Innovation—whether achieved through adoption, adaptation, or the creation of new technology—needs to be financed. And financing the innovation activities of China’s business enterprises is clearly an area where further improvement can be made. For example, as noted in the previous chapter, respondents to the World Bank CSMEI Survey ranked “lack of capital” as one of the top difficulties they face in pursuing innovation. Innovation financing is not just about allocating money for innovation. It is also about the effectiveness and efficiency of innovation activities, because performance in innovation can be enhanced by improvements in corporate governance demanded by a firm’s investors.

Innovation can be financed internally or externally. External financing generally plays a positive role in the commercialization stage of an innovation. In early-stage technological development (ESTD), evidence in developed economies suggests that most innovative firms use internal and informal financing. In a basic framework for innovation financing, the types of financing used changes as innovation passes through various stages from invention to sale of the firm or product (table 4.1). In that framework, formal financial institutions, such as venture capital (VC) funds, private equity, investors, and banks, do not get involved until the early phases of production.

CHAPTER 4

Strengthening the Ecosystem for the Venture Capital Industry
Firms that are in the start-up or very early stage in bringing a new invention to the market typically experience the greatest difficulty in raising funds. The difficulties of early funding are even more pronounced in emerging markets, where the formal financial institutions that provide various forms of risk capital are not well established. In the United States, one of the world’s most advanced and innovative economies, ESTD is largely financed by an entrepreneur or the firm’s own funds and by government programs (figure 4.1). Internal funding overcomes the problem of information asymmetries with regard to the quality of the innovation, potential market applications, and commercialization, but internal funding is available only to entrepreneurs and firms with sufficient cash. Government funding comes in a variety of forms, but it is mainly grant based; and given the public policy nature of such funding, the asymmetric risks and potential for return are not necessarily the overriding concerns. The other main providers of early funding in the United States are “angel” investors. Angel investors are generally successful entrepreneurs that invest in ESTD projects in fields they have already succeeded in, and these investors generally get deeply involved in the business development and management of the investee firms. In the

Table 4.1 Basic Framework for Types of Financing Used at Selected Stages of Innovation

<table>
<thead>
<tr>
<th>Stage</th>
<th>Own funds, friends, and family</th>
<th>Angel investors, seed funding</th>
<th>Government programs</th>
<th>Corporate venture (retained earnings)</th>
<th>VC</th>
<th>Private equity</th>
<th>Banks, investment banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invention and R&amp;D</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business plan and market definition</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pilot production</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing, sales, and distribution</td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Full commercialization</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Market expansion and increased penetration</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Sale of company or product</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

Source: Based on Goldberg 2004.
United States, financial institutions in the ESTD phase of innovation provide very little external risk capital—in 2002, VC funds provided only 4 percent of all ESTD funding (Auerswald and Branscomb 2003). As entrepreneurs and firms move from ESTD toward commercialization, a number of factors still make financing a challenge: low expected returns due to an inability to capture the profits from an invention or innovation, the uncertainty and risk associated with the project, and overoptimism and untested capacities on the part of managers (most of whom may not have any tangible assets or track records) (Hall 2005). Some of these risks can be mitigated through intellectual property protection, subsidies, or tax incentives, but there is still a “wedge, sometimes large, between the rate of return required by an entrepreneur investing his own funds and that required by external investors” (Hall 2005, p. 3).

The combination of risks, both perceived and actual, surrounding innovation makes its financing stand out as a special issue because it requires not only capital, but also external risk capital—that is, capital from external providers that are willing and able to take high risks involved in the creation, adaptation, and adoption of technology. This is where the VC industry emerged to fill the funding gap, or wedge, for start-up and early-stage risk capital for innovative firms.

**Figure 4.1 Sources of Funding for Early-Stage Technology Development in the United States, 2002**

![Pie chart showing sources of funding for early-stage technology development in the United States, 2002.](chart.png)

*Source: Auerswald and Branscomb 2003.*
Of course, VC does not completely fill the financing void for innovative firms, as was shown earlier. However, research has shown that VC plays a strong role in encouraging innovation and, more important, facilitating the commercialization of innovation. VC firms play their role in several ways: expert selection of investments, expert advice to investee firms, assistance in business management and corporate governance, connecting of firms to potential buyers of their products, efficient longer-term financing of the firms, and performance monitoring and advice from the start to the realization (sale, or “exit”) of the VC investment (Lerner and Watson 2007). International experience also shows that VC is a key area in which governments commonly intervene in attempting to catalyze new and early-growth innovative businesses.

This chapter studies the emerging domestic VC industry in China, drawing in part on Mackenzie (2007). It explores ways in which the development of the industry can be catalyzed to support the enterprise-led innovation strategy. The discussion here emphasizes a view of the VC industry as an ecosystem.

The Ecosystem for the VC Industry

VC has a long history dating back to the period of the 15th to the 18th centuries, when the rulers of Europe supported the exploration and subsequent colonization of many parts of the world. Modern-day venture funding emerged in the United States in 1958 with the creation of government-backed Small Business Investment Companies and subsequently with the development of private VC funds in the 1960s and 1970s (Lake and Lake 2000, p. 6). The U.S. VC industry has gone through a number of activity cycles, and the most recent boom began in 2001. The evolution of the VC industry has shown that its success depends on a surrounding “ecosystem.” The VC ecosystem has many elements, but four are fundamental: structure, funding, management, and exit.

Structure of a VC Fund

A VC fund, structured as an independently managed pool of funds from institutions and individuals, is generally managed by a VC firm. The VC firm invests the funds in firms to support them in four basic stages of development: (1) seed or start-up, (2) early growth, (3) business expansion, and (4) later-stage activities. The investment essentially represents a business partnership in which the VC firm shares the risks and rewards of the business and provides advice and expert assistance. The United
States is the world’s largest private equity and VC market, and therefore the legal form of the industry has been shaped by the U.S. experience. The primary legal form of VC firms, with local variations, is usually a fixed-life investment vehicle that consists of a general partner, or GP (the management firm, which has unlimited liability), and limited partners, or LPs (the investors, who have limited liability). In managing the partnership, the GP receives a management fee (usually 2 percent) and up to 20 percent of the profits (sometimes called “carried interest”). The LPs receive income, capital gains, and tax benefits from their investments. The fee structure helps to align the interests of the GP with LPs to maximize returns while covering the minimum operating costs to run the fund.

