

CONVERTIBLE PREFERRED STOCK: TESTING THE LEGAL FRAMEWORK OF
THE U.S. VENTURE CAPITAL MODEL IN CHINA

by

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Abstract

Convertible preferred stock is a risk-mitigating security integral to the success of venture capital (VC) investment strategy in the United States (U.S.). Its function in protecting ownership rights and illiquid investment, as well as facilitating sales of the portfolio company has attracted the attention of the People's Republic of China (PRC or China) that has implemented its own convertible preferred stock provisions in search of similar gains. Importantly, the PRC lacks the institutional stronghold of the U.S. – stringent securities regulations and a stock market centered economy - which provides an optimal environment for convertible preferred stock. Despite this, VC analysts unidirectionally support the U.S. model as a template for the PRC without explaining the addition of the provisions as needed law in China's VC systems.

This thesis rethinks the 'ivory tower' approach of the U.S. VC model and addresses a missing link in the literature: the tension between what is borrowed from Western structures for the formation of convertible preferred stock and domestic PRC market needs. Through the consideration of law as an instrument of policy, I argue that the party-state's incremental implementation of convertible preferred stock provisions reflects Western expressions of economic autonomy while also reflecting counteracting socialist goals of state supremacy. This tension provides academic insight into VC and securities laws previously unexplored by the literature, particularly valuable in light of the U.S. and PRC's status as competing super economies in our modern world.

Preface

This thesis is the original, unpublished, independent work of the author.

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List of Abbreviations

ATSD	Advanced Technology Science Division
UCC	United States Uniform Contract Code
CJV	Cooperative Joint Venture
CPC	Communist Party of China
CSRC	China Securities and Regulatory Commission
DTAT	Double Taxation Avoidance Treaties
EITL	Enterprise Income Tax Law
EJV	Equity Joint Venture
FBIE	Foreign-Funded Business Enterprise
FIE	Foreign Invested Enterprise
FIJSC	Foreign Invested Joint Stock Company
GDP	Gross Domestic Product
JSC	Joint Stock Company
IPO	Initial Public Offering
HKSE	Hong Kong Stock Exchange
LLC	Limited Liability Company
M&A	Merger and Acquisition
MLMZT	Marxism Leninism Mao-Zedong Thought
NVCA	National Venture Capital Association
NYSE	New York Stock Exchange
PRC	People's Republic of China
R&D	Research and Development
RMB	Renminbi
SAFE	State Administration of Foreign Exchange
SASAC	State-Owned Assets Supervision and Administrative Commission
SAT	State Administration of Taxation
SHSE	Shanghai Stock Exchange
SME	Small and Medium-Sized Enterprises
SOE	State-Owned Enterprise
SPV	Special Purpose Vehicle

SZSE	Shenzhen Stock Exchange
UCL	Contract Law of the People's Republic of China
U.S.	United States
USD	United States Dollar
VC	Venture Capital
VIE	Variable Interest Entity
WFOE	Wholly Foreign-Owned Enterprise
WTO	World Trade Organization

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To my beautiful family

Chapter 1: Introduction

1.1 Overview

Venture capital (VC) is investment by financial firms in “high-growth, high-risk private start-up for high return in the future”.¹ Companies like Apple and Facebook – the showpieces of the American economy - exist today as creations of VC strategy goals during early stage investment. The phenomenon of VC investment has spread globally in the past 25 years, reflecting a conscious attempt to copy U.S. industry practice.² Specifically, the People’s Republic of China (PRC or China) has emulated American technique in search of similar gains, but has produced lackluster results largely tied to political and legal hazards that heighten investment risks.

This thesis focuses on a lesser known VC risk-mitigating instrument that has also been replicated in China – convertible preferred stock. Used during the corporate governance and exit stages of VC investing, it protects ownership rights, illiquid investment, while also facilitating the sale of the portfolio company.³ Studies show the performance of convertible preferred stock makes it a near-exclusive means of financing for U.S. venture backed companies.⁴ Critically, data shows it is mainly American venture capitalists that invest through convertible preferred stock, and only to back the capital formations of U.S.

¹ BS Black & Ronald J Gilson, “Venture Capital and the Structure of Capital Markets: Banks Versus Stock

² Garry D Bruton, Vance H Fried & Sophie Manigart, “Institutional Influences on the Worldwide Expansion of Venture Capital” (2005) 29:6 *Entrep Theory Pract* 737, online: <<http://doi.wiley.com/10.1111/j.1540-6520.2005.00106.x>>.

³ Ronald J Gilson & David M Schizer, “Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock” (2003) 115:3 *Harv Law Rev* 874.

⁴ John Orcutt & Hong Shen, *Shaping China’s Innovation Future: University Technology Transfer in Transition* (Northampton, MA: Edward Elgar Publishing, 2010) 215.

companies.⁵ Given this ubiquity, the implementation of convertible stock provisions in China is questionable for several reasons. Firstly, other securities and contract provisions can easily replicate the effects of convertible preferred stock.⁶ Secondly, it is observed that convertible preferred stock operates in an optimal corporate governance environment.⁷ The U.S. institutional structure - laws, business practices, and social norms - has been cited by academics as the keystone for managing corporate governance hazards of uncertainty, information asymmetry and opportunism that, if managed, facilitates VC success.⁸ In contrast, China's immature VC system, fraught with regulatory and institutional instability, represents a heightened risk to a convertible preferred stock structure.

The aforementioned barriers have not been considered conjunctively by VC analysts to explain the necessary addition of convertible preferred stock provisions in China's VC systems. The tendency of academics has been to unidirectionally advocate for the U.S. model as a template for both industries without considering law as an instrument of the Communist Party of China's (CPC) policies. Thus, the aim of this thesis is to rethink this 'ivory tower' approach of the U.S. VC model and so address a gap in the literature: i) the tension between what is being borrowed from Western structures for the formation of convertible preferred stock and ii) domestic PRC market needs. In doing so, this thesis will acknowledge that the paradigm of the U.S. model is being replicated, but will fundamentally ask: *should* it be

⁵ Gilson & Schizer, *supra* note 3.

⁶ See Giacinta Cestone, "Venture Capital Meets Contract Theory: Risky Claims or Formal Control?" (2014) 18:3 Rev Financ 1097. See also Arnold R Cowan, "Tax Options, Clienteles, and Adverse Selection: The Case of Convertible Exchangeable Preferred Stock" (1999) 28:2 Financ Manag 15. Further discussion of this will be found at 3.4.5.1, below.

⁷ Gilson & Schizer, *supra* note 3. See also Lin Zhang, *Venture Capital and the Corporate Governance of Chinese Listed Companies* (New York, NY: Springer New York, 2012). The literature on corporate governance in venture capital consistently supports this claim. Further discussion of corporate governance issues will be found in Chapter 3, below.

⁸ *Ibid.*

replicated? The answer to this question is predicated on institutional theory to explain the context of the U.S. VC industry, its success, the use of convertible preferred stock, and the argument that the replication of convertible preferred stock in PRC increases VC sophistication, but does not provide the same benefits as in the U.S.

1.2 Institutional Tensions

Policy instrumentalism reflects the political priorities of both the U.S. and PRC in their respective approaches to VC investing. In this thesis, two fundamental policy modes are contemplated: facilitation and regulation. Attention to the former has been an expression of U.S. market liberalism wherein market participants function as autonomous economic actors. Attention to the latter is an expression of modern PRC Party-State objectives aimed both developing creating autonomic economic transactions and retaining the authority of the state over economic production.

Understanding this conflicted practice involves recognizing the policy goals of China's legal regime. The PRC has developed predominantly on a state-planned model for producing explosive economic growth. Since the decision of the *3rd Plenum of the 11th CPC Central Committee* in 1978, production and development have been key imperatives in strengthening the PRC economy.⁹ Yet, Western market expressions of economic autonomy conflict with socialist policies of state supremacy and the constitutional imperative of upholding Marxist-Leninism Mao Zedong Thought ('MLMZT').¹⁰

⁹ Pitman B Potter, *China's Legal System* (Cambridge, UK: Polity Press, 2013) 90.

