China Focuses on Domestic Venture Capital

——— David Yu

Various Chinese authorities[1] have jointly promulgated the Provisional Administrative Measures on Venture Capital Enterprise ("**Measures**"), effective as of March 1, 2006. The Measures are significant in that China has unswervingly launched a drive to create a domestic venture capital industry to fund companies in high-growth sectors such as technology.

It was not a simple decision for the Chinese regulators to make this move. Though China has made several relevant rules since the introduction of venture capital and has promulgated special measures on foreign invested venture capital[2], there is no specific regulation addressing the domestic venture capital, which leaves an uncertain and open-ended policy direction in the development of domestic venture.

In recent years, with the pressing concerns in relation to the funding problems in the Chinese small businesses and the increasingly substantial returns being reaped by the foreign venture capitals in China, the regulators are bound to react. The enactment of the Measures is the first step to foster a domestic venture capital industry.

Definition of Venture Capital

The Measures define the venture capital as a type of equity investment in growing companies at their start-up or reorganization stage. The investor may receive capital gain after the sale of their equity investment. It is worth noting that though the Measures are designed to promote the development of small and medium-sized enterprises (in high-tech industry especially) as stated in the Article 1 of the Measures, the companies being invested ("**Target Enterprise**") are not confined to such enterprises. Moreover, since the definition of "growing" is rather vague and a record filing system will be adopted (as discussed below), the domestic venture capital enterprises ("**VCE**") may enjoy a great variety of choices in their investment.

Form of Domestic VCE

Despite the fact that some local rules (e.g. the ones applicable to Zhongguancun Hi-Tech Zone[3]) encourage the limited partnership, a form of organization which is widely adopted in the venture capital overseas. However, such forms are unlikely to be permitted under the Measures because Article 6 of the Measures specifies that a domestic VCE may take the form of a limited liability company, a company limited by shares or other enterprises specified by laws. The existing Partnership Enterprise Law[4] only allows unlimited liability partnership, it is therefore impossible, at least currently, for a venture capital to enjoy the benefits of partnership of limited liability. Moreover, one might be very cautious in reading Article 6, as the wording "specified by laws" does not include "the rules and regulations", which has the implication that the adoption of local rule is not encouraged.

Investment

The Measures limit the business scope of the domestic VCE to: 1) the venture capital business; 2) the agency of venture capital business on behalf of individuals or other VCEs; 3) the consultancy for venture capital; 4) the venture capital management and services for other VCEs; and 5) the participation in the establishment of other VCEs and venture capital management and consulting enterprises.

In respect of the venture capital business, a domestic VCE may invest its total assets to the Target Enterprises, provided that a maximum investment in a single Target Enterprise does not exceed 20 percent of such total assets. Apart from the investment in the Target Enterprises, the domestic VCEs are only allowed to deposit at banks and to purchase treasury bonds or other securities with fixed dividends. In order to prevent the potential conflict between the speculations in security and the exit route from the security market, the Measures have specified that the domestic VCEs may retain the shares of a Target Enterprise after IPO. According to an official press conference[5] ("Press Conference") regarding the issuance of the Measures, these provisions intend to disperse the venture investment and prevent speculative behavior in the securities or futures market.

Although the regulators tried to carve these provisions in detail to achieve the purposes stated above, confusion may arise in its implementation. For instance, it may be worthwhile specifying a certain point in time to determine the assets which float from time to time. Furthermore, as the newly amended Company Law[6] has provided for one-year lock-up period on share transfer[7], it may incur some risks on the IPO exit route.

Financing

It is noted that the implication on the foreign invested VCEs in loan financing[8] does not find its equivalent to the domestic VCEs. Instead, a new provision is introduced to provide that a domestic VCE may improve its investment capability through debt financing. According to the Press Conference, this provision is designed to allow the domestic VCEs to finance their capital from loans under the exception specified in the Article 20 of the General Rules of Loan[9], which provides that loans, in general, can not be used to make equity investment.

Shareholding in the Target Enterprise

The Measures provide that a domestic VCE can enjoy quasi equities, such as preferred shares or convertible preferred shares. Such provision may reflects the oversea adoption (e.g. in exchange for the investment, the venture capital investor gets minority ownership in the Target Enterprise while the entrepreneurs of the Target Enterprise work to develop the business, with some advice and support from the venture capital investors). However, the above-mentioned term of preferred shares or convertible preferred shares are not defined in the newly amended Company Law which has somehow lifted the restriction on shareholding by creating different classes of shares[10]. Therefore, it is advisable to implement the preferred shares and convertible preferred shares under the framework of the newly amended Company Law.

