technology Enterprises Incubator Venture Capital and Credit Risk Compensation Fund, Yuekeguicaizi [2015] No. 21 states that VC 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.
203 Shanghai Angel Investment Risk Compensation Interim Measures [shanghaishi tianshi touzi fengxian 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.
30% if at start-up stage,\textsuperscript{204} 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.\textsuperscript{205}

Such VC firms are less incentivized to perform effectively and work for the best interests of the funds. Guarantee schemes that are funded by taxpayers’ money also create public grievance towards the GGFs as the very nature of VC investments is high-risk. Guarantee schemes are also problematic because they are usually implemented by officials who may not possess sufficient expertise in calculating the losses suffered, and who may prefer to compensate VC 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.\textsuperscript{206} Statistics show that many of the VC firms that received compensation for their investment losses were indeed government-backed firms.\textsuperscript{207}

Fourth, GGFs often negotiate for a smaller compensation package for GGF-backed VC 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”.\textsuperscript{208} The GP receives 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.\textsuperscript{209} This is however not always the case in China. Local governments are often overly protective of the taxpayer’s money while negotiating

\textsuperscript{204} Id., Article 9.
\textsuperscript{205} Id., Article 10.
\textsuperscript{206} Id., Article 11.
\textsuperscript{207} Id., Article 8 specifies that applicants for compensation shall make a filing with the relevant registrar in charge of VC investments. Statistics show that out of more than 110 VC firms which had made filings for compensation as of January 2016, most were state-owned VC 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.
\textsuperscript{208} Under this rule, the venture capitalists are entitled to a flat 2\% of total asset value as a management fee and an additional 20\% of any profits earned as the carried interests.
profit allocation, resulting in the VC firm being paid less than a 20% carried interest, or in the GGFs being given priority in the distribution of profits over the VC firm. Meanwhile, there is a lack of clear and detailed rules on the evaluation of the fund and the appraisal system of the GP in some local GGFs.

Lastly and most importantly, there are two institutional obstacles that prevent local governments from allowing local GGFs to operate based on market forces. The first one is the flawed cadre appointment system in China. Since the revolutionary years, China’s cadres have always been appointed by higher-level supervisors. Also, under the cadre responsibility system (gangwei zerenzhi), the appointed cadres are personally held responsible to achieve certain targets and policies laid down by higher-ups. In the context of GGFs, these systems have led to the inevitable intervention of local governments in selection of the portfolio companies. In order to make sure that public capital is properly used and to make the officials in-charge have some form of personal responsibility, municipal governments typically mandate the mayor of the city to be the chairman of the steering committee of the GGF. The second institutional obstacle is the flawed incentive mechanisms of government officials. In China, GDP growth remains one of the key performance indicators of the municipal government. This has encouraged many local

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210 Zero2IPO, supra note 81.
212 Article 24 of the Implementation Rules of the Shanghai Angel Investment Guidance Fund, supra note 190 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. 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.
215 See text accompanying supra notes 197-198.
216 Telephone interview with Mr. W, Head of the General Office of Human Resource Department, Guangdong Branch of the Communist Party of China, (August 19, 2016); Telephone interview with Mr. Z, Deputy Head of Panyu District of Guangzhou City, Guangdong Province (August 20, 2016) (on file with author).
GGFs to mandate that the fund invest only in certain industries and companies in their region that have already gained significant market success.\textsuperscript{217}

Nevertheless, these problems have not prevented the growth of the VC market. The negative impact caused by the flawed structure of the local GGFs appears not to have been significant economically. One reason may be that the size of GGF has been small – it accounts for only 2\% of the total investment amount in the market (Table 1). The figure was much smaller before 2011\textsuperscript{218} and is even smaller for local GGFs (Figure 1). Another reason may be the fact that most of the local GGFs were established in 2015, so the negative impact caused by the guarantees and problematic compensation, is still limited at the moment. Moreover, cognizant of the problems within the local GGFs as discussed above, the Chinese central government and many local governments have begun to move towards a market-oriented approach in the provision of funding for VC.\textsuperscript{219} This involves attracting more private investors and reducing government intervention in the operation of the GGFs.\textsuperscript{220} The Interim Measures of the Government Investment Fund 2015 and many local regulations governing the GGFs also specify that the GGFs should operate based on market forces and the fund should be managed by professional GPs instead of the government.\textsuperscript{221}

The national-level SVCIGF is a positive step forward on both points (see Diagram 1) – the SVCIGF will comprise 40 billion RMB of capital funding, with 10-15 billion RMB coming from the government and the remaining 25-30 billion RMB from other investors such as