¹⁰ *Ibid* at 49-51. According to Potter, MLMZT concerns "policy commitments linking the class analysis of Marxism and the hierarchical politics of Leninism with Mao's interpretation of China's needs and conditions – limiting challenges to ideological orthodoxy and barring review of policy mistakes of the Maoist era". While state policy has remained pivotal to upholding socialism, MLMZT has been reinterpreted to include Deng

This struggle that the CPC has been engaged in is observed by Potter as a conflict between civil and economic law- the former relating to the role of law for “autonomous social and economic interactions”; the latter relating to the regulation of economic behavior by the state.¹¹ Consequently, VC laws and measures reflect the ongoing compromise between economic autonomy and state control.¹² On one hand, the CPC permits the incremental import of Western VC practices to China through the transplant of American-style laws. On the other hand, the CPC implements a planned VC system through industrial policy that gives preferential treatment to some industries, but restricts others.¹³

Another facet of the PRC’s planned economy has been state-owned enterprises (SOEs), government-owned company giants of which there are thousands. The traditional SOE model monopolized various sectors and blocked out smaller entities from market participation. In 1999, the CPC recognized this inefficiency and prioritized a “modern enterprise system”¹⁴ through the incremental phase-out of government control from SOEs. The effort has resulted in a significant SOE decline – 83% before the reforms to 5% in 2010.¹⁵ Presently, the government is also initiating a ‘mixed ownership’ pilot program structured to partially privatize SOEs.¹⁶

Xiaoping’s economic reform policies, Jiang Zemin’s ‘Three Represents’ proposing widespread social productive forces, and Hu Jintao’s policy on ‘scientific development’.

¹¹ *Ibid* at 93.

¹² *Ibid*.

¹³ “Foreign Investment Industrial Guidance Catalogue”, National Development and Reform Commission separates industries (Guidance Catalogue NDRC) [2014]. The Guidance Catalogue identifies ‘encouraged’, ‘permitted’, or ‘restricted’ industries. New investment is not permitted in any ‘restricted’ industry. *See* Aldo Musacchio & Sergio G Lazzarini, *Reinventing State Capitalism Leviathan in Business, Brazil and Beyond* (Cambridge, Massachusetts: Harvard University Press, 2014) at 285. “The industrial policy view posits that governmental action at the industrial level will be particularly useful when shallow undeveloped markets preclude private entrepreneurial action”.

¹⁴ “Decision on SOE Reform, 15th CPC Central Committee” (Sept. 22, 1999).

¹⁵ Daniel CK Chow & Anna M Han, *Doing Business in China Problems Cases and Materials* (St. Paul, MN: Thompson Reuters, 2012).

¹⁶ *Ibid*.

These initiatives demonstrate a transition to a state-capitalist model.¹⁷ The CPC has shifted away from public bureaucracy to a system in which it exerts widespread influence on the economy through ownership of equity positions in companies or through the incentivization of private companies.¹⁸ Problematically, state-capitalism is unlike free-market capitalism to which the U.S. VC framework belongs.¹⁹ Heterodox economist, Rothbard, describes the difference between the two types:

“The two are as different as night and day in their nature and consequences. Free-market capitalism is a network of free and voluntary exchanges in which producers work, produce, and exchange their products for the products of others through prices voluntarily arrived at. State capitalism consists of one or more groups making use of the coercive apparatus of the government — the State — to accumulate capital for themselves by expropriating the production of others by force and violence”.²⁰

The salient feature of free markets in this analysis is the liberty of private initiative of will as an embodiment of contract law, a premise classically crystallized by Anglo-American liberalist, John Locke.²¹ The idea is that actors need no official license to use their own labor to exploit opportunities offered by their surroundings.²² Hector St. John de Crevecoeur commended this formation within 18th century American society as a positive function of the individual’s ability to create self-designed “schemes” for economic improvement.²³

¹⁷ Musacchio & Lazzarini, *supra* note 13.

¹⁸ *Ibid.*

¹⁹ Although plenty can be argued in current times about the path of state-capitalism the U.S. has gone down, this work adheres to the traditional definition of American free-market capitalism and its manifestation in the VC industry. For a contrasting analysis, see David Stockman, *The Great Deformation The Corruption of Capitalism in America* (New York: PublicAffairs, 2013).

²⁰ Rothbard & Murray N, *Economic Controversies* (Ludwig von Mises Institute, 2011).

²¹ John Locke, *The Second Treatise of Civil Government*, J.W. Gough, ed. (Oxford: Basil Blackwell, 1946). See also James Willard Hurst, *Law and Markets in United States History: Different Modes of Bargaining Among Interests* (The Lawbook Exchange, Ltd., 1982) at 23.

²² J Hector St John de Crevecoeur, *Letters from an American Farmer* (New York: Duffield, Fox, 1904). Hurst, *supra* note 21.

²³ *Ibid.*

The concern for private will and its embodiment within the market and law is a strong concept within this thesis. China's statist influence on the economy limits private autonomy and represents the encroachment of central planning on private initiative. By extension, this limits VC that operates in the private investment sphere.

In light of these tensions, the remainder of this thesis contemplates the comparative aspects of start-up and exit modes in PRC VC, critically asking: how are convertible preferred stock provisions implemented given PRC's shifting regulatory environment still aimed at preserving party goals and the ability of other securities and contractual provisions to replicate the effect of preferred stock?

1.3 Methodology

Satisfying the objectives of the thesis are best achieved by a comparative, doctrinal and interdisciplinary study of U.S. and PRC frameworks. The comparative method effectively functions to draw parallels and tensions between Western and Eastern approaches to VC investing and operation. 'Head-on' comparisons work best and so U.S. and Chinese concepts will be paired as closely as possible for analysis. Inevitably, overlap exists in certain ideas and the private/public equity (SOE) distinctions in both countries create some conflict.

The majority of the thesis aims to be doctrinal in the analysis of the legal effectiveness of both U.S. and PRC systems. Broad review of past and present U.S. and Chinese legislation including applicable sections of securities laws, tax laws, company laws, regulations and circulars will be examined. Additionally, the thesis uses data from U.S. and Chinese public and private documents, official records, and data archives, as well as mass media opinions.

Constant review was particularly necessary for the PRC component of this thesis due to the rapidly changing legal environment in China. For instance, new preferred stock pilot provisions were released in 2014²⁴ at the beginning of my research, while a multi-billion dollar government startup fund was announced in 2015 at the conclusion of my writing.²⁵ There is a high probability the law will undergo additional changes by the time you read this.

Literature obtained from books, working papers, business and law journals and articles from leading newspapers were used to research Chinese and American legal, commercial and ideological contexts. Online legal databases, specifically China Law & Practice and Westlaw China, were most useful for extracting Chinese-narrowed literature and documents. I also note that this thesis was written during a time of economic recovery in the U.S. following the 2008 recession. As most literature on VC and preferred stock was published in the early 2000s before the economic downturn, I address the conditions of the VC industry as the U.S. economy is regaining momentum. Opinions about VC exits, for instance, may be different from what certain literature suggests.

This thesis will be grounded in the scholarship of seminal authors within the venture capital and private equity disciplines. Venture Capital is generally understood to mean “privately transacted, early stage equity investments typically in small firms with high growth potential”.²⁶ Private equity is used to describe “later stage mezzanine arrangements, buyouts

²⁴ *State Department Guidance on Carrying out a Pilot Preference Shares Guo Fa [2013] No. 46*. Further discussion of the pilot provisions will be found at 4.3, below.

²⁵ Jianxin Lu & Pete Sweeney, “PE HUB » China to create \$6.5 bln venture capital fund to support start-ups”, online: *Reuters* <<https://www.pehub.com/2015/01/china-to-create-6-5-bln-venture-capital-fund-to-support-start-ups-reuters/>>. Further discussion of the fund will be found at 4.2, below.

²⁶ David Ahlstrom, Garry D Bruton & Kuang S Yeh, “Venture capital in China: Past, present, and future” (2007) 24:3 *Asia Pacific J Manag* 247, online: <<http://link.springer.com/10.1007/s10490-006-9032-1>> at 249.

and turnaround investments”.²⁷ To be clear, my analysis attempts to use both terms independently, but some overlap will inevitably result as VC companies transition into private equity companies upon maturity.

Venture capital is a practice and trend-based industry. Traditional forms of literature have done an excellent job reporting industry practices at the time of publication. However, the bulk of academic writing made available throughout the early to mid 2000s is now dated. To observe the most current status and VC practices, this thesis uses online blogs written by venture capitalists, startup managers and lawyers disseminating the latest practices from Silicon Valley, the hub of the global VC industry located in California.

Notably, the methodology used for the writing of the thesis was restricted to English-only sources that function as a thorough and trustworthy source.