The LPs generally invest in the fund without knowledge of which companies the fund will invest in (a “blind pool”), and they do not participate in the investment decision-making process or operations of the fund. The GP usually has actual or effective control over the portfolio companies and specializes in “finding, analyzing, investing in, managing, and exiting in what are generally private companies” (Lake and Lake 2000, p. 10). The GP usually has expertise in a particular sector (for example, information technology, biotechnology, or health care), in the markets of a particular country, and in one of the four investment stages (seed, start-up, and so on). The partnership is a closed-end fund that normally lasts 10 years, during which time the investment is essentially locked-up and illiquid (although technically the investor can sell the partnership interest).

The reason for the evolution of a special corporate form for VC funding, the limited partnership, is the need to balance the desire of the investor to incentivize the VC firm to make attractive returns with the desire to restrict the VC firm from engaging in unduly risky behavior or from engaging in activities that would conflict with the investors’ objectives. The VC fund by definition invests in risky and illiquid companies that will in most cases take many years to bring to profitability and liquidity; the VC firm therefore needs the time and freedom to pursue that approach without undue pressure from investors for short-term profits while still being under pressure to generate profits for the investors in the medium to long term. Therefore, the typical corporate form of a limited liability or joint stock company, which normally is of unlimited duration and in which the investors ultimately control the company via the board of directors or shareholders’ body, has been seen as not ideal for VC investing (Gompers and Lerner 1999; Lerner 2000). Finally, limited partnerships have the added benefits of being tax efficient because usually
the limited partnerships are nontaxable entities—profits generated by the fund are not taxed at the limited partnership level. They flow back to the individual investors, who are taxed on the basis of their own individual situation, and, thus, profits avoid double taxation. A number of legal jurisdictions around the world with investor-friendly corporate and tax laws are the most popular for domiciling VC limited partnerships, including the United States, the United Kingdom, and the Cayman Islands.

**Sources of VC Funding**

VC firms are intermediaries whose funding is derived from institutional and individual investors (the latter are sometimes referred to as “family offices”). Institutional investors include pension funds, banks, investment funds, and other specialized financial institutions. Also, some corporations or financial institutions establish their own VC vehicles, but those entities represent a much smaller portion of the VC industry. In most developed countries, such as the United States and in western Europe, institutional investors have many decades of experience in VC investing. There is a deep pool of funding for VC investments, but VC will generally represent only a small portion of an investor’s portfolio, given the high level of risks in this market segment.

The higher returns and long-term nature of VC investments are attracting an increasing amount of funds into VC. For example, in the United States, most large institutional investors now tend to allocate 5–15 percent of their total assets in alternative investments, which mainly consists of hedge funds, private equity, and VC investments. In Europe, pension funds provide 25 percent of all funding for VC (and private equity), followed by banks (16 percent), funds (13 percent), and insurance companies (10 percent); and the majority of the funding for the industry comes from within Europe (63.4 percent).48

**The Role of VC in Investee Companies**

VC firms need to operate under legal guidelines that allow the investee companies and the investments to be structured to align the interests of VC funds and the companies they invest in.

In the basic VC investment situation, a small team of entrepreneurs has a new technology or idea around which a business can be built but does not have the capital to fund it. A VC fund that is attracted to the project provides some initial equity investment as well as expertise in developing and commercializing the idea. The successful VC firm typically has management and staff members with entrepreneurial experience, sector
experience, or other specialties that can be applied directly in the investee company. As previously mentioned, the VC firm is essentially a business partner of the investee company and typically is highly involved in all decisions facing the investee firm, including the hiring and firing of management, and actively participates in the governance of the company. The VC firm also gets deeply into the strategic planning of the investee company and into some operational areas such as product development, distribution, and marketing. Another valued skill brought by the VC firm is a network of contacts to help the investee company make links with suppliers and buyers and with other investors to finance the next stage of growth (Dotzler 2001). Therefore, the VC industry is necessarily largely a localized business because the VC firm must have in-depth knowledge of the management and market of the investee company in order to add sufficient value to bring the company to the next stage of development.

VC investments are generally made with special classes of shares and with numerous controls and conditions that allow the investor to have a degree of preferential treatment and control that would not exist if both the investee team and the investor had the same class of shares. The reason for the preferential status is the high degree of risk surrounding investments in innovative sectors, including lack of proof of concept of the business idea, information asymmetry between the investor and investee, and a lack of assets at the investee company. Generally, during the life of a typical VC-financed company, the capital structure will be continuously changed, a process requiring a very flexible regulatory environment.

Exit: Realizing VC Investments

On the investor side, a VC fund offers new channels for diversifying risks and opportunities for higher returns as well as a longer-term investment vehicle. The exit strategies for a VC investment generally fall into one of four categories if the investment is successful: (1) initial public offering (IPO), in which the shares of the invested firm are sold to the public on a stock exchange, (2) merger and acquisition (M&A), in which the shares are sold to a third party that is typically a strategic buyer, (3) buyback, in which the firm’s management buys the company’s shares from the VC investors, and (4) sale of the firm. Of course, if the investment is a failure, the scenario is different, and other options (such as a write-off) constitute the investors’ choices for exit.

Exit via an IPO is generally the most lucrative option, but the firm for sale must meet many prerequisites, such as long-term stability, persistent
profitability, sound cash flow, strong customer base, sizable market share, good corporate governance compliance, and effective management. Recent surveys of U.S. venture funds indicate that the preferred exit route changes on average 1–3 times during the life of the investment (Center for Private Equity and Entrepreneurship 2005). However, in the United States, whose VC industry is the largest and most mature in the world, sale to a strategic buyer is overwhelmingly the preferred exit strategy, particularly early in the life of the investment. Although the average size of VC-backed IPOs was $120 million in 2007, which was larger than M&A exits ($78 million), exits via M&A were 3.5 times more numerous than via IPO. In addition, M&A exits represented 70 percent of the total value of all VC-backed divestments in the United States (National VC Association 2007). In Europe, the dynamics are very similar, but in emerging markets across Asia, the situation appears to be exactly the opposite—exits are dominated by IPOs. For example, in 2007, 78 percent of the total number of divestments in Asia were in the form of IPOs (Centre for Asia Private Equity Research 2007). However, the dominance of IPOs in Asia probably reflects the underdeveloped environment for M&As and the fast-growing stock markets in the region more than anything else.