\textsuperscript{217} See text accompanying \textit{supra} notes 191-192.
\textsuperscript{218} \textit{Supra} note 81.
\textsuperscript{219} \textit{Id}.
\textsuperscript{220} See \textit{Zero2IPO}, \textit{supra} note 81.
\textsuperscript{221} See \textit{e.g.} Interim Measures of the Government Investment Fund, \textit{supra} note 212, Article 11.
private enterprises and institutional investors.\textsuperscript{222} With a target of 40 billion RMB, together with a number of forthcoming local GGFs, the SVCIGF tackles the problem of the old GGFs being too small to make a difference in guiding capital flow to startups. Moreover, by allowing more than half the funding to originate from the private sector, government interference is mitigated and the fund is likely to rely chiefly on the market for guidance. Fund managers can make more informed commercial decisions on capital allocation.\textsuperscript{223} Further, investment-wise, the SVCIGF will invite public tenders from professional fund managers, with priority for returns given to private investors free from government intervention. Nevertheless, as the SVCIGF was just launched, it remains to see whether it will be implemented effectively according to the announced guidelines.


\textsuperscript{223} Id.
Diagram 1: State Venture Capital Investment Guidance Fund (SVCIGF) 2015

- **Government & Private Sector Investors**
  - Funds from the Central Government
  - Matching Funds from the Private Sector

- **Fund of Funds**
  - Arm's Length Fund of Funds

- **Private Sector Venture Capital Funds**
  - Private Sector VC Fund A
    - General Partner A
    - Fund manager selected via public bidding
  - Private Sector VC Fund B
    - General Partner B
    - Fund manager selected via public bidding
  - Private Sector VC Fund C
    - General Partner C
    - Fund manager selected via public bidding

- **Individual Private Companies**
  - Entrepreneurial Firm X
  - Entrepreneurial Firm Y
  - Entrepreneurial Firm Z
  - Entrepreneurial Firm A
  - Entrepreneurial Firm B
  - Entrepreneurial Firm C
  - Entrepreneurial Firm 1
  - Entrepreneurial Firm 2
  - Entrepreneurial Firm 3
In light of the public nature of the GGFs, the unique party-state system, and protectionism at the local level, I suggest the following ways to improve government participation in GGFs.

First, 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. Requiring matching funds from the private sector would help to reduce the dangers of uninformed decisions and political interference. The local government should avoid intervention in the selection of portfolio companies and fund manager. Funding should be provided to early-stage startups that are in high demand of capital, instead of later-stage, government-link companies that allow the generation of quick returns.

Second, the impact of government-sponsored funds depends not only on the design of the program but also on the selection of the managers. Instead of appointing government-linked VC firms, governments should select experienced, professional and independent VC firms to manage the funds.

Third, a well-designed appraisal and compensation system (such as the 2/20 rule) should be established to provide incentives to the fund’s manager. Also, more detailed rules should be provided on the evaluation, regular reporting and auditing of the GGFs to fill the legislative gap in the existing regulations governing GGFs.

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224 See Lerner, supra note 5, at 128-133.
225 Lerner, supra note 5, at 128-133.
227 Supra note 208.
228 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 190; Measures on the Jiangsu Emerging Industrial Venture Capital Investments Guidance Fund, supra note 201.
Fourth, the structure of the GGFs should be simplified to reduce bureaucracy and transaction costs. A “fund of funds” (FOF) approach taken by the SVCIGF seems more desirable for GGFs (Diagram 1). Under this 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, in contrast to GGFs of old whereby a local fund is usually restricted to only one project.  

Fifth, there are no detailed rules governing the stage wherein investments are made into portfolio companies under the various local regulations. Giving the fund disproportionate representation or even control of the portfolio company’s board of directors could help to reduce agency costs at the financing stage. I suggest 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.

B. Problems with Investment Vehicle

Although there is little doubt that the adoption of the limited partnership in China has contributed to a more favorable environment for the VC industry and reduced transaction costs in fund raising process, there are some special features require further legislative attention.

229 Id.
230 Id.
231 Gilson, supra note 1, at 1082.
First, unlike other jurisdictions such as US-Delaware,232 the U.K.,233 and Singapore,234 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 of fifty partners.235 The maximum number of partners may unduly constrain the size of the fund and is inconsistent with international practice. As such, I suggest that the restriction on the number of partners be removed.