1.4 Theoretical Framework

Preferred stock conditions can be analyzed by examining the unique interplay between venture capital and institutionalism. Similarities and differences in VC behavior around the world are the result of the framework of regulatory institutions, namely, the laws and political powers that regulate individual and organizational action.²⁸

Comparative literature has identified two overarching institutional concepts to explain the integration of global investment practice into one common model: convergence and divergence. Convergence has been defined as “the tendency of societies to grow more alike,

²⁷ *Ibid.*

²⁸ WR Scott, *Institutions and Organizations* (Thousand Oaks: Sage Publications, 1995).

to develop similarities in structures, processes and performances”.²⁹ Divergence captures ‘path dependence’, a theory advanced by Douglass North, which explains the persistence of systems to retain indigenous legal characteristics by virtue of certain institutions in operation.³⁰ My focus is to determine whether China’s legal order prevents the full convergence of its VC system with that of the U.S. model regarded as the global gold standard, or if it can transcend any limits of path dependence and structure its system and preferred stock laws to function with identical efficiency as those found in the U.S.

Convergence and divergence models broadly inform other modes of theory, three of which I argue formulate the ideal VC environment through a layer effect: the legal origins theory, the doctrine of legal transplants, and the Rainforest. Research on legal origins broadly organizes orders into ‘families’ originating from either the Anglo-American tradition (market-centric and based on wide ownership) or the German-Japanese tradition (bank-centric and based on concentrated ownership).³¹ The doctrine of legal transplants builds on the legal origins theory by providing perspective on the move of legal systems within various families.³² Discussion of convergence and divergence of VC systems are also closely linked to ‘innovative human

²⁹ Clark Kerr, *The Future of Industrial Societies Convergence or Continuing Diversity?* (Harvard University Press, 1983).

³⁰ Douglass C North, *Institutions, Institutional Change and Economic Performance*, James Alt & Douglass North, eds. (Cambridge: Cambridge University Press, 1990) at 112. Bebchuk and Roe articulate the difference between convergence and divergence: “Path dependence explains persistence. Structures, once built long ago, can persist even if they would not be built today. Keeping them may be efficient in a basic economic sense: the cost of tearing down and rebuilding could exceed the value of the new improved model... These two forces for persistence have meant that, while some structures converge, some other older structures persist, some change slowly in some dimensions, and a few change not at all”. Jeffrey N Gordon & Mark J Roe (eds), *Convergence and Persistence in Corporate Governance* (Cambridge University Press, 2004).

³¹ Chenxia Shi, *Political Determinants of Corporate Governance in China* (New York: Routledge, 2012); Holger Spamann, “Contemporary Legal Transplants – Legal Families and the Diffusion of (Corporate) Law” (2009) 6 *BYU Law Rev* 1813, online:

<<http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=2476&context=lawreview>>.

³² Alan Watson, *Legal Transplants: An Approach to Comparative Law* (University of Georgia Press, 1974).

capital',³³ an unexamined model in comparative VC literature that concentrates on the creation of knowledge within individuals as a driver of capital. The importance of innovation within an economics model is well recognized and begins with the work of Joseph Schumpeter that underscores the role of science, technology and human capital in the production of economic growth through entrepreneurial activity.³⁴ Innovation is meant to be understood as the reconfiguration of old forms into new combinations of production, markets, and goods and industries.³⁵ Little has been said about the application of human innovation capital to VC until recently, however. The latest theory spurred by Silicon Valley venture capitalists Victor H. Hwang and Greg Horowitz introduces the concept of 'the Rainforest,' an innovation ecosystem built on human capital claimed to be the building blocks to an optimal VC environment.³⁶ These institutional theories will operate as the substratum in the rest of this paper to uncover whether China can properly build a VC environment conducive to convertible preferreds.

1.4.1 Legal Origins Theory

In the legal sphere, the manifestation of institutions is the division of law into civil and common law systems that directly impacts the nature of capital market systems and investor protection.³⁷ China originates from the civil law tradition that generally provides weak investor protection.³⁸ Since investor protection is associated with strong corporate

³³ Helen McGuirk & Helena Lenihan, *Innovation and Human Capital: The impact of firm and regional factors on Innovative Human Capital* (2013).

³⁴ Joseph Schumpeter, *The Theory of Economic Development* (New Brunswick: Transaction Publishers, 1934).

³⁵ *Ibid.*

³⁶ Victor W Hwang & Greg Horowitz, *The Rainforest: The Secret to Building the Next Silicon Valley*, 1.02 ed (Los Altos Hills: Regenwald, 2012).

³⁷ Bruton, Fried & Manigart, *supra* note 2.

³⁸ *Ibid.*

governance, it follows that China has weaker corporate governance models that, in turn, negatively impact VC and the function of convertible preferred stock.

Civil systems are also defined by bank-based economies. China's banks, especially the four largest state-owned banks,³⁹ yield enormous power over the economy. Roughly 82% of total financing in the financial sector comes from banks.⁴⁰ Although pivotal to the development of the Chinese economy through debt-based financing, the bank-based system restrains the formation of VC businesses that are dependent on equity-based financing.

The U.S. originates from the common law tradition and therefore vastly differs from the PRC system in its approach to VC and convertible preferred stock use. In fact, the universal argument among academics is that the tradition of effective corporate governance practices resulting from strong investor protection provides the ideal environment for VC investing.⁴¹ Common law systems are also largely decentralized and characterized as market-based.⁴² Banks in the U.S. are not permitted to own the stocks of borrowing public and private companies.⁴³ For this reason, the U.S. promotes wider dispersion of stock ownership and is considered a stock market-centered economy.⁴⁴ This regulatory difference has shaped the monolith of the U.S. VC industry that raises a total amount of \$1 trillion yearly and comprises 11% of the country's gross domestic product (GDP).⁴⁵ Importantly, however, the market-centered scheme manifests itself to the benefit of the VC industry by an emphasis on

³⁹ The banks are: Bank of China, Industrial Commercial Bank of China, Construction Bank of China and Agricultural Bank of China. Further see Chenxia Shi, *Political Determinants of Corporate Governance in China* (New York: Routledge, 2012) at 45.

⁴⁰ *Ibid.*

⁴¹ Bruton, Fried & Manigart, *supra* note 2.

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ NVCA, *National Venture Capital Association Yearbook 2014* (2014).

informing legal norms through ideals of transparency and disclosure. This is a fundamentally different structure than that of the PRC in which the legal regime functions as an extension of socialist state policy.

1.4.2 Doctrine of Legal Transplants

In principle, the legal origins theory supports the idea that a market-based system can improve stock conditions and, by extension, VC conditions in China. The follow-up question is: can a U.S. stock market-based system be imported into China to replace the CPC's centralized model? The short answer is 'no'. A civil law country cannot simply adopt a common law system and expect capital markets to flourish. What it can do, however, is imitate foreign norms and institutions when there is need for them. This is the proposition advanced by Berkowitz et al. who argue that a transplantation of law can work if there is a demand for it.⁴⁶ China's commitment to economic production and subsequent ascension into the World Trade Organization (WTO) has initiated an environment in which laws must be rapidly adopted to keep up with the pace of the economy. American VC laws, specifically, have been adopted to create a VC industry with 'Chinese characteristics', a further reflection of the CPC's conviction that it is capable of adopting American investment mechanisms within the socialist framework.

Transplant theory's demand model is qualified by prerequisite of a similar legal order system in the transplant country to that of its origin provider.⁴⁷ The U.S., for instance, is a transplant nation itself, but is considered receptive as a result of deriving its legal order from the

⁴⁶ Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, "The Transplant Effect" (2003) 51 Am J Comp L 163.

⁴⁷ *Ibid*; Watson, *supra* note 32.

English common law.⁴⁸ Tuebner opines that legal transplants are “legal irritants” to a non-receptive recipient system.⁴⁹ Foreign laws that function optimally in the origin country can impact the recipient but will not reach the same level of success because they become reconstructed to suit local conditions.⁵⁰ In China’s case, the VC laws that were borrowed without an understanding of the underlying free market system ultimately conflict with the State’s command of legislation. Thus, the PRC system is considered to suffer from what Berkowitz et al. call the ‘transplant effect’.⁵¹ VC laws examined in forthcoming chapters exhibit this weakness as a result of the backdrop of tensions between market and socialist policy.

1.4.3 Enter ‘the Rainforest’

Neoclassical economics supports the view that the glowing results of the American VC system can be understood as nothing but a series of optimal market dynamics. An implemented framework of capital resources, laws – securities, tax, and contract – and a largely ‘hands-off’ approach by governments are suggested to create a system bursting with innovation.⁵² Yet, this theory presents some challenges when tested. Empirical studies show that countries with free markets, reliable laws and common law systems have not been able to reproduce the success of the American VC system.⁵³ Moreover, if we narrow the scope of economics theory to a U.S.-only outlook, the results are more perplexing. Nearly half of

⁴⁸ Berkowitz, Pistor & Richard, *supra* note 46.

⁴⁹ Gunther Teubner, “Legal Irritants: Good Faith in British Law or How Unifying Laws End Up in New Divergences” (1998) 61 Mod Law Rev 11.