The failure rate of individual VC investments is quite high, with some estimates ranging up to 40 percent (Ernst and Young Venture Capital Advisory Group 2006). One VC fund in the United States estimates that the experience with the total portfolio of investee companies is largely broken down into thirds, with one-third of the companies failing, one-third underperforming expectations, and one-third meeting expectations and generating a return of five times the original investment (Union Square Ventures 2007). Therefore, a VC fund must generate a large flow of deals and high returns from the investee companies that succeed. Despite the high failure rate, the overall industry has yielded high returns relative to benchmark equity indexes. By the end of 2007, VC funds in the United States provided a 10-year annualized return of 18.3 percent, with seed and start-up funds providing a return of 35.5 percent, versus a return of 5.3 percent for the Nasdaq and 4.2 percent for the S&P 500 stock indexes (National VC Association 2008). Due to the need for such high rates of return, VC funding tends to go toward clusters of innovation located in particular regions and into sectors with particularly high growth potential. In the United States, the life sciences industry (biotechnology and medical devices) captured 31 percent of all VC investments in 2007, followed by the software industry (18 percent), and the energy sector (9 percent). VC
also tends to be clustered in the locations where those economic activities are based, so 34 percent of all U.S. VC investments in 2007 went to Silicon Valley (California), 22 percent to New England, and 7 percent to the San Diego area (National VC Association 2007).

The Domestic VC Industry in China

From its inception, China’s domestic VC industry has had heavy government backing. In 1984 the importance of VC was officially recognized, and in 1985 the first VC firm, China VC Company for New Technologies, was established with government funds (and was subsequently closed down in 1997) (Bottelier 2004). Since the establishment of the first VC companies in Shenzhen in the late 1980s, governments at all levels in China have invested directly in VC funds as majority shareholders or directly in start-up high-tech firms. Domestic VC funds in 2006 raised 37.2 percent of their funding from the government, SOEs, and PSUs (figure 4.2).

The government-sponsored VC funds have traditionally targeted either specific industry sectors or certain types of firms, such as SMEs. One example of that type of fund is the National Electronic and Information Technology Development Fund (IT Fund), sponsored by the former Ministry of Information Industry (MII). The fund makes equity investments in high-growth, technology-based SMEs in the information

Figure 4.2 Sources of Funding for China’s Domestic VC Firms

technology sector. By the end of 2006, the IT Fund had invested Y 266 million in 24 projects, with a total rate of return of 86 percent over eight years and total value of equity of Y 497 million. One highly visible investment by the IT Fund was in China Vimicro, a small firm developing integrated circuits in Zhongguancun, Beijing, by a team of overseas returnees. With an investment of Y 10 million, the IT Fund owned 12 percent of the company, which was then charged by MII, through the IT Fund, to develop China’s digital microchip industry and design commercial products. By the end of 2006, Vimicro became an internationally competitive producer of multimedia processors, with more than 100 million chips sold in 16 countries and regions. Vimicro was listed on the Nasdaq on November 15, 2005.

In some cases, local governments either set up VC funds or invest in private sector VC funds (rather than in high-tech firms directly) to attract more private investment into high-tech firms. Examples include the Zhongguancun High Tech VC Co-financing Fund, Suzhou Industrial Park VC Co-financing Fund (Y 1 billion for the first round), and Shanghai Pudong New Economic Zone VC Co-financing Fund (Y 1 billion from the local government and Y 1 billion from other sources). Meanwhile, the Ministry of Finance (MOF) approved a Y 100 million National VC Promotion Fund in the government’s budget in early 2007 to nurture the development of a robust domestic VC industry. That government VC fund claims to be modeled after Israel’s Yozma Fund. The National VC Promotion Fund is designed to be a “fund of funds,” investing in other VC funds instead of directly making investments in companies so as to attract more private VC investment in the early stage for high-tech firms. As of this writing, the fund has made no investments. Very little information is publicly available on the direct role of the government at any level (national, provincial, or municipal) in the VC industry; therefore, verifying the data and assessing the effectiveness of government intervention is not possible at this stage.

The direct role of the government in the VC industry was recently detailed in a document jointly issued by the MOF and MOST on July 6, 2007: “Interim Measures for the Administration of Guidance Funds for Promoting VC Investments in Small and Medium-Sized Technology Enterprises.” As they are currently understood, the so-called interim measures apply to all levels of government. The document covers the purpose, funding, investment requirements, and organizational structures of “Guidance Funds,” through which government will direct and promote VC investment in high-tech SMEs at the start-up stage of their business.
The Guidance Funds may invest in VC funds or directly in target companies. Capital for the Guidance Funds would be allocated from the central government and would be invested with VC firms with a minimum capitalization of at least Y 100 million. The Guidance Funds could be invested (1) through equity investments in VC funds, (2) through coinvestment with a VC fund in a particular targeted SME, (3) directly in a targeted SME as seed capital, or (4) in the form of an initial loss-funding for investments in the targeted high-tech SMEs. The interim measures thus allow for a wide range of activities by the government at all levels in the VC space in China.

The Entrance of Foreign VC Funds

The early history and statistics suggest that government was the dominant player at the outset of the Chinese VC industry. Although the government still has a strong presence in the domestic VC industry, foreign VC firms have come to control the majority of VC activities in China today. In 1992, the first foreign VC fund was established in China by the International Data Group (IDG). By 2007, foreign VC funds had raised 82 percent of all new VC investment by value, with only 13 percent coming from domestic VC funds (table 4.2). Because the number of new VC funds that year was split fairly evenly between domestic and foreign, the average amount of capital in the new foreign funds was more than five times that in the new domestic funds.

Foreign VC funds were also more active in terms of investing in China than were their domestic counterparts (table 4.3). Investment by foreign VC funds in 2007 represented 89 percent of the total value of all new VC investments in China in 2007. The average deal size for the domestic firms was about one-third that for the foreign firms. The average size of joint venture deals was about equal to that for foreign VC funds.