Second, partners are allowed to transfer their partnership shares to outsiders (subject to various requirements) under the PEL.236 An assignee of a GP will become a GP himself and be subject to rights and obligations in accordance with the amended agreement and the PEL.237 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.238 Arguably, any change in GP is likely to result in serious consequences for a fund, particularly with regard to the LPs’ interests since they rely on the expertise of the GP when deciding to invest in the fund. Therefore, PEL should not entitle the transferee, during the continuance of the partnership, to participate in the fund’s management.

Third, 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. There is a practical need for VC limited partnerships to be able to convert into companies, because

233 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.
234 Id., at para. 8.4.
236 Id., supra note 135, Articles 22 and 73.
237 Id., supra note 135, Article 24.
portfolio companies backed by limited partnership-type funds are not allowed to list on the stock exchange under current Chinese law.\textsuperscript{239} Consequently, funds must deregister as limited partnerships and re-establish themselves as companies in order to realize their exits. Ideally, the Chinese legislature would provide a seamless process for the conversion of limited partnerships to companies.\textsuperscript{240} 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.

Fourth, the U.S. does not require newly admitted partners, whether general or limited, to be personally liable for the prior obligations of the partnership.\textsuperscript{241} 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 Germany\textsuperscript{242} and Japan,\textsuperscript{243} a GP 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 LP will bear liability to the extent of his capital contribution even if the partnership’s debts were incurred before he joined the firm.\textsuperscript{244} This restriction would reduce the attractiveness of the limited partnership to the venture capitalists and investors. I suggest the PEL does not require newly admitted GPs or LPs to be personally liable for the prior obligations of the partnership.

\textsuperscript{239} Yang Guang, \textit{RMB Funds Change Face: A Trend of Converting Back to Companies through Increasing Capital Contributions by GP}, \textit{CHINESE VENTURE} (Jun 2, 2009).
\textsuperscript{240} See Delaware Revised Uniform Limited Partnership Act §17-217.
\textsuperscript{241} See Delaware Revised Uniform Partnership Act §15-306 (b); Uniform Partnership Act §306 (1997).
\textsuperscript{242} 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.
\textsuperscript{243} Japanese Commercial Code, Article 82 provides that in a corporate partnership (\textit{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.”
\textsuperscript{244} Partnership Enterprise Law of the PRC, \textit{supra} note 135, Articles 44 and 77.
Lastly, another distinctive feature of the PEL is the requirement that limited partnerships be dissolved and be converted into a general partnership in the event that the limited partnership is left with only LPs after the departure of all GPs. Equivd equivalent provisions are not found in its German, French and U.S. counterparts. A Chinese limited partnership with only LPs should be allowed to continue operating as a limited partnership over a grace period so as to explore possible options and attract incoming GPs. Also, as a typical VC fund usually lasts for ten years and makes long-term investments in a number of 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 VC fund.

C. Problems with Entrepreneurs

Despite the effective policies and mechanisms put in place to promote the growth of entrepreneurs and entrepreneurial firms as discussed in the last part, more gaps in legislation must be filled to continue to address the issue of entrepreneurship in China, particularly in enhancing the protection of intellectual property rights. Interviewees stated that insufficient intellectual property protection has been a main concern for entrepreneurs and venture capitalists in China.

Moreover, there is a lack of personal bankruptcy laws in China. In China, there are several sanctions for debtors that default on loans: (1) the debtor will be included in the *List of Dishonest Persons subject to Enforcement* and will face a series of penalties; (2) the

\[245 Id., supra note 135, Articles 24 and 75.\]

\[246 Telephone interview, Mr. G, Partner, X Capital, Shanghai, (August 1, 2016) (on file with author).\]

\[247 This is of particular relevance to a corporate debtor who may face more restrictions in its subsequent business operations. Several Provisions of the Supreme People's Court on Announcement of the List of Dishonest Persons subject to Enforcement, Interpretation No. 17 [2013] of the Supreme People's Court, Article 1.\]
debtor may be subject to expenditure limits\textsuperscript{248} and restrictions on international travel;\textsuperscript{249} (3) depending on the severity of the situation, courts may fine or impose custodial sentences to the debtor;\textsuperscript{250} (4) if elements of criminal offences are met, the debtor may be prosecuted for his refusal to comply with payment judgments.\textsuperscript{251} As noted by Armour and Cumming, a liberal personal bankruptcy regime has a positive impact on the success of a VC market.\textsuperscript{252} Conversely, a stricter bankruptcy regime discourages potential entrepreneurs from taking risks and failed entrepreneurs from re-engaging in business.\textsuperscript{253} Given the high-risk nature of VC, 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.