⁵⁰ Shi, *supra* note.

⁵¹ Berkowitz, Pistor & Richard, *supra* note 41.

⁵² See Adam Smith, *The Wealth of Nations: (A Modern Library E-Book)* (Random House Publishing Group, 2000).

⁵³ Ronald J Gilson, “Engineering a Venture Capital Market: Lessons from the American Experience” (2003) 55 Stanford Law Rev 1067.

America's VC investment originates from Silicon Valley.⁵⁴ How is this possible if when the rest of the U.S. enjoys the same legal framework?

Hwang and Horowitz lend an answer proposing it takes something more unique than unbridled markets to replicate the magic of the Valley.⁵⁵ Their exposition describes the power of human innovation as a force that supersedes the power of markets. The authors analogize the concept of innovation systems to the contrast between agriculture and rainforests. Plantations, as part of an agricultural model, rely on precision and control of human productivity to create value in a business. An 'agriculture' business operates like the prototypical factory – rows upon rows of laborers using the latest technology to calibrate the most dependable product possible. Like weeds that compromise growth on a plantation, employees that build the product different to specifications are removed. Rainforests, conversely, function outside of a controlled environment. An organic process by which the right chemical elements converge takes over to create unexpected life forms. Hwang and Horowitz explain that if we think about a VC business in Rainforest terms, the weeds are the most valuable. The goal is to create an environment with the right elements to enable the growth of these independent thinkers that eventually become the wunderkinds who create billion dollar companies.

⁵⁴ 46% according to "Silicon Valley Competitiveness and Innovation Project - 2015", online: <<https://flipflashpages.uniflip.com/3/88537/344668/pub/html5.html>> at 6. "Silicon Valley's ability to develop new technologies and businesses is stronger than other key innovation regions in the U.S., based on high levels of venture capital deals and investments, robust later-stage startup company valuations and a vast majority of the region's initial public offerings in innovation industries."

⁵⁵ Hwang & Horowitz, *supra* note 37 at 22.

The dynamics of the Rainforest vest themselves in the life cycle of a VC company. As it will be observed in subsequent chapters, the key players in a VC fund operate as autonomous economic actors when in a Rainforest. China currently lacks the political framework for a Rainforest to function. It also misses the requisite stock market economy and suffers from the transplant effect, all significant hurdles to the implementation of a successful VC industry. Despite these concerns, China has aggressively promulgated laws advancing VC as well as convertible preferred stock. The remainder of the thesis observes the ways in which China's VC industry functions outside of these institutional frameworks and how it can be better served with an implementation of Rainforest dynamics. Convertible preferred stock has never enjoyed Rainforest analysis and so I aim to provide the first ever analysis of the theory's function within the comparative framework of U.S. and PRC VC systems.

1.5 Organization of the Thesis

The entire analysis is divided into five (5) chapters. Chapter 2 provides an introduction to VC through a contextual analysis of legal definitions and the lifecycle of a venture. It further describes the development and idiosyncrasies of both the US and PRC VC industries as a substantive prelude to Chapter 3 in which convertible preferred stock is comparatively analyzed on a micro level. This chapter will address the security's specific functions in American practice and further describe its dysfunction in PRC legislation. Chapter 4 will then offer recommendations to resolve the tensions inherent to the function of convertible preferreds within the Chinese VC framework. Chapter 5 will conclude the thesis with a summary and final thoughts about the future of convertible preferred stock use in China.

Chapter 2: Venture Capital in Context

2.1 Introduction

Venture capital is a heavily nuanced system operating within a context of rules, actors and the state. On a basic level, VC is based on a model where the founders of a newly established high-technology company supply a product hypothesis and investors supply the capital to bring the hypothesis to fruition. The logistics of a venture's journey from its conception to end are important to the understanding of the function of preferred stock. Thus, this chapter first outlines legal definitions of VC within a broader framework of market and contract allocations, and follows with an explanation of a venture's lifecycle.

The most pressing issue to be considered is whether a U.S. VC system can properly function in China. I seek to answer this question by exploring key episodes from the history of the VC industry in both the U.S. and China, critically evaluating the institutional facets driving their respective development.

A significant piece of the puzzle is the role of government involvement in VC. Fundamentally, this chapter challenges the orthodoxy of the VC system as a private equity form operating exclusively outside the purview of government. It will justify public intervention as a necessity for the promotion of entrepreneurship and the many lessons the CPC has yet to learn.

2.2 Legal Definitions of Venture Capital Projects in the United States and China: Ideological Tangles

There is no standard legal definition of ‘venture capital’ in U.S. legislation. The National Venture Capital Association (NVCA), the private body representing the American VC community at large, describes VC as the offering of money by investors to “young, rapidly growing companies that have the potential to develop into significant economic contributors”.⁵⁶ The investor is called a venture capitalist. It is a professional person who “provides financial backing to and management expertise to startup companies in return for an ownership stake in those companies”.⁵⁷

The distinctive feature of these definitions is the private contractual domain in which they operate. By background, U.S. contract law is said to embody economic freedom of private will.⁵⁸ Contractual actors autonomously create their own designs presumed legal unless a court refuses to enforce them.⁵⁹ As operative outside a legislative framework, the organic definitions demonstrate the law’s presumption of VC as an extension of terms agreed to by actors and upheld to their satisfaction outside the command of government. In this sense, parties to VC contracts enforce a public policy generous to market liberty – the freedom to contract enhances marketplace flexibility through autonomous obligations. Only if the investment vehicle is a VC fund does it enter the public domain by the trigger of the

⁵⁶ NVCA Yearbook, *supra* note 40.

⁵⁷ NVCA, *Venture Capital Funds and SEC Disclosure: An Overview* (National Venture Capital Association, 2009).

⁵⁸ Hurst, *supra* note 21 at 23.

⁵⁹ *Ibid.*

Securities Act.⁶⁰ Then, the law serves as a bulwark to protect the uninformed public from unsound securities.⁶¹

By contrast, the PRC contracting model balances contractual liberty with the policy goal of promoting “socialist modernization”.⁶² Liberty facilitates the contractual freedoms introduced by the CPC to support production. Generally, only contracts that harm public interests, or violate laws and administrative regulations are invalid.⁶³ The economic contract law model, conversely, limits the extent to which individuals can form their own contracts, a preemptive action to maintain the State’s power over production. China, therefore, has a tightly drafted definition of venture capital in its legislation reflecting this restriction in autonomy. *Establishing a Venture Investment Mechanism Several Opinions 1999* (‘Opinions’) provides,

“Venture capital refers to investment acts whereby equity capital, management and consultancy services are provided mainly to high growth venture enterprises in the science and technology sector in the hope that medium to long term capital gains can be reaped through an equity transfer after the enterprise has developed and matured”.⁶⁴

⁶⁰ VC funds in the U.S. are generally structured as limited partnerships whose interests qualify as securities. Under the Securities Act of 1933, ‘profit sharing contract’ or ‘investment contract’ which constitutes a security. See Joseph C Long, “Partnership, Limited Partnership, and Joint Venture Interests As Securities” (1972) 37 *Miss Law Rev*, online:

<<http://heinonline.org/HOL/Page?handle=hein.journals/molr37&id=591&div=&collection=journals>> at 611.

(“Limited partnership interests are always securities under the [Howey] test”). See also exceptions to the test EJ Everhard, “The Limited Partnership Interest: Is It a Security--Changing Times,” (1992) 17 *Delaware J Corp Law*, online:

<<http://heinonline.org/HOL/Page?handle=hein.journals/decor17&id=451&div=&collection=journals>>.

⁶¹ See *Slevin v. Pedersen Assocs.* 540 F. Supp. 437, 441 (S.D.N.Y. 1982).

⁶² Article 1 Purpose, UCL. See Potter, *supra* note 9 at 97. The travails of government restrictions on the number of autonomous contractual actors are a remnant of China’s socialist past.

⁶³ Article 52 (iv)-(v); Potter at 97.

⁶⁴ *Establishing a Venture Investment Mechanism Several Opinions*, 16 November 1999, issued by the Ministry of Science and Technology, the State Development Planning Commission, the State Economic and Trade

This definition is not much different from the NVCA definition. Yet, its entrenchment in legislation subverts the standard of market primacy elemental to VC. It validates the actions of non-government actors to participate in the high-tech industry, but only within the government's prescribed interpretation of VC. Importantly, a legislative definition also limits the development of the term 'venture capital'. VC predominantly captures investments in technology, but is a constantly evolving term often used loosely to refer to other up-and-coming industries in the private realm.