<table>
<thead>
<tr>
<th>Origin of VC funds</th>
<th>Number of new funds</th>
<th>Value ($ millions)</th>
<th>Average per fund ($ millions)</th>
<th>Share of value (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>25</td>
<td>1,106.21</td>
<td>44.25</td>
<td>13</td>
</tr>
<tr>
<td>Foreign</td>
<td>29</td>
<td>6,886.72</td>
<td>237.47</td>
<td>82</td>
</tr>
<tr>
<td>Joint venture</td>
<td>4</td>
<td>437.71</td>
<td>109.43</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>58</td>
<td>8,430.64</td>
<td>145.36</td>
<td>100</td>
</tr>
</tbody>
</table>

These differences are part of one of the most striking characteristics of VC activities in China—the dual VC structure (figure 4.3). The essential differences between the two models, i.e., the foreign model and the domestic model, are clear. In the case of the foreign model, all of the activity, except for that of the ultimate operating company, takes place offshore, while in the domestic model all the activity takes place within China. In almost all cases, the vast majority of the capital invested by the VC fund in the offshore holding company is actually used to invest in the operating company—that is, the funds do flow into China.

Foreign VC funds have backed a number of successful innovative companies in China that were started by a new generation of Chinese entrepreneurs. Although a few of those companies have significant exports, most are focused on the domestic market, and in all cases, the vast majority of the value-creating activity occurs within China. All of the VC firms invested their funds via an offshore-registered holding company. They were all incorporated outside of China, and all of the institutional investors in these VC funds were foreign. But significantly, most of the staff members at the foreign VC firms involved in the deals were Chinese. All of these successful innovation companies successfully executed an IPO on a stock market. But in each case, it was not a domestic Chinese entity that was listed on a Chinese stock exchange; rather, it was the offshore holding company that was listed on a foreign stock exchange, specifically a U.S. exchange and mostly on the Nasdaq. Thus, although the businesses of these companies are in China, virtually all parts of the VC system that supported them were offshore (Mackenzie 2007).

**Current VC Market Dynamics**

The VC industry in China has grown by almost 150 percent in five years as measured by assets under management, moving from $11.3 billion in

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**Table 4.3  Investments in China Made by VC Funds, by Domestic and Foreign Origin, 2007**

<table>
<thead>
<tr>
<th>Origin of VC funds</th>
<th>Number of investments</th>
<th>Value ($ millions)</th>
<th>Average value of investment ($ millions)</th>
<th>Share of total value (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic</td>
<td>87</td>
<td>290.53</td>
<td>3.34</td>
<td>8</td>
</tr>
<tr>
<td>Foreign</td>
<td>317</td>
<td>3178.68</td>
<td>10.03</td>
<td>89</td>
</tr>
<tr>
<td>Joint venture</td>
<td>11</td>
<td>119.61</td>
<td>10.87</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>415</strong></td>
<td><strong>3,588.82</strong></td>
<td><strong>8.65</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

2003 to more than $28 billion by 2007 (table 4.4). The average annual growth in the value of investments was 47 percent during this period, and the average annual growth in the number of investments was 20 percent. The number of VC firms increased about 80 percent over those years, from 166 to 298, with 2005 witnessing the most rapid rise. The number of investments made per year rose 150 percent, from 164 in 2003 to 415 by 2007, and the average size of investments increased from $4.6 million per deal to $8.7 million.

In terms of the investment targets, most have been in the expansion stage of financing. Of the 415 new investments in 2007, 142 were for business expansion and constituted 54 percent of the total value of all venture investments (table 4.5). Developmental financing was in second place. However, early-stage financing still accounted for 22 percent of all deals that took place in 2007.

The growing capital markets in China have opened a domestic exit channel for VC-backed investments. IPOs represented 88 percent of all divestments in 2007, with M&A taking up a distant second place with 12 percent, a dramatic change from 2006, when IPOs were only...
43 percent of all divestments (table 4.6). Much of the change could be attributed to the confidence and blistering growth in the domestic capital markets in China in 2007, which in large measure was due to a series of important reforms in the capital markets (such as the nontradable-share-reform process).\textsuperscript{52} While divestments grew only 10 percent from 2006 to 2007, the growth in divestments via domestic IPOs was 250 percent, and the 68 percent shrinkage in the use of M&As was an extraordinary change in divestment tactics by the VC industry in just one year.

An important reason for the improved environment in the domestic capital market was the creation of the Shenzhen SME Board in 2004.

### Table 4.4 Characteristics of VC in China, 2003–07

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number</td>
<td>164</td>
<td>194</td>
<td>298</td>
<td>362</td>
<td>415</td>
</tr>
<tr>
<td>Value ($ millions)</td>
<td>746.2</td>
<td>873.6</td>
<td>1,430.4</td>
<td>2,181.4</td>
<td>3,588.8</td>
</tr>
<tr>
<td>Average size ($ millions)</td>
<td>4.6</td>
<td>4.5</td>
<td>4.8</td>
<td>6.0</td>
<td>8.7</td>
</tr>
<tr>
<td>VC firms</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number</td>
<td>166</td>
<td>183</td>
<td>256</td>
<td>278</td>
<td>298</td>
</tr>
<tr>
<td>Capital managed ($ millions)</td>
<td>11,310</td>
<td>11,870</td>
<td>17,210</td>
<td>20,042</td>
<td>28,043</td>
</tr>
<tr>
<td><strong>Change (percent)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number</td>
<td>8</td>
<td>18</td>
<td>54</td>
<td>21</td>
<td>15</td>
</tr>
<tr>
<td>Value</td>
<td>40</td>
<td>17</td>
<td>64</td>
<td>53</td>
<td>65</td>
</tr>
<tr>
<td>Average size</td>
<td>52</td>
<td>-1</td>
<td>7</td>
<td>26</td>
<td>44</td>
</tr>
<tr>
<td>VC firms</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number</td>
<td>9</td>
<td>10</td>
<td>40</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>Capital managed</td>
<td>8</td>
<td>5</td>
<td>45</td>
<td>16</td>
<td>40</td>
</tr>
</tbody>
</table>