Further, although there is an increasing number of second-generation entrepreneurs in China, these entrepreneurs are still relatively new and inexperienced in the VC market. The future challenge would likely 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 likely remain a gap between China and U.S. in terms of entrepreneurial culture.\textsuperscript{254}

\textsuperscript{248} Several Provisions of the Supreme People’s Court on Restricting High Consumption of Judgment Debtors, Interpretation No. 8 [2010] of the Supreme People’s Court, Article 1.
\textsuperscript{249} Interpretation of the Supreme People’s Court of Several Issues concerning the Enforcement Procedures in the Application of the Civil Procedure Law of the People's Republic of China, No. 13 [2008] of the Supreme People’s Court, Article 37.
\textsuperscript{250} Civil Procedure Law of the People’s Republic of China, (Adopted at the Fourth Session of the Seventh National People’s Congress on April 9, 1991 and promulgated by Order No. 44 of the President of the People's Republic of China on April 9, 1991), Article 241.
\textsuperscript{251} Supra note 247.
\textsuperscript{253} Armour & Cumming, supra note 99, at subsection 3.3.
\textsuperscript{254} See \textit{We Are 90-Post, We Are Entrepreneur}, TENCENT INTERNET AND SOCIETY RESEARCH CENTER (2015).
III. Lessons Learned

Economic theory suggests two main rationales for public intervention to encourage entrepreneurship and favor startups.\textsuperscript{255} 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.\textsuperscript{256} Whereas, the market failure hypothesis explains that governments may rectify market imperfections by fostering legal and fiscal environments that are conducive to private investors and entrepreneurs to operate (e.g. tax relief, bankruptcy process facilitating reorganization, a stock market that facilitates SME exits).\textsuperscript{257}

As discussed in Part I, governments face difficulties in resolving the simultaneity problem in engineering a robust VC market. Several governments, such as those of Germany, India and Singapore, have attempted to tackle this problem but it has proven to be a difficult task. However, there is evidence to show that the three essential determinants have been gradually addressed by China. This part will discuss specifically the lessons that other countries could learn from China in tackling the simultaneity problem, as well as examine similar flaws present in the Chinese and other countries’ models, which will require more attention in future legal and policy reforms.

\textsuperscript{255} Marina di Giacomo, Public Support to Entrepreneurial Firms: An Assessment of the Role of Venture Capital in the European Experience, 8(1) J. PRIV. EQUITY 22, 25 (2004).

\textsuperscript{256} Zvi Griliches, The Search for R&D Spillover, 94 SCANDINAVIAN J. ECON., 29-47 (1992); cited in id, at 25.

\textsuperscript{257} Lerner, Josh, When Bureaucrats Meet Entrepreneurs: The Design of Effective Public Venture Capital Programmes, 112 ECON. J. F73, (2002); cited in id, at 25.
A. Capital

1. Increased domestic and foreign capital supply

First, as to domestic private capital, China has gradually removed regulatory barriers to allow more institutional investors to invest in the VC market. Arguably, this liberalization of the financial markets can be easily replicated by other countries.

Second, in terms of foreign capital, China has launched various programs for foreign investors to raise funds and make equity investments. Other countries can learn from China’s attempt to create a foreign investor friendly regulatory environment and engage in capital control liberalization. However, this may be subject to the specific political, economic and legal environments of a nation. For example, in Brazil, while FMIEEs (*Fundos Mutuos de Investimento em Empresas Emergentes*) are made available to serve as special investment vehicles for VC investments, the FMIEEs’ unpopularity shows that the Brazilian government has yet to provide sufficient regulatory incentives that would encourage investors to take advantage of this structure. Brazil also discourages foreign investment by imposing a financial transactions tax on foreign capital inflows – a macroeconomic policy measure intended to prevent excessive inflation, reduce risks of asset price bubbles, and curb strong exchange rate appreciation which may hurt Brazil’s export competitiveness.

258 Part I(B)(3) in this article.
259 Part I(B)(4) in this article.
262 *Id.* at 2. Brazil’s justification that strict capital control is necessary to maintain economic and financial stability, however, is not entirely sound. Its short crash and boom cycles, rapidly fluctuating currency, and high inflation are just symptoms of multiple political problems (such as corruption, paralysis of policymaking process, lack of implementation of structural economic reform) that it faces.
Third, with regard to public funding, China’s establishment of various government programs\(^{263}\) has substantially increased the supply of funding to the VC market. The reality is that countries have differing availability of public funds. Lackluster economic growth and fiscal profligacy in the boom years may cause a government to be burdened with dwindling public finances and face budgetary constraints. Germany’s WFG program, for example, was only funded 50 million DM\(^{264}\). Though the WFG program was conducted from 1976 to 1991 and inflation must be accounted for, its modest size provides less of an “add-on effect” in raising capital.