The Opinions go on to say:

“The establishment of a venture investment mechanism requires the creation of a favorable external environment and reform system and the fostering of an economic operation system which is appropriate to the economic patterns of a socialist market economy, conducive to accelerating technological innovation and the transformation of achievements, and capable of integrating the promotion of technological progress carried out by the economic authorities with the protection and support offered by the financial authorities”.⁶⁵

The Opinions evince the joint dimensions that govern CPC market socialist politics: control and the public-private divide. They are a clear mandate for CPC authority over private initiative. Non-state actors are encouraged to participate in the high-tech industry provided they adhere to the government's industrial policy and the VC laws that recognize party authority. One theory elaborates on this relationship between actors and the CPC describing it as an implicit social contract.⁶⁶ The CPC provides industrious growth in return for a docile

Commission, the Ministry of Finance, the People's Bank of China, the State Administration of Taxation and the China Securities Regulatory Commission.

⁶⁵ *Ibid.*

⁶⁶ Michael Trebilcock & Jing Leng, “The Role of Formal Contract Law and Enforcement in Economic Development” (2006) 92 Univ Virginia Law Rev 1517.

population that will not press for greater liberties.⁶⁷ Unlike the American definition formed organically by non-state participants and further realized by a body separate from government, the PRC definition presents the CPC's front of command in VC investing.

To its own peril, China's VC legislation reflects the concern that unregulated use of private investment may leverage the market over the country's socialist framework.⁶⁸ Consequences arise from this. VC becomes inhibited when the autonomy of non-State actors is limited. The displacement of private initiative is hugely significant to legislation concerning convertible preferred stock throughout this analysis.

2.3 Lifespan of a Venture Capital Investment

Every VC project has a lifespan with 4 phases: seed, startup, expansion, and exit. Each phase additionally falls under a broader category of informal or formal VC. Informal VC describes the point at which the venture relies on personal capital for growth whereas formal VC captures the point at which the venture attracts the attention of institutional investors to ensure its survival.⁶⁹ Once the venture has formalized by garnering funding from a firm, it is referred to as a 'portfolio company'.⁷⁰ In the past, it was only startups that generated institutional funding. However, we will see that early investing trends in the seed phase have blurred these distinctions. In the interest of clarity, the subsequent sections adhere to the classic view of the seed phase as an informal form of VC and are particularly attentive to the startup and exit phases where convertible preferred stock operates.

⁶⁷ *Ibid.*

⁶⁸ Tahirih V Lee, ed, *Contract, Guanxi, and Dispute Resolution in China* (Taylor & Francis, 1997) at 209.

⁶⁹ Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States Tax Paper No. 108* (Toronto, 2004).

⁷⁰ *Ibid.*

2.3.1 Informal Venture Capital

2.3.1.1 Seed Stage

The earliest stage in the VC life cycle is the seed stage in which the venture is an idea in the works. The founding entrepreneur focuses on developing the technology, conducts market research and pieces together a rudimentary business plan.⁷¹ Most ‘seeds’ conventionally require hands-on support making them unattractive to institutional investors that view the input cost of labor as too high-risk.⁷² From a financial point of view, the uncertainties associated with untested technology, an absent client base and negative cash flow make an investment at this stage unfeasible for a return.⁷³ Therefore, the founder’s own money as well as friends-and-family financing (referred to as ‘love capital’) are crucial to the seed’s survival.⁷⁴ Sources of love capital can include retirement savings, home equity, credit cards and personal savings.⁷⁵ The ability to access these sources hedges on the availability of institutional policies that encourage entrepreneurialism. For instance, the ease with which a founder can tap into retirement savings, or even decide to leave employment to pursue the venture affects the likelihood of first-time use of sources.⁷⁶

Efforts of the founder, friends and family are often insufficient to back the growing needs of a venture. This funding gap between the genesis of the idea and the point of further investment can be a death sentence to a seed that relies on every dollar for its survival.⁷⁷ In comes the role of a newly trending form of privatized capital – seed accelerators. These

⁷¹ *Ibid.*

⁷² *Ibid.*

⁷³ *Supra note* 16 at 224.

⁷⁴ Sandler at 5.

⁷⁵ *Ibid.*

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

programs resolve the gap by offering a new venture between \$20 000 and \$50 000, office space, access to technology and mentorship in exchange for equity.⁷⁸

2.3.1.2 Startup

The startup phase focuses on getting the business idea on its feet. The product prototype undergoes development and is usually tested in ‘beta’ by users before it is mass marketed to the public.⁷⁹ At this point, the founders also draft business proposals and set up a management team with the aim of attracting investors.⁸⁰ Critically, the same funding gap afflicting seeds also afflicts startups. When love capital becomes insufficient, founders looking for more money turn to other forms of financing from angel investors and accelerators, at this point referred to as venture capitalists.⁸¹ The ‘angel’ investor is typically an affluent individual or group of affluent individuals committing, on average, \$250 000 to \$2 million to a startup.⁸² Since angels are taxable individuals, attractive tax incentives are needed to encourage these investors to reinvest. Accelerator programs welcoming startups provide another capital raising avenue.

A portfolio company under the financial direction of VCs will undergo ‘rounds’ of financing. ‘Series A’ is the first round in which approximately 50% of the company is purchased in exchange for funding to hire top talent, spur development and to, ultimately, attract further investing for the Series B round.⁸³

⁷⁸ Lisa Barrehag et al, *Accelerating Success: A Study of Seed Accelerators and Their Defining Characteristics* (Chalmers University of Technology, 2012) [unpublished].

⁷⁹ *Ibid* at 5.

⁸⁰ *Ibid*.

⁸¹ *Ibid*.

⁸² William R Kerr, Josh Lerner & Antoinette Schoar, *The Consequences of Entrepreneurial Finance: A Regression Discontinuity Analysis*, 10-086 (2010).

⁸³ Sandler, *supra* note 70.

Funding is important to a startup, but human capital may be equally (or more) important. Fiscal pressures on a struggling startup (such as money for a quality website, airfare to meet key personnel and payroll checks) can undercut an effort before it effectively starts.⁸⁴ However, Rainforest reasoning suggests these obstacles require little to be solved in monetary terms.⁸⁵ If the startup attracts any investors, money is readily available to cover these expenses. Rather, it is the actions of the people involved in capital structuring that are crucial to the success of the startup.⁸⁶ Employees accept lower salaries than those offered by established companies, or no salary at all in exchange for stock options.⁸⁷ Convertible preferred stock (the focus of this thesis) is one type of security implemented in a stock plan that functions to mitigate the risks of an early stage company and to protect both founders and investors.

The current apparatus for executive incentivization in China-domiciled start-ups is still cash compensation.⁸⁸ Although cash rewards managerial labor, studies show incentives from stock ownership better align the interests of investors and founders, reduce information asymmetry and compel executive effort for value creation.⁸⁹ Chapter 3 provides a complete analysis of these incentives and further examines whether convertible preferred stock functions as effectively in China as it does in the U.S.

⁸⁴ *Supra* note 13 at 223.

⁸⁵ *Ibid.*

⁸⁶ *Ibid.*

⁸⁷ *Supra* note 22 at 10.

⁸⁸ Zhang, *supra* note 7.

⁸⁹ *Ibid.*, 18.

2.3.2 Formal Venture Capital

2.3.2.1 Expansion

A maturing portfolio company will have commenced production and sales, but will require further funding for future product development, marketing and production in the form of Series B and C financing. The goal of B round financing is to reach the level at which total cost and revenue are equal (otherwise known as the ‘break-even point’).⁹⁰ Generally, this requires an increase from \$1 million in revenue to \$10 million in sales.⁹¹ C rounds enable the company to reach mass scale revenue between \$25 million and \$1 billion thus resulting in a profit.⁹² The habit of any VC, American or Chinese, is to target the investment with the lowest risk and highest yield. Consequently, expansion stage financing attracts the most attention since investors are inclined to allocate funds to a business with demonstrated traction.⁹³

In advisory to the reader, convertible preferred stock provisions in the contract remain dormant at this point and so this phase will be left relatively undiscussed in subsequent chapters.

2.3.2.2 Exit

Exit is the final phase in which the portfolio company is liquidated. Since VCs make equity investments that do not receive a dividend throughout the life cycle of the venture, securing

⁹⁰ MaRS, “Venture capital: Financing a startup | Later stages of growth”, (2013), online: <http://www.marsdd.com/mars-library/venture-capital-financing-a-startup-in-the-later-stages-of-growth/>.

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ *Ibid.*

the highest possible return on the initial investment is important.⁹⁴ The return is usually the sale price minus the purchase price.⁹⁵ Accordingly, the contracting strategy at the start of the investment becomes critical to constructing the exit terms. American founders and VCs stipulate the choice form of exit with conditions for profit milestones in line with the UCC or applicable state law.