### Table 4.5 VC Investments in China, by Stage of Business Development, 2007

<table>
<thead>
<tr>
<th>Stage</th>
<th>Number of investments</th>
<th>Share of total number (percent)</th>
<th>Value ($ millions)</th>
<th>Share of total value (percent)</th>
<th>Average value of investment ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Early</td>
<td>91</td>
<td>22</td>
<td>278.95</td>
<td>8</td>
<td>3.07</td>
</tr>
<tr>
<td>Development</td>
<td>163</td>
<td>39</td>
<td>1,160.83</td>
<td>32</td>
<td>7.12</td>
</tr>
<tr>
<td>Expansion</td>
<td>142</td>
<td>34</td>
<td>1,935.55</td>
<td>54</td>
<td>13.63</td>
</tr>
<tr>
<td>Profitable</td>
<td>19</td>
<td>5</td>
<td>213.49</td>
<td>6</td>
<td>11.24</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>415</td>
<td>100</td>
<td>3,588.82</td>
<td>100</td>
<td>8.65</td>
</tr>
</tbody>
</table>

Although it got off to a relatively shaky start, its performance has surged as the overall capital market has improved. As of year-end 2004, the Shenzhen SME Board had 38 listed companies with a total market capitalization of Y 41 billion. By year-end 2007, it had 202 listed firms with a total market capitalization of Y 1.1 trillion, a fourfold increase in listed firms and an increase in market capitalization of 25 times. The number of listed companies has increased, and they include more than a dozen firms invested in by local VC companies. The debut of International Data Group–backed YGSOFT Corporation was especially in the spotlight. It was the first time that a venture backed by a foreign VC fund had debuted in China’s domestic capital market. Domestic VC funds had invested in 10 private Chinese companies that became listed on the Shenzhen SME Board in 2006, but those IPOs represented only 23 percent of all VC-backed IPOs in 2006—the rest of the transactions took place in foreign markets. However, progress was made in 2007, when 36 percent of all VC-backed IPOs (or 35 out of 96) were executed domestically (Zero2IPO 2007).

A final characteristic of the VC industry is financial performance. Actual performance of China’s VC industry is difficult to estimate because performance measurement based on the available sources is not entirely clear or standardized. It would appear that those VC-backed firms that listed on both international and domestic exchanges yielded the highest returns to investors, with some IPOs returning many multiples (on the order of 4 to 10 times) of the original investment (as compared with about 5 times in the United States). But the failure rate for individual investments was relatively high, with some estimates suggesting upward of 60 percent of all investments (as compared with 20 percent to 40 percent in the United States) (Wang, Wang, and Liang 2007). Thus, it would appear that the performance of VC activity in China is governed by the extremes of both high risks and high returns.

### Table 4.6 Number of VC Divestments in China, by Method, 2006–07

<table>
<thead>
<tr>
<th>Method</th>
<th>2006</th>
<th>2007</th>
<th>Change (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial public offering</td>
<td>43</td>
<td>96</td>
<td>123</td>
</tr>
<tr>
<td>Domestic</td>
<td>10</td>
<td>35</td>
<td>250</td>
</tr>
<tr>
<td>Foreign</td>
<td>33</td>
<td>61</td>
<td>85</td>
</tr>
<tr>
<td>Mergers and acquisitions</td>
<td>41</td>
<td>13</td>
<td>–68</td>
</tr>
<tr>
<td>Other</td>
<td>15</td>
<td>0</td>
<td>–100</td>
</tr>
<tr>
<td>Total</td>
<td>99</td>
<td>109</td>
<td>10</td>
</tr>
</tbody>
</table>

Strengthening the Ecosystem for the VC Industry

Despite the rapid evolution and growth of VC in China, it faces many challenges that constrain China’s ability to fully realize its potential in developing its innovative industries. In particular, with the exception of a few spectacular success cases, the domestic VC firms are still at an early stage of development, beset by a range of difficulties. The experience of foreign VC firms suggests that, contrary to conventional belief, the flow of innovations, ideas, and products within China that are worthy of VC investment does not seem to be the binding constraint. The further development of the domestic VC industry could benefit greatly from actions aimed at a strengthened ecosystem, particularly in four dimensions: structure, funding, management, and exit.

Testing of the New VC Structures

There are no major constraints to structuring a VC fund in China at this moment. The reforms in the corporate legal structures in China in the past three years represented a solid step forward (box 4.1). The revised Company Law and Partnership Law, as well as the subsequent regulatory issuances, effectively removed legal barriers to the proper structuring of a domestic VC fund in the form of a limited partnership. A few new funds reportedly have been established under the new laws, which will allow for the structure to be tested. However, the revisions of the laws are so new that too few funds have so far been established under them. Therefore, the immediate challenge will be for some new funds to be established to allow for a domestic model to emerge.

Recommendations

With the close involvement of institutional investors, the government could conduct an assessment of the operations of the first batch of domestic VC funds created following the newly amended Partnership Law and identify loopholes and weaknesses that might require further legislative or policy actions. Once the weaknesses in the application of the legal framework for fund structuring have been identified, they should be addressed through new regulations.

Expanding of the Sources of Venture Funding

The potential sources of funding for the VC industry in China, such as investment funds, pension funds, banks, and insurance companies, are growing rapidly. The story of the size of China’s banking system is well
known, and financial institutions now have more than Y 40.1 trillion in total deposits as of year-end 2007 (PBOC 2007). The investment fund sector, which is relatively new by comparison, is much more modest in size, with about Y 3.1 trillion in assets under management in China at the end of 2007 (CSRC 2008). Although China’s pension fund system is still very much a fledgling (and China has essentially no private foundations or endowments), its existing pension funds and insurance company assets are already quite substantial, and by most accounts, these pools of contractual savings will grow over the next few decades to be among the largest in the world. The National Social Security Fund (NSSF) has about Y 300 billion in assets. Provincial government pension funds have an estimated Y 800 billion in assets. Finally, total insurance company assets as of the middle of 2007 were in excess of Y 2.5 trillion.