Supporting Policies

The Measures have indicated that the development of venture capital are supported by policies, namely, the promotion by governmental guiding funds, the favorable tax treatment and an improved capital market and exit routes.

However, there are no detailed rules specifying the policies in the Measures, which make such provisions merely policy indicators. According to the Press Conference, China will facilitate the enactment process of such policies as soon as possible and it is expected to find more supplementary rules in such respects.

Record-filing

The Measures impose a record-filing system. Domestic VCEs that register with the Administration of Industry and Commerce may apply to the National Development and Reform Commission or relevant local authorities for record filing.

As specified in Article 3 of the Measures, such record filing formalities merely serve as a gateway to the supporting policies rather than setting up an approval or permit system for business operation. According the Press Conference, there is no need to establish an approval system for the market-conduct nature and varied types of the venture capital. The sole purpose for record filing is to classify certain types of domestic VCEs which are entitled to the supporting policies.

In order to file with relevant authorities, a domestic VCE must meet the following conditions: 1) the registration with Administration of Industry and Commerce; 2) the operation of business as specified in the Measures; 3) the contribution of at least RMB 30 million in registered capital, or the contribution of at least RMB 10 million in the first payment of capital with the remainder being made up within five years; 4) the number of investors should not be more than 200, or not more than 50 for a limited liability VCE (all capital must be contributed in cash and each investor must invest at least RMB 1 million); and 5) the employment of at least 3 senior management officials with at least 2 years venture capital or relevant experience (in the case of engaging a venture capital consulting enterprise, the consulting enterprise shall meet such employment requirements).

The Measures have also clarified that a record-filed domestic VCE shall be subject to the supervision while the non-recorded ones will not be supervised by relevant venture capital authorities. Compared with establishment approval and compulsory record filing for the foreign invested VCEs[11], the domestic VCEs will benefit from a more streamlined system of governmental formalities together with less strict regulations.

Foreign Invested VCE

Similarly, foreign invested VCEs are also entitled to enjoy the supporting policies in the Measures, provided that their business operations meet relevant conditions. Unfortunately, the Measures fail to specify the "relevant conditions" in detail. According to the Press Conference, the national treatment is applicable to this provision, so that it may be predicted that the "relevant conditions" shall mean the record filing conditions on a domestic VCE as discussed above. As the establishment requirements to foreign invested VCEs are much stricter than the record filing conditions on domestic VCEs, it won't be difficult for the foreign invested VCEs to receive the supporting policies if the regulators as intend.

A Major Step Forward

The promulgation of the Measures is a major step forward in the development of the domestic venture capital industry. It is expected that the relevant authorities will implement more detailed supplementary rules in guiding fund, tax treatment and exit routes. However, there is still much more to be done since the equity investment, debt financing and exit through sales and IPO all depend on a far more complex system that China is yet to develop.

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1 National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People's Bank of China, State Administration of Taxation, State Administration of Industry and Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission and State Administration of Foreign Exchange

2 the Provisional Rules on the Foreign Invested Venture Capital Enterprise, promulgated on August 28, 2001 and became invalid as of March 1, 2003; the Administrative Measures on Foreign Invested Venture Capital Enterprise, promulgated on January 30, 2003 with effect as of March 1, 2003

3 the Administration of Limited Partnership, promulgated by Beijing Municipal Government on February 21, 2001 with effect as of the same date

4 promulgated by the Standing Committee of the National People's Congress on February 23, 1997 with effect as of August 1, 1997

5 an official press conference by National Development and Reform Commission

6 promulgated by the Standing Committee of the National People's Congress on October 27, 2005 with effect as of January 1, 2006

7 see Article 142 in the newly amended Company Law

8 see Article 32 in the FIE Measures

9 promulgated by People's Bank of China on June 28, 1996 with effect as of August 1, 1996

10 see Article 35, Article 43 and Article 167 in the newly amended Company Law

11 see Article 6, Article 7, Article 8 and Article 45 in the FIE Measures