2.3.2.2.1 Exit Mechanisms

Exits can be realized through a number of ways including IPOs and M&As (the most popular), or stock buy backs and secondary sales.⁹⁶ In both China and the U.S., an IPO is the most glamorous form of exit on account of its profitability and visibility.⁹⁷ The company will offer its shares on the stock market to third parties to increase its liquidity.⁹⁸ “Going public”, however, is an uncommon exit route for a portfolio company in the U.S.⁹⁹ NVCA data shows that 88 companies reached IPO in the first 9 months of 2014 – roughly 13% of domicile ventures.¹⁰⁰ A myriad of issues including expense involved with prospectus and disclosure requirements,¹⁰¹ and market fluctuations¹⁰² can be attributed to this small percentage.

⁹⁴ Sandler, *supra* note 70 at 10.

⁹⁵ *Ibid.*

⁹⁶ *Ibid.*

⁹⁷ *Ibid.*

⁹⁸ Philippe Espinasse, *IPO: A Global Guide*, 2nd ed (Hong Kong: Hong Kong University Press, 2014) at 1.

⁹⁹ *Ibid.*

¹⁰⁰ Ben Veghte & Lauren Herman, *Venture-backed Exits Q3 2014* (2014). This number shows an increase in IPO listings from 81 in 2013.

¹⁰¹ *Ibid.*

¹⁰² Martin Zwilling, “10 Reasons Why IPO Is No Longer A Good Startup Exit”, (2013), online: *Forbes* <<http://www.forbes.com/sites/martinzwilling/2013/09/10/10-reasons-why-ipo-is-no-longer-a-good-startup-exit/>>.

The literature demonstrates a correlation between the IPO market and the health of the VC industry.¹⁰³ When equity markets are slow, the number of IPO activity is low, and the funds raised by VC firms dwindle.¹⁰⁴ VCs, nevertheless, tend to strategize an IPO exit at the start of the investment to encourage long-term growth for the venture and to highlight the IPO as the ultimate marker of success.¹⁰⁵

M&A is a suitable option where an IPO is unfeasible. Typically, a portfolio company will merge with or be acquired by a larger private or public company. Unlike an IPO where duties associated with listing continue over the long run, the worry in an M&A exit ends at the point of sale.¹⁰⁶ The VC's initial investment realizes a gain once the acquisition or merger is finalized and the VC fund is liquidated. M&A is considered a liquidation event that, like IPO, will trigger the conversion of preferred stock.

Other lesser used exit mechanisms for a mature portfolio company include the buyback of the investor's shares by a private equity firm or the founding entrepreneurs, or a secondary sale in which a third party purchases the VC's shares.¹⁰⁷ Finally, there is the nightmare scenario – a write-off where the portfolio company is deemed a failure and the VC is forced to hold on to shares indefinitely without a return.¹⁰⁸ The focus of this thesis on convertible preferred stock limits the discussion of these exits.

¹⁰³ Paul A Gompers & Josh Lerner, "What Drives Venture Capital Fundraising?" (1994) Brookings Pap Econ Act Microeconomics 149 at 161.

¹⁰⁴ *Ibid.*

¹⁰⁵ Unknown, "New Exit Strategies for Venture Capitalists", (2014), online: *Forbes* <<http://www.forbes.com/2010/03/05/venture-capital-ipo-entrepreneurs-finance-wharton.html>>.

¹⁰⁶ *Ernst & Young: Adapting and Evolving: Global Venture Capital Insights and Trends 2014* (2014).

¹⁰⁷ Sandler, *supra* note 70 at 22.

¹⁰⁸ *Ibid.*

2.3.2.2.2 The Impact of Financial Markets on Exit – Regulatory Challenges

An active stock market is needed for IPO.¹⁰⁹ The U.S. stock exchanges – NYSE, NASDAQ and other affiliates - are considered active as a result of the transparency objectives of the Securities and Exchange Commission (SEC) that oversees the Securities Act of 1933 and the Securities Exchange Act of 1934. Both acts require full and fair disclosure through extensive reporting requirements more stringent than those of any other country.¹¹⁰ As a result, U.S. stock markets are a reliable arena for VC exits.

On average, a U.S. portfolio company exits after 5-7 years whereas a Chinese venture exits after 1.5-2 years.¹¹¹ With regard to exit strategy, the reverse is true in China. The private equity route through sales or acquisitions is unpopular and IPO is the choice method of exit. 95% of Chinese ventures exit through one of China's 3 equity markets: the main board, SME board and ChiNext.¹¹² Highly profitable companies list on the main boards Shanghai Stock Exchange (SHSE) or Shenzhen Stock Exchange (SZSE), the equivalent of a NYSE listing. The SME board operating under the SZSE provides ground for the listing of SMEs provided they satisfy the listing requirements of the main boards. The real promise for startups is

¹⁰⁹ Bernard S Black & Ronald J Gilson, "Does Venture Capital Require an Active Stock Market?" (1999) 11 J Appl Corp Financ 36, online: <<http://dx.doi.org.ezp-prod1.hul.harvard.edu/10.1111/j.1745-6622.1999.tb00512.x>><http://www3.interscience.wiley.com.ezp-prod1.hul.harvard.edu/cgi-bin/fulltext?ID=119086201&PLACEBO=IE.pdf&mode=pdf>>.

¹¹⁰ Merritt B Fox, "Required Disclosure and Corporate Governance" (2000) 62:3 Law Contemp Probl 113, online: <<http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1138&context=lcp>>.

¹¹¹ Peggy H Fu, "Developing Venture Capital Laws in China: Lessons Learned from the United States, Germany, and Japan" (2001) 23 LA Int'l Comp L Rev 487.; 'Adapting and evolving, Global venture capital insights and trends 2014', online: Ernst & Young <[http://www.ey.com/Publication/vwLUAssets/Global_venture_capital_insights_and_trends_2014/\\$FILE/EY_Global_VC_insights_and_trends_report_2014.pdf](http://www.ey.com/Publication/vwLUAssets/Global_venture_capital_insights_and_trends_2014/$FILE/EY_Global_VC_insights_and_trends_report_2014.pdf)>.

¹¹² Ufuk Güçbilmez, "Why do some Chinese technology firms avoid ChiNext and go public in the US?" (2014) 36 Int Rev Financ Anal 179, online: <http://ac.els-cdn.com.ezproxy.library.ubc.ca/S1057521914000337/1-s2.0-S1057521914000337-main.pdf?_tid=4a6ef9bc-943e-11e4-b1eb-00000aab0f27&acdnat=1420395778_e4e03b4034c1e3a3e1fd2c563117863b>.

ChiNext, China's newest exchange modeled on the NASDAQ, allowing companies with small levels of market capitalization to list.¹¹³

The outlets for IPO in China clearly exist, but are debilitated by the convergence of capitalist market ideals and state control. By their nature, financial markets are structured to “maximize current exercise of private will in transactions”.¹¹⁴ They are a place where entrepreneurs and investors join in pursuit of one common objective – money. There is little regard for social arrangements in stock markets.¹¹⁵ An interest can be sold by an investor without so much as a thought about community stakeholders.¹¹⁶ This demonstrates that market allocations have accepted private decision-making within the existing power structure.

With its own socialist agenda, China missioned to emulate the utility of U.S. stock markets. The objective during the early 1990s was to reform and corporatize SOEs.¹¹⁷ In 1994, the CSRC signed a Memorandum of Understanding with the SEC designed to “formalize a cooperative and consulting relationship” and the “provision of technical assistance”.¹¹⁸ The CSRC adopted many U.S. securities laws but, in its own fashion, retained ‘Chinese characteristics’ pivotal to maintaining control. PRC Securities Law gives the CSRC choice

¹¹³ “Nasdaq Initial Listing Guide”, online: <<https://listingcenter.nasdaqomx.com/assets/initialguide.pdf>>.

¹¹⁴ Hurst, *supra* note 21 at 63.

¹¹⁵ Robert Kuttner, *Everything for Sale: The Virtues and Limits of Markets*, First ed (New York: Alfred A. Knopf, 1997).

¹¹⁶ *Ibid.*

¹¹⁷ Chenxia Shi, *Political Determinants of Corporate Governance in China* (New York: Routledge, 2012) at 46.

¹¹⁸ “Memorandum of Understanding Between the United States Securities and Exchange Commission and the China Securities Regulatory Commission Regarding Cooperation, Consultation, and the Provision of Technical Assistance”, (April 28, 1994), online: <https://www.sec.gov/about/offices/oia/oia_bilateral/china.pdf>.

over the selection of firms that can list on the stock exchange.¹¹⁹ The state's classic (and erroneous) position was that VC-backed companies were already financially strong and should not need the funds that an offering would provide.¹²⁰ Instead, capital raised through IPO should be directed to desperate SOEs.¹²¹ By contrast, the SEC has limited authority to regulate listings.¹²² Now that SOE strategy has been put on the backburner in favor of a modern corporate system, the hurdle for ventures is not one of listing approval but of transparency.