However, these funds are not making it into the VC arena. As was shown in figure 4.2, domestic VC funds receive no investment from

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**Box 4.1**

**Recent Progress in the Reform of Company and Partnership Laws in China**

In 2007, the National People’s Congress ratified a substantial revision to China’s Partnership Law, to take effect on June 1, 2007. The revisions make substantial improvements to the 1997 Partnership Law and have significant implications for the VC industry. The new Partnership Law allows for the following innovations: limited partnerships with two kinds of partners, general and limited; “pass-through” tax treatment—that is, the limited partnership is not a taxable entity, and profits and losses are passed through to the individual investors; legal persons are allowed as investors; and foreign natural persons and foreign legal persons are permitted to invest in domestic limited partnerships.

Also in 2007, the Ministry of Finance and State Administration of Taxation released a Circular Concerning the Tax Policies for the Promotion of Venture Capital Enterprises that granted properly approved venture capital enterprises making qualified venture capital investments the ability to deduct 70 percent of the amount of each individual investment from the income tax payable of the venture capital enterprise. This helps to address the residual issue of taxability of limited liability companies.

insurance companies, pension funds, or other institutional investors. Only 7.5 percent of total funding is from banks, and 2.4 percent is from trust companies. The issue with capital from pension funds and insurance companies in China concerns investment policy and is quite simple: currently, China’s pension funds and its insurance companies are prohibited from investing in private equity or VC funds, that is, they have zero percent of their funds allocated to this asset class.\textsuperscript{59} It is obviously hard to develop a domestic VC industry if the major holders of domestic long-term capital are not allowed to invest in VC. Not only are the regulations problematic, but even in the absence of these regulations, there is a general perception in the market that VC funds are poorly managed, which further compounds the aversion to this asset class. The VC exposure of the more conservative investors, such as banks, is likely to have been the most affected by this risk perception. As for family offices, foundations, and endowments, these types of professional investors are essentially absent from China.

**Recommendations**

The main objectives of reform in this area would be twofold: first, to allow China’s existing but nascent institutional investors to eventually begin investing in domestic venture capital institutions, and second, to promote the creation of other forms of investors oriented to the long term, such as family offices, foundations, and endowments. In the long run, China’s institutional investors, such as its pension funds, insurance companies, investment funds, and banks, will likely emerge as the main source of funding for a truly viable domestic VC industry. The availability of such funding has been the case in economies with successful VC industries, where institutional investors lead the funding in VC as part of their effort to find higher long-term returns and to diversify their portfolio risk. In making their VC investments, these institutional investors are charged with delivering an appropriate risk-adjusted return while not putting the funds’ principal at undue risk. The stringent regulatory limits placed on the various institutional investors in China on their exposure to VC as an asset class is, therefore, not conducive to the industry’s development. The government should consider policy measures to allow for institutional investors to begin investing in domestic VC institutions.

Recognizing that the risks of VC investing are higher, the financial supervisory authorities may want to take a slow approach on this issue. The first step could be to develop a short- to medium-term action plan that would provide a roadmap allowing these institutional investors to invest in private equity and VC funds. One immediate first step could be
to set new prudential guidelines on the investment by institutional investors in the wider alternative-asset class (hedge funds, private equity, and VC). The guidelines could set appropriate exposure limits and risk weightings for investments in alternatives that would be determined by the supervisory authorities in consultation with market participants. As part of this gradual approach, the supervisory authorities could first allow only a select group of financial institutions to pilot such investments, provided that they qualify under some predefined criteria for measuring financial health and the quality of risk management. The supervisory authorities could allow these institutions to invest in established foreign private equity and VC funds only. Those funds could be foreign or domestic in terms of their investments to provide maximum flexibility and comfort to the regulatory authorities. This approach would give the institutions experience in investing in this asset class and allow them to learn how to pick fund managers.

Another step could be to allow institutional investors to support foreign private equity and VC fund managers that were willing to establish an RMB-denominated and China-domiciled fund. That would allow Chinese institutional investors to gain experience in investing in domestically oriented VC funds without taking excessive risk on new fund managers. An assessment could then be made of the risks, performance, and other factors, and the limits could then be adjusted upward by the authorities if warranted. In parallel, the financial supervisory bodies may also consider studying the regulation of the alternative-investment class in China with a view toward promoting its growth while maintaining a degree of transparency and stability.

Finally, but as a second-order priority, the government could promote the creation of other forms of long-term-oriented investors such as family offices, foundations, and endowments. As China’s economy continues to grow rapidly, more and more entrepreneurs will become wealthy and will become potential VC investors. The government should, therefore, study the current and projected population of these investors and the detailed constraints they face in forming foundations, endowments, and other such vehicles.

**Building Stronger Venture Partners for Investee Companies**
The lack of professional investment fund managers in China is a particularly acute problem in the domestic VC industry. Given the relatively recent growth in the industry and the dominance of foreign VC funds, it is not surprising that few VC fund managers have a long track record of
investment. The domestic VC industry does not appear to have provided adequate incentives in terms of pay and promotion, particularly when compared with their foreign counterparts, which may have hindered them from attracting the best talent in the market. However, skills are even more necessary in the VC industry than in most other types of funds because of the nature of the investments—they require a hands-on approach and a range of specialized talents to extract value from the investee companies. The problem is compounded by a general dearth of high-quality business managers, and good and experienced new venture managers are a scarce resource in China (Deloitte Research 2006). Thus, such companies need even more help from VC investors at a time when the VC firms do not have sufficient numbers of skilled management and staff.

Inexperience has also led to problems in the corporate governance of domestic VC funds, especially for the large number of government-sponsored or -dominated VC. Despite significant variation across firms and regions, many of them suffer the same limitations as other state-owned financial institutions—the managers are largely government bureaucrats with mixed incentives and limited knowledge of VC investing, and they lack adequate risk-management controls. These governance problems extend to the wider corporate sector, where the culture and regulatory structures of developed economies, such as those of the United States and Europe, are not yet strongly rooted in China. Despite the new provisions in the Company Law that impose a duty of care and loyalty on directors, supervisors, and the senior management of companies, many ambiguities remain as to how directors would comply with the new requirements. In addition, many entrepreneurs do not fully understand the differences in institutional rights between VC, private equity, bank loans, or other forms of financing (Deloitte Research 2006).