Public fund size,\(^{265}\) however, is not the only determining factor. Many other factors affect the success and effectiveness of government programs, including the duration of the programs,\(^{266}\) their flexibility,\(^{267}\) the presence of incentives for the financial intermediary to monitor portfolio companies,\(^{268}\) and the implementation process.\(^{269}\) Notably, China’s new SVCIGF program has taken a market-oriented approach, by allowing, inter alia, matching of more than half of the funding from the private sector, appointment of GPs via public bidding, and use of FOF structure to diversify investment risks.

Nevertheless, there are similar flaws found within China’s local GGFs and other countries’ public programs. For instance, like WFG, some China’s local GGFs guarantee investment losses suffered by VC firms, resulting in a lack of incentives for venture capitalists to monitor the portfolio companies. Further, there was government intervention in the selection of the

\(^{263}\) Part I(B)(2) of this article.

\(^{264}\) Gilson, supra note 1 at 1095.

\(^{265}\) LERNER, supra note 5, at 117-123 (arguing that either too small or too large a government initiative can pose profound difficulties).

\(^{266}\) Id., at 112-116 (arguing that encouraging entrepreneurship requires a long-term commitment on the part of public officials).

\(^{267}\) Id., at 124-127 (suggesting that government officials must appreciate the need for the flexibility in VC investment and rely more on market forces in selecting portfolio companies).

\(^{268}\) See Gilson, supra note 1.

\(^{269}\) LERNER, supra note 5.
portfolio companies in WFG and China’s local GGFs due to the flawed incentive and appointment structure of GPs.270

Therefore, when emulating China’s VC public funding system, other countries should take note to avoid the similar structural deficiencies present in some local GGFs and instead refer to the newly launched SVCIFG’s market-oriented design. The government’s role in the fund raising process should be limited to being a LP who does not participate in the management of the fund. By doing so, the government leaves capital allocation decisions to the market force.

2. Tax Incentives
Multiple Chinese local governments have offered significant tax exemptions to both GPs and LPs in VC funds.271 These tax exemptions increase investment profitability, thereby encouraging the supply of the VC to the industry. Various forms of tax relief are also provided to scientific parks and incubators to encourage innovation.

However, it could be difficult for certain states to follow China’s example of greatly reducing tax rates. France, for instance, imposes a progressive income and capital gains tax rate up to 45%.272 The high tax rates limit returns to a successful entrepreneurial venture and put a damper on VC activity. While individual investors may claim an exemption from income tax on investment income and capital gains derived through FCPI (Fonds Communs de Placements dans l’Innovation), in order to qualify for these tax exemptions, they must hold their shares for 5 years, immediately reinvest all fund distributions and hold no more than 25%

270 See text accompanying supra notes 193-221 in this article.
271 Part I(B)(5) in this article.
of the portfolio company’s shares. Such onerous exemption requirements reduce the effectiveness of the tax policy in encouraging VC investments.

Meanwhile, Japanese tax law’s hostility to the use of equity as an incentive means that additional cash-flow rights cannot be used by venture capitalists to encourage entrepreneurs to give up management control. Japan’s ambiguous and unfriendly tax rules thus present a real hindrance to the development of its VC industry.

Ultimately, the policymaker should strike a right balance when providing tax breaks. If the policymaker is of the view that the benefits of encouraging VC shall outweigh the potential loss in tax revenue, it may introduce a more favorable tax regime to boost the VC sector. However, excessive tax incentives would distort the efficacy of market forces in allocating capital and may allow poor performing VC firms to survive on tax incentives and government subsidies.

3. Active Stock Market

Through the launch of the national OTC market – NEEQ, and the NASDAQ-like ChiNext Board with lowered listing requirements, China has greatly improved the IPO exit options for VC-backed firms. Arguably, the establishment of SME-specific Board and the reduction of listing requirements can be copied by other stock market-centered countries to foster VC if they are willing to bear the high legislative costs. Moreover, the effectiveness of the new stock exchanges is affected by the existing structure of the financial market. For countries like Japan and Germany, given their longstanding and well-established bank-centered

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274 Supra note 4. Sweat equity may be challenged by the Japanese National Tax Agency as a gift and entrepreneurs will have to pay gift tax.
275 Supra note 66.
systems, they may face difficulties in attempting to develop into market-centered systems without far reaching reforms. Path dependency may present a thorny problem for institutional change.