Portfolio companies that gain approval for IPO exit encounter problems governance issues of fraudulent disclosure, insider trading, and controlling shareholders' tunneling as a result of weak securities laws and accounting standards.¹²³ As Chinese economist Jinglian Wu pointed out, "China's stock market is worse than a casino. At least in a casino there are rules".¹²⁴ Fundamentally, the root of these problems lies in the limited enforcement of transparency by the CSRC. The regulator's official role is to act as a watchdog over the activities of underwriters, accountants and lawyers in the enforcement of the Securities Act to ensure compliance with existing disclosure standards. However, in comparison to the SEC, the CSRC is a tiger without teeth. It has the muscle to enforce securities laws in place, but is rendered toothless in the absence of a stringent framework as that in the U.S and continued bureaucratic intermingling. The affairs of the SHSE and SZSE following the 2008 global economic crisis provide a case in point. Issuers desperate for exit fraudulently disclosed

¹¹⁹ Securities Law Art. 118; Garry D Bruton & David Ahlstrom, "An institutional view of China's venture capital industry: Explaining the differences between China and the West" (2003) 18 J Bus Ventur 233.

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² Shi, *supra* note.

¹²³ Masahiko Aoki, *Corporate Governance in Japan: Institutional Change and Organizational Diversity* (Oxford: Oxford University Press, 2007) at 33.

¹²⁴ Xiangyang Huang, "It's time to clean up the stock 'casino'", (2012), online: <http://www.chinadaily.com.cn/cndy/2012-03/08/content_14784047.htm>.

company performance and engaged in conspiracies with accountants and underwriters to falsify audits and IPO prices.¹²⁵ One of the headlining examples was that of Wanfu Biotechnology Agricultural Development, accused of inflating sales figures after its share price plummeted more than 75%.¹²⁶ The CSRC's only means of enforcement within the ambit of the Securities Act was a 3 month suspension of the underwriter which handled the listing. Ironically, however, it was 7 members of the CSRC approval committee (all senior accountants and lawyers) that approved the Wanfu listing.¹²⁷ Whether a sign of bureaucratic infighting or plain negligence, the enforcement inadequacies present a dangerous situation in which any efforts for enforcement could be derailed by corruption.

Given the difficulties surrounding China's unhealthy stock markets, the current environment for the development of convertible preferred stock use in PRC exit strategy appears unfavorable. The IPO market will be discussed in greater detail in subsequent chapters as the IPO market reflects the health of the VC industry and is essential to the function of convertible preferred stock.¹²⁸

2.4 The U.S. Venture Capital Industry

Objectively, it looks easy to create a successful portfolio company. Think of an up-and-coming tech idea, attract VC financing and become a billionaire à la Marc Zuckerberg.¹²⁹ To

¹²⁵ Guanchun Dai, "Why the IPO reforms don't go far enough", (2014), online: *China Law Pract* <<http://www.chinalawandpractice.com/Article/3297937/Why-the-IPO-reforms-dont-go-far-enough.html>>.

¹²⁶ "Can China get IPOs right this time around?", (2013), online: *China Econ Rev* <<http://www.chinaeconomicreview.com/can-china-get-ipos-right-time-around>>.

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

¹²⁹ In reference to Marc Zuckerberg, founder and CEO of Facebook, Inc. See "Powerful People #22 Mark Zuckerberg", online: *Forbes* <<http://www.forbes.com/profile/mark-zuckerberg/>>.

think of the U.S. VC industry in these clichéd terms undermines its development from an idiosyncratic process. The rest of this section describes the U.S. VC industry as one dependent on delicate variables sourced from history, trial and error programs and institutional motivations.

2.4.1 Origins

America's involvement in the Second World War accelerated development of high technology to aid the military in a new era of mechanized war craft.¹³⁰ Federal government financing for research and development (R&D) contracts and decentralization efforts set the stage for a new mode of private enterprise. At the forefront of the research were the Massachusetts Institute of Technology (MIT) in Boston and Stanford University in Palo Alto, California (known as Silicon Valley). MIT is credited for the most military research during the war as the recipient of heavy contracts from the OSRD.¹³¹ Yet, it was Stanford that paved the way for VC entrepreneurship. Fred Terman, electronics professor at the university, loaned students William Hewlett and David Packard \$538 and additionally helped them secure a \$1000 bank loan to build an oscillator.¹³² The company they formed - Hewlett-Packard - became the bedrock for the Silicon Valley we know today.

After the war, consumer demands for high tech products ignited production in both Boston and Palo Alto. However, it was the institutions Stanford opened during the war that caught the most revenue. The Stanford Research Institute and Stanford Industrial Park (now called

¹³⁰ For a thorough history of Silicon Valley, see Sandler, *supra* note 70 at 43.

¹³¹ *Ibid.*

¹³² *Ibid.*

Stanford Research Park) facilitated on site development of high-tech businesses. The byproduct was the trickle-down effect to small businesses benefitting from sales.

This history points towards the idea of the U.S. VC industry as the byproduct of a particularly American variant of entrepreneurialism. While economic acceleration has been the result of defense R&D following war in other countries,¹³³ the commercialization of research has not been. What makes the U.S. different? What is the behavioral inertia for creating business out of untested ideas that has contributed to making Silicon Valley, one geographically segregated area, the envy of the world for VC investment?

We can look to interpretations of American history for half the answer. The Frontier Thesis by Frederick Jackson Turner contends that the Western shift of frontiers during the 17th century formed the substance of the American individualist identity.¹³⁴ Before construction of the railways, settlers navigating westwards undertook a month long journey through the rugged American wilderness dependent only on the ad-hoc communities they formed. Every community to cross through new frontiers became detached from the East coast way of life informed by European expressions of class division, church rules and intrusive government.¹³⁵ As the furthest frontier, California became the pinnacle for intolerance of these old world institutions. Silicon Valley itself is said to be a “product of the collision of frontier culture with the hyper-diversity of modern California”.¹³⁶ In antithetical formation to

¹³³ Vernon D Ruttan Regents, *Is War Necessary for Economic Growth? : Military Procurement and Technology Development: Military Procurement and Technology Development* (Oxford University Press, 2005). For instance, Europe experienced its own economic boom in the 1950s and 1960s following World War II.

¹³⁴ Frederick Jackson Turner, “The Significance of the Frontier in American History”, (1893), online: <<http://nationalhumanitiescenter.org/pds/gilded/empire/text1/turner.pdf>>.

¹³⁵ *Ibid.*

¹³⁶ Hwang & Horowitz, *supra* note 37, at 160.

a crop, independent thinkers from all ethnicities and walks of life cluster as weeds in the Valley to pursue ideas and innovation. In fact, we can think of Terman, Hewlett and Packard as the first weeds in the innovation ecosystem of Silicon Valley. Their efforts reflected the essence of frontier traditions: self-responsibility in the borrowing of initial capital and subsequent gains and losses. With this model, Silicon Valley has been nurturing a Rainforest while the rest of the world has been sowing crops.

2.5 U.S. Federal Involvement in Venture Capital – Dominator to Collaborator

In the U.S., there is a general dislike of government interference in private enterprise.¹³⁷ The antipathy stems from the idea that government involvement in the affairs of companies hinders the free enterprise system and is generally an affront to capitalist society where the economy is dictated by the market.¹³⁸ Yet, the U.S. is not the ‘laissez-faire’ nation common perception touts it to be, particularly in the case of VC investment. Since the post-war surge of R&D, the government has involved itself in VC for reasons reflecting a spectrum of political determinants.

Early subsidization efforts were guided by conflicting goals of economic stability and profitability. In 1946, the eminent fear of reverting to a pre-war depression initiated the creation of American Research and Development (ARD), the first VC fund structured to accept both private investment and national institutional capital.¹³⁹ The primary purpose of

¹³⁷ Sandler, *supra* note 70 at 188.

¹³⁸ Joseph Shaanan, *Economic Freedom and the American Dream* (New York: Palgrave Macmillan, 2010) at 92.

¹³⁹ Josh Lerner, *Boulevard of Broken Dreams - Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed - and What to Do About It* (Princeton: Princeton University Press, 2009) at 37.

ARD was to increase the standard of living for Americans.¹⁴⁰ Financial returns to private investors were treated second-handedly as an unavoidable fact.¹⁴¹ The fund ultimately failed for the reason that investors could not withstand the wait for the capital gains of startups in the ARD portfolio to realize, particularly after being sold on them by aggressive brokers.