In the most advanced legal jurisdictions, VC investors have the basic freedom to obtain the economic and governance rights appropriate to the risk profile of their investment. In addition, they have the basic freedom to restructure ownership of the company simply via registration and without government approval. The revised Company Law in China has introduced the concept of share classes; and even before the revisions, a company and investor faced no barriers in constructing a legal agreement to ascribe various rights. However, the problem is largely that in the case of a dispute, investors do not have adequate assurance that China’s legal system would recognize such agreements even if they conform to the law; and enforcing contracts in China is time-consuming and uncertain given
the state of the judicial system. Therefore, the exertion of control and consequent engagement in the key management decisions in an investee company by VC firms is quite challenging in China. The combination of inexperience and the weak corporate governance environment has resulted in some domestic VC funds acting as ordinary equity investors with a short horizon for their investment returns, a low tolerance of risks, and an inability to pick and choose truly profitable innovative firms and products.

Recommendations

The key challenges in this element of the VC ecosystem are long term. The lack of professional VC fund managers will evolve over time. Given that the domestic VC industry is nascent, the likely evolution of the industry will involve the transfer of knowledge from foreign VC firms to domestic firms. In that process, domestic firms could benefit from a clear talent strategy defined in connection with the overall business strategy of the firm, including, for example, market positioning. The best strategy is not necessarily one that intends to recruit and retain the best talents in the market. Rather, it is one that best fits the firm’s overall strategy.

Improving corporate governance is another long-term challenge that is critical to strengthening the ecosystem of VC. In this regard, the primary policy actions that can be taken are related to enforcement of the amended 2005 Company Law. First, it is advisable for the government to organize the formulation of what might be called a “Code of Conduct for Corporate Governance” covering both state-owned and private companies. It can be an updated and expanded version of the Listed Company Corporate Governance Rules issued jointly by the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission in January 2002. In addition to general guidelines, the code of conduct should seek to operationalize the rules of the 2005 Company Law (box 4.2). For example, it could specify in more detail the concepts of duty of loyalty and duty of care and clarify the circumstances in which a director or officer can be viewed, according to the Company Law, as taking “advantage” of their “positions in the company” to exploit “opportunities that belong to the company,” which also require specification. Second, to promote the proper use of preference shares, as in other developed company law environments such as those in the United States and Cayman Islands, the State Council might consider, as authorized by the Company Law, the promulgation of a regulation to govern the issuance of preference shares. The regulation could spell out,
among other things, what might be allowable and how registration authorities are to accommodate these new legal tools.

**Widening the Exit for Venture Investments**

Chinese companies have been listed on overseas stock exchanges since the early 1990s. Through the late 1990s, it was essentially only the largest SOEs that listed overseas (almost entirely on the New York Stock Exchange or Hong Kong Stock Exchange). There were few non-state-owned companies that were qualified to list in that period, and for those
that were, the government sought to control their ability to list by requiring that they get permission to do so from the securities regulator. However, as the number and quality of private firms increased, many of them with capital from foreign private equity and VC funds, the government also liberalized its position on listing abroad and eventually removed itself entirely from the approval process. That was the situation through the beginning of 2005. The first part of this decade became a bit of a golden age for foreign VC in China because the VC firms had found a model by which they were able to legally invest in Chinese companies and list the successful investments overseas. All of the well-known VC-invested Chinese companies of recent times were divested under that model, and foreign VC funds during that period almost universally targeted the listing of their Chinese portfolio companies on overseas exchanges.

The large changes in the domestic stock markets over the past couple of years have created a fundamentally new situation—for the first time in modern China, private entrepreneurs have seen not just a reason to list their company domestically but also a more realistic prospect that they might actually be able to achieve it. The full implications of this novel situation for VC financing in China cannot yet be known—but they are certainly likely to be positive. An important element of the improved domestic capital market environment has been the creation of the Shenzhen SME Board, which saw 10 VC-backed IPOs in 2006 (although that was only 23 percent of all VC-backed IPOs in 2006; the rest took place in foreign markets). Despite the existence of a stronger IPO avenue for domestic exits, there has been much less progress for one of the other primary channels for exit—strategic sale (that is, merger or acquisition). The revised Company Law still requires that the shares held at the time of the IPO be subject to a one-year lockup. No existing shareholders are allowed to sell at the IPO. That rule significantly increases the minimum holding period for a VC investor.

Acquisitions of Chinese businesses by foreign investors and the establishment of related onshore acquisition vehicles are subject to a multistep, multiagency government approval process, and these approvals depend on the ownership of the target (state-owned, private, or publicly listed), type of transaction, amount invested, and industry involved (Eich and Li 2007). For instance, special approval is required from the central SASAC if one is buying an SOE and the transaction goes beyond the scope of the normal approval process for any acquisition. Because of the various laws that govern foreign investment in China and the required government review and approval, foreign VC firms have chosen to
invest in foreign-domiciled holding companies and sell these vehicles to
a third party as a completely offshore transaction that would not require
any approvals by the Chinese government.

Recommendations
The preferred method of realizing VC investments in China is through an
IPO. The domestic markets have grown and matured over the past few
years and have increasingly become a desirable exit route for realizing VC
investments. However, improvements can still be made to market-based
divestments by VC funds, and those improvements are largely within the
scope of the CSRC.

First, the time required by the application process could be
reduced, and the overall transparency of the domestic listing process
could be improved. Reducing government involvement in, and man-
gagement of, listing volumes would also be an important contribution
to efficiency. Indeed, listings have been stopped intermittently and for
long periods. The potential for such bans or slow downs to reappear
creates considerable uncertainty about the reliability of the domestic
stock market as an exit route for VC investment.

Second, the government could consider the further shortening of lock-
pup periods to the international practice of six months and allowing early
investors to sell shares at the IPO stage. VC investors will have invested
in a company for several years before its listing and need the maximum
flexibility possible to liquidate their positions.

Finally, the government can provide a mechanism for foreign-VC-
invested companies to list on foreign as well as local exchanges, a move
that would undoubtedly lead to more companies listing in China. In the
short term, it is foreign-financed firms that will generally have better
practices in terms of equity structuring, governance, accounting trans-
parency, and so on. Allowing such firms to list is the easiest way to pro-
duce quick models and also encourage VC firms to look harder at
domiciling their funds domestically and investing directly in domestically
domiciled corporations.