B. Investment Vehicle

The Chinese limited partnership vehicle is made available for both domestic and foreign investors, and remarkably provides the twin benefits of separate legal personality and tax transparent treatment at the entity level.

In Taiwan, the recently introduced limited partnership is not seen as a viable investment vehicle for venture capitalists. The limited partnership is taxed the same way as a Taiwanese company and the lack of tax transparent treatment severely limits its functionality. In the U.K. and Singapore, the limited partnerships do not have separate legal personality as they are based on the common law aggregate approach on partnership. Singapore’s drafter specifically highlighted the concern that overseas tax authorities may treat the Singapore limited partnership as an opaque entity for tax purposes if it has a separate legal personality and therefore negatively affect the adoption rate of the limited partnership in Singapore. However, the tax transparency benefit arguably does not need to be inevitably intertwined with the absence of separate legal personality. The entity approach will facilitate in the continuity of partnerships by conferring perpetual succession and provide a more ideal business vehicle for investors.

276 Supra note 35 (discussing the correlation between stock market and VC market in bank-centered systems).
277 Part I(C) in this article.
India, on the other hand, has no limited partnership and the VC funds largely rely on the trust structure. Investors become trust beneficiaries and contractually retain the ability to exercise restricted passive control over the GP’s investment decisions via the Contribution Agreement.  

The trust offers organizational flexibility, limited liability for investors and tax transparency. However, notwithstanding the Indian trust’s ability to reasonably govern the investment relations between the managers and investors, its drawback of lacking separate legal personality remains.

Arguably, if the jurisdiction has preexisting business forms that are functionally similar to the limited partnership, there is then less pressing need to enact limited partnership legislation. Moreover, if governments wish to introduce the limited partnership, they must be willing to provide the vehicle with sufficient benefits and attributes to meet the business needs of the potential users – failure to do so will result in waste of legislative resources.

C. Entrepreneurship

To encourage entrepreneurship, China engaged in a series of entrepreneur-friendly company law reforms. This can be easily learned by other jurisdictions. Taiwan, for example, is also currently undergoing company law reform to streamline the business incorporation and operation process.

China also provided numerous policy incentives and tax reliefs to improve innovation, legislative and institutional infrastructure for the VC industry. The continuous nature of these policy incentives is key to the rapid development of the Chinese VC market.

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281 See supra note 47.
283 Part I(D) in this article.
284 Supra note 164.
The importance of continual government support may also be seen in Taiwan’s example where investors in high-tech start-ups were historically granted a hefty income tax deduction. While this tax relief policy brought about substantial capital injection in VC sector from 1995 to 2000, it was subsequently abolished in 2000.\textsuperscript{285} The termination of policy incentives directly contributed to the Taiwanese VC industry’s decline in recent years, proving that governmental promotion of entrepreneurship requires consistent and long term effort.\textsuperscript{286}

**Conclusion**

China, as an experimentalist in law and development, offers an important example of how a government can engineer a VC market. While pointing out the mistakes of the government in building a market is easy, it is more difficult to identify what has been done right. This article finds that the Chinese government has played an important role in helping the nation to establish a market that has not developed organically.

This article has shown the important role of the government in creating a VC market through law and policy. One characteristic of the Chinese VC market is that it is created and led by governments, both on central and local levels, through \textit{continuous} law and policy reforms. Meanwhile, although China’s market is established by governments, a key reason for its rise is the central government’s efforts at adopting a more market-oriented approach towards capital allocation. This is reflected in: (1) the newly established SVCIGF and the new regulations governing the GGFs, (2) 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, (3) the fact that private capital is becoming the major

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\textsuperscript{286} Id.
source of VC (Table 1) with the eased regulatory regime, the more liberal regulatory framework governing the VC market, the predominance of the limited partnership, and the increased number of private VC firms, startups and entrepreneurs. By providing the legislative and institutional infrastructure for the VC market, the government can facilitate the increased role of market forces, and especially in the area of capital allocation.

The Chinese experience offers several lessons to other countries: (1) the government can help solve the three-factor simultaneity problem -- by providing public funds through the well-designed government programs, by introducing business-friendly legal vehicle, as well as improving regulatory environment for funding raising, investments and exits, government can encourage capital supply, boost entrepreneur participation, and attract knowledgeable financial intermediaries to the market; (2) the government can facilitate the creation of a market premised on market forces and private contracting by restricting its own participation to being a LP, and leaving capital allocation decisions to private-sector parties with right incentives. Failure to do so would prevent the industry from attaining sustainable growth.

Nevertheless, there is substantial room for improvement in China. Various institutional impediments within each factor, as highlighted above, may prevent the industry from realizing its true potential. Moreover, in light of China’s unique party-state system, the problematic central and local government conflicts, the flawed cadre appointment system and the flawed incentive mechanisms of government officials, it is difficult to ensure that local governments completely do not intervene in the capital allocation process. I suggest 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.

287 See generally, Gilson, supra note 1.
Additionally, the next big challenge for the government is to further develop a VC market based on private contracting. In this regard, one key task is to ensure the effective enforcement of the various contracts covering the entire VC cycle. 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 VC market also requires a wide range of complex social, legal, and economic institutions: robust stock markets, sophisticated auditing and legal professions, effective judicial enforcement of contracts, 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 can be maximized. Ultimately, it remains to be seen whether the Chinese VC market can replicate the success of the U.S. market in the long run.
## Appendix 1: Legislative Efforts at Tackling the Simultaneity Problem in China

<table>
<thead>
<tr>
<th>Capital</th>
<th>Legislative efforts</th>
<th>Existing/Potential Problems</th>
<th>Suggestions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private capital:</td>
<td>(1) Removed regulatory restrictions that prevented certain institutional investors from investing in VC funds, thus broadening the investor base; (2) Tax incentives to attract private capital in VC investments; (3) Foreign investors were progressively permitted to make equity investments through various special schemes; (4) Regulatory environment for exits was improved to attract venture capital investments.</td>
<td>Public capital: (1) Certain local governments’ heavy intervention in the management of the fund and allocation of capital; (2) Governmental guarantees of investment losses; (3) Complicated internal structure of local GGFs.</td>
<td>Public capital: (1) Governmental guarantees of investment losses should be abolished. (2) Governmental intervention in the selection of portfolio companies and funds’ managers should be restricted. (3) The structure of the local GGFs should be simplified to reduce bureaucracy. (4) A well-designed appraisal and compensation system should be established to provide right incentives. (5) Continuous education of government officials on the nature of the VC industry.</td>
</tr>
<tr>
<td>Public capital:</td>
<td>(1) A large number of GGFs were set up to inject capital into the market, with the intention of attracting matching capital from the private sector; (2) The SVCIGF scheme supports a market-oriented approach to capital allocation.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specialized Financial intermediaries</td>
<td>(1) The limited partnership was introduced; (2) Various foreign investment vehicles were introduced to attract foreign capital.</td>
<td>(1) Regulatory problems concerning the limited partnership; (2) Private ordering problems for limited partnerships: LP activism and internal conflicts.</td>
<td>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 LPs’ derivative action.</td>
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<td>-----------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Entrepreneurship</td>
<td>(1) The government has embarked on a policy of encouraging mass entrepreneurship and mass innovation through institutional measures; (2) The company law, tax law and securities law were revised to facilitate setting up and doing business; (3) A large number of substantive laws were promulgated or revised to improve IT infrastructure.</td>
<td>(1) Excessive tax preference treatment is given at the local level; (2) A lack of personal bankruptcy law and a lack of dual class structure; (3) A lack of dual-class stock structure under Chinese corporate law; (4) IP rights are insufficiently protected.</td>
<td>(1) Considering promulgating personal bankruptcy law to ensure that honest failed entrepreneurs are protected and given a fresh start. (2) Considering adopting the dual-class stock structure. (3) IP rights protection should be enhanced.</td>
</tr>
</tbody>
</table>
### Appendix 2: Legal Developments and the Government’s Role in Developing the Venture Capital Market of China