As for the primary method of divestment in the most mature VC
markets—M&As—there are many possible actions to be taken to advance
that method in China. The government could move from a system requir-
ing government approval of changes to the shareholder structure (that is,
ownership) toward one of registration. Consideration could be given to
clarifying what constitutes a strategic industry (in which transactions
require a high level of scrutiny and a rigorous system of government
approvals) so as to allow the increasing liberalization of the rules for all other transactions. The benefit of having strategic shareholders is well documented and proven worldwide, particularly in innovative industries with intensive knowledge-transfer needs. The current system of government approvals is, to a certain degree, a holdover from the period during which all companies were state-owned. However, as China’s economy is increasingly privately owned and market oriented, it needs regulations that allow companies to be more flexible and nimble. The behavior of state-owned companies should be controlled by their shareholders, and the responsibility of all companies and persons to behave legally should be overseen by the rule of law.

The Role of the Government in Supporting the VC Industry

On the one hand, China’s VC industry could benefit from government actions to strengthen the VC ecosystem; on the other hand, the government seems to have concentrated on heavy and direct investment in the VC industry, as was discussed earlier in this chapter. This contrast raises the critical issue of the proper role of the government in supporting the VC industry. A thorough investigation of this issue would go beyond the scope of this study, given the scarcity of relevant data in the public domain. Nonetheless, three observations can be made on the basis of existing knowledge.

First, there are some theoretical justifications for government intervention in supporting the VC industry. They begin with the idea that VC supports innovative industries that produce positive externalities that ripple through the economy (Secrieru and Vigneault 2004). Thus, to follow this rationale, government intervention is needed and is appropriate to get nascent businesses off the ground. Government intervention could also help in the process by signaling that the quality of the start-up and early-growth firms is sufficient to warrant other sources of external funding. Finally, government activities in the fiscal, regulatory, and R&D areas can help create the enabling environment for both the VC industry and the potential VC investee companies.

Second, countries have mixed experiences with direct government involvement in the VC industry, and there are some lessons to learn. Many governments around the world have been deeply involved in the development of the VC industry at the early stages and beyond. The efficacy of direct government engagement in the sector is subject to debate; the transparency of government interventions and the academic
study of their effects have both been very limited. A few government programs have been successful in promoting the VC industry, while others have resulted in a substantial waste of public resources and have put the VC industry on a worse footing than before. For example, research on one U.S. government program suggests that it did not meet various targets, such as increased geographic distribution of VC funding, and the performance of the investee companies was no different than that by those receiving purely private VC investments (Lerner 1999). Other studies have suggested that government intervention can generate problems in terms of creating market distortions, crowding out the private sector, failing to meet public policy goals, and deploying public resources inefficiently (Lerner 2002). On balance, the evidence seems to imply that the most successful direct government interventions have several features in common. They (1) substantially leverage government funding by requiring as much or more in private funding, (2) use private sector management of the fund, (3) set forth a clear investment objective (for example, a sector development target) with clear return benchmarks, (4) establish a finite period for exiting the investments, (5) are closely coordinated with broader economic development activities as well as other fiscal incentives, such as tax breaks for specific industries, and (6) are geared to improving the general investment climate for the VC industry (including the regulatory framework, tax efficiency, sophisticated infrastructure and financial institutions, and human resource policy).

Third, for China, priority should be given to strengthening the VC ecosystem, and the merits of direct government involvement in the VC industry should be assessed in a broad framework. As with many other countries, the transparency as well as the rigorous empirical study of government direct interventions in China’s VC industry have been limited. And such a study would necessarily be complex. There is also a need to go beyond the VC industry to assess the merits of the various modalities of government financing of the early-stage development phases of innovation, from R&D to pilot production. After all, VC financing, as important as it is, has only a limited role to play (as indicated at the outset of this chapter) and is oriented to the commercialization of innovation, not the initial creation of innovation. With a comprehensive assessment, a strategic plan could point the way forward by clearly defining the role of government in the VC industry and in the financing of innovation more broadly.
Conclusions

Within the broad topic of supporting innovation, financing commercialization stands out as a special issue. It requires not only capital, but also external risk capital, that is, capital from outside the firm that is supplied by investors willing and able to take the risks involved in technology creation, adaptation, and adoption. The VC industry emerged to fill the funding gap for start-up and early-stage risk capital for innovative firms.

Despite its relatively early start in the mid-1980s and strong government backing, China’s domestic VC industry remains in an early stage of development. Creating a viable VC industry involves more than setting up and capitalizing a number of individual VC funds. More important is the creation of the ecosystem for the industry, the key elements of which include the structure, funding, management, and exit routes for VC investments. The VC industry in China faces challenges in those areas. The way forward is for the government to invest more in improving the ecosystem, as follows:

- **Structure:** With close involvement of institutional investors, assess the new VC structures by conducting an assessment of the operations of those domestic VC funds created following the newly amended Partnership Law and by identifying loopholes and weaknesses that require further legislative or policy actions.
- **Funding:** Expand the sources of VC funding by considering policy measures to allow institutional investors to begin investing in domestic VC institutions. Because the risks of VC investing are high, the first step could be to develop a short- and medium-term action plan that would provide institutional investors with a roadmap for investing in private equity and VC funds.
- **Management:** Build stronger venture partners for investee companies by enhancing corporate governance. The government could organize the formulation of a Code of Conduct for Corporate Governance to facilitate the enforcement of the amended Company Law. It is particularly advisable for the State Council to adopt a regulation to govern the issuance of preference shares.
- **Exit:** Further widen the exit routes for venture investments by providing mechanisms for foreign-VC-invested companies to list on both foreign and local exchanges and continuously improve the domestic listing process. These steps may include a further reduction of application time, greater transparency, and reducing government management of listing volumes.
Finally, a cross-cutting area of the VC industry is the direct role of the government. As is the case in many other countries, there is very limited transparency regarding direct government intervention in China’s VC industry and little rigorous empirical study of its effects. Nonetheless, the practical experiences of other countries are mixed. China could consider giving priority to strengthening the VC ecosystem as detailed previously while it simultaneously assesses the merits of direct involvement in the VC industry and considers the most appropriate role for government intervention in innovation financing more generally.