#### 1978-2015

<table>
<thead>
<tr>
<th>Dates</th>
<th>Law/policy</th>
<th>Implications for the VC market</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 9, 2006</td>
<td>“Outline of the National Medium and Long-Term Science and Technology Development Plan” (2006-2020) published.</td>
<td>Encouraged setting up guidance funds to support startups in the seed stage.</td>
</tr>
<tr>
<td>July 6, 2007</td>
<td>“Interim Measures for the Management of Venture Capital Guidance Funds which support Science and Technology-based Small and Medium Enterprises” published.</td>
<td>Introduced institutional mechanisms to encourage innovation and support high-tech startups.</td>
</tr>
<tr>
<td>June 5, 2008</td>
<td>National Social Security Fund was allowed to make equity investments.</td>
<td>Greatly increased the VC funding.</td>
</tr>
<tr>
<td>September, 2010</td>
<td>“Interim Measures for Equity Investment with Insurance Funds” issued.</td>
<td>Insurance funds were allowed to invest in VC funds.</td>
</tr>
<tr>
<td>January, 2011</td>
<td>Shanghai published the “Implementation Measures on the Pilot Program for Development of Foreign-invested Equity Investment Enterprises”.</td>
<td>Foreign-LPs are permitted to convert foreign currency capital into RMB to invest into RMB funds.</td>
</tr>
<tr>
<td>May, 2011</td>
<td>First batch of Qualified Foreign Limited Partner (QFLP) funds set up under Chongqing QFLP Pilot Program.</td>
<td>Encouraged foreign capital to make equity investments in Chongqing.</td>
</tr>
</tbody>
</table>

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288 This table seeks to highlight the most important legal developments in relation to the development of the VC market in China.
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 18, 2013</td>
<td>“Interim Provisions on the Management of Securities Investment Funds by Asset Management Institutions” issued.</td>
<td>More institutional investors, such as social security funds, insurance funds, and fund companies were permitted to make equity investment.</td>
</tr>
<tr>
<td>May 11, 2016</td>
<td>CSRC issued a pilot scheme to grant ten banks access to VC investments following the removal of a legal bar on banks holding equity in non-financial companies they lend money to.</td>
<td>Allowed banks to make VC investments.</td>
</tr>
</tbody>
</table>

### Financial Intermediaries

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 31, 2002</td>
<td>“Provisions Concerning the Administration of Foreign-funded Venture Investment Enterprises” was passed.</td>
<td>Regulated foreign invested enterprises.</td>
</tr>
<tr>
<td>October 27, 2005</td>
<td>PRC Company Law was revised.</td>
<td>Introduced the one-person company and streamline the process of setting up a company.</td>
</tr>
<tr>
<td>November 15, 2005</td>
<td>“Interim Measures for the Administration of Venture Capital Enterprises” was passed.</td>
<td>Regulated domestic VC enterprises and provided tax incentives to foreign invested VC enterprises.</td>
</tr>
<tr>
<td>August 27, 2006</td>
<td>PRC Partnership Enterprise Law was passed.</td>
<td>Introduced the limited partnership.</td>
</tr>
<tr>
<td>June 1, 2007</td>
<td>“Circular on Tax Policies Promoting Development of Venture Capital Enterprises” came into force.</td>
<td>Provided tax incentives to VC Invested Enterprises.</td>
</tr>
<tr>
<td>Date</td>
<td>Event</td>
<td>Description</td>
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</tr>
<tr>
<td>October 18, 2008</td>
<td>“Guiding Opinions on the Normalized Establishment and Operation of the Venture Capital Guiding Fund Made by the Departments Including the Development Reform Commission” was issued.</td>
<td>Provided clearer guidance on the operation of the funds.</td>
</tr>
<tr>
<td>November 25, 2009</td>
<td>Administrative Measures for the Establishment of Partnership Enterprises within China by Foreign Enterprises or Individuals was published.</td>
<td>Provided a new foreign-invested vehicle for foreigners.</td>
</tr>
<tr>
<td>December 28, 2013</td>
<td>Amendments to the PRC Company Law, effective on March 1 2014.</td>
<td>Abolished the requirement of minimum registered capital.</td>
</tr>
<tr>
<td>September, 2015</td>
<td>China’s business registration system reform on integrating “three certificates into one” with unified credit codes.</td>
<td>Streamlining the registration process of starting a business.</td>
</tr>
<tr>
<td></td>
<td><strong>Entrepreneurship</strong></td>
<td></td>
</tr>
<tr>
<td>March, 1986</td>
<td>Launch of National High Technology Research and Development Program of China (863 Program).</td>
<td>Aimed to improve the country's innovation ability and development of cutting-edge technology.</td>
</tr>
<tr>
<td>August, 1988</td>
<td>The Torch Plan was launched.</td>
<td>A guiding plan for the development of high tech industries.</td>
</tr>
<tr>
<td>May 4, 1998</td>
<td>Project 985 was launched.</td>
<td>Aimed to develop world-class universities.</td>
</tr>
<tr>
<td>November 20, 2014</td>
<td>“Opinions of the State Council on Supporting the Sound Development of Micro and Small Enterprises” introduced.</td>
<td>Introduced policy measures to support SMEs through financial support, tax incentives, etc.</td>
</tr>
</tbody>
</table>