Similar tensions also pervaded the U.S. Small Business Administration (SBA) established by the government in 1958. Risk capital pools called Small Business Investment Companies (SBICs) formed under the SBA experienced corruption and fraud.¹⁴² These failures are evidence that the U.S. government did not always get it right. However, these mistakes taught the government a few valuable lessons. Firstly, Government-backed VC must be influenced by profit rather than being driven by the government policy. Secondly, private sector investors need to be kept satisfied through returns. Thirdly (and most obviously), VC funds must be law abiding.

Today, the SBA has shifted its policy from one of domination to collaboration limited to targeting the funding gap experienced by seeds and startups. The function of public subsidies is to work with startups at risk of dying and infuse funds to ensure their survival. With Barack Obama's election in 2009, this collaborationist approach to VC gained new ground. The Obama White House launched 'Startup America', an aggressive set of initiatives focused on reducing barriers to high-growth startups.¹⁴³ Through the program, the SBA allocated \$1 billion for impact investments, promising a 2:1 match to private funds raised by clean tech

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ The White House, "Fact Sheet: White House Launches 'Startup America' Initiative", online: <<http://www.whitehouse.gov/startup-america-fact-sheet>>.

companies, or companies located in underserved communities.¹⁴⁴ Another \$1 billion was allocated by the SBA to match capital raised by early-stage companies struggling with first round financing.¹⁴⁵ Says SBA administrator, Sean Greene, “the government shouldn’t be making decisions about what companies should be invested in, and funds raised by the public sector are a fantastic validation”.¹⁴⁶ Greene only rearticulates the fine balance between the public-private intersection. The SBA refrains from direct investment into startups and instead uses qualified investment firms thereby keeping VC decision-making within the private sphere.

Of course, the system has its concerns. Government sponsorship can create dependency, thwart the ambitions of infant companies, or even stifle business development. Startup founders might feel pressured to please government aims to get more funding. These risks are offset by benefits. The billions of dollars invested by the government functions to close the startup equity gap. These programs affirm the consultative process by which the U.S. government supports the VC industry.¹⁴⁷ Rather than acting as a front of command, the federal government takes the role of a supportive wingman.

2.6 The PRC Venture Capital Industry

2.6.1 Evolution of Venture Capital in the PRC

Unlike the U.S. VC industry that was built on the crisis of war, China’s VC industry was solely built on the promise of profit. The State’s shift in focus from revolution to economic

¹⁴⁴ *Ibid.*

¹⁴⁵ *Ibid.*

¹⁴⁶ <http://www.forbes.com/sites/maureenfarrell/2011/02/15/startup-america-a-venture-capital-bailout/>

¹⁴⁷ Robert Kuttner, *Everything for Sale: The Virtues and Limits of Markets*, First ed (New York: Alfred A. Knopf, 1997) at 224.

development at the 3rd Plenum in 1978 called for a new commitment to production,¹⁴⁸ including promotion of a high-tech industry. Since then, China has embarked on a decades-long process to build a profitable VC industry on home soil. The following subsections loosely divide the progress of China's VC framework into two stages: the Novice Stage, from 1980-1998 and the Developmental Stage from 1998-Present.

I note that each stage will highlight key achievements and policies rather than listing every VC law passed by the PRC government.¹⁴⁹ Instead of providing a lesson in history, this study underscores the trial and error process of the CPC in installing a VC system and the tensions arising of the use of the U.S. VC model as a benchmark for development.

2.6.1.1 Novice Stage: 1980 - 1999

In 1984, the National Research Center of Science and Technology for Development recognized the need for a high-tech sector and a VC system to foster it.¹⁵⁰ However, investors tended to focus on lower-risk industries like hotels and tourism that produced limited financial returns and ultimately dissuaded further investment.¹⁵¹ The CPC responded with a strong intention to promote VC development, but misguided the early industry with party-minded policy favoring state over investor profits. Most of China's government-backed VC funds qualified as SOEs as a result of the majority blocks held by various government ministries.¹⁵² Consequently, the funds had characteristics of a "central government agency with the mandate to support national policy objectives, rather than a profit-oriented

¹⁴⁸ Potter, *supra* note 9, at 30.

¹⁴⁹ For a comprehensive table of laws *see* Orcutt & Shen, *supra* note 4, at 188.

¹⁵⁰ Ahlstrom, Bruton & Yeh, *supra* note 26.

¹⁵¹ *Ibid.*

¹⁵² Orcutt & Shen, *supra* note 4, at 190.

enterprise”.¹⁵³ These early efforts reflected the inseparability of VC from socialist forces. Left to its own logic, the CPC retained control over the private sphere of VC investing that proved ineffective. Broadly speaking, China’s first VC funds bore similarities to the early ARD model. So far as both were motivated by profit, they were unconcerned about the private nature of VC investment by making use of policy to, perhaps inadvertently, handicap individual investors.

The VC industry is never without its outliers, however. Chunxian Chen, former professor at the Chinese Academy of Science, envisioned a Chinese version of Silicon Valley after touring the U.S. in 1979.¹⁵⁴ Chen noted the speed and novelty of U.S. high-tech development as well as the critical difference between American scientists and their Soviet rivals. Both excelled in the production of cutting-edge technology, yet the Americans had the special trait of entrepreneurship that stimulated business.¹⁵⁵ Inspired by the U.S. model, Chen promoted the opening of Zhongguancun, China’s Silicon Valley clone. He then became its entrepreneurial star by starting the first entirely privatized technology consulting firm called Advanced Technology Service Division (ATSD).¹⁵⁶ It was the first time a tech business operated outside the purview of government. ATSD reflected the very essence of self-responsible investment behavior VC pioneered by Turner, Hewlett and Packard. Chen was the breakthrough weed – entirely self-financed through private loans from colleagues.¹⁵⁷

¹⁵³ Steven White, Jian Gao & Wei Zhang, “Financial Systems, Investment in Innovation, and Venture Capital: The Case in China” in Anthony Bartzokas & Sunil Mani, eds, *Financial Systems, Corporate Investment in Innovation, and Venture Capital*, (2004) 173. Also see Orcutt & Shen at 190.

¹⁵⁴ Cheng-Hua Tzeng, “Managing innovation for economic development in greater China: The origins of Hsinchu and Zhongguancun” (2010) 32:2 Technol Soc 110, online: <<http://linkinghub.elsevier.com/retrieve/pii/S0160791X10000357>>.

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*

Notably, the specific adoption of the Silicon Valley finance model points to the idea that PRC non-state actors became receptive to Western investment behavior long before becoming receptive to Western laws.

ATSD's eventual success persuaded State officials to legitimize Zhongguancun and catalyze the launch of the National Torch Program, China's first (and now largest) startup program.¹⁵⁸ However, deep change to startup investment was hindered by China's bank-centered financing model. At the time, China's four major banks were responsible for up to 70% of financing for startups.¹⁵⁹ Investment in high-risk startups was an unfeasible long-term strategy for the banks that prioritized with mature investments.¹⁶⁰ Additionally, Chinese bankers had a less rigorous screening process for startups qualifying for funding than American VC funds did which resulted in misevaluations.¹⁶¹ But, for all its defects, the incubation of startups in Zhongguancun legitimized the U.S. entrepreneurial model as a means for the production within the state-capitalist ideal.

2.6.1.2 Developmental Stage: 1998 - Present

In 1998, the PRC government revamped its VC strategy and aligned it with Western practice. Paper No. 1 from the 9th National Committee of the Chinese People's Political Consultative Conference overhauled of the understanding of VC as government subsidy to a form of private equity defined by private VC funds. Four types of VC firms emerged that continue to

¹⁵⁸ *Ibid.*

¹⁵⁹ Orcutt & Shen, *supra* note 4, at 194.

¹⁶⁰ *Ibid.*

¹⁶¹ *Ibid.*

operate today: foreign, government, university and corporate.¹⁶² Paper No. 1 signifies China's encouragement of a receptive and innovative VC industry.¹⁶³

In 1999, the State Council further emphasized that a “healthy venture capital investment system is important to propel the establishment of a country’s technology innovation system, promote national economy and comprehensive national capacity, and realize leapfrog development for China.”¹⁶⁴ With this drive, China entered a stage of rapid growth. The influx of investment, both domestic and foreign, triggered mass proliferation of VC laws as the State tried to keep up with the market’s legal needs. Problematically, deregulation and the ability of various State organs to promulgate laws has resulted in a hodgepodge of regulations. VC laws are not only far from complete, but mismatched and confusing. On one hand, the CPC is responsible for the disharmony. On the other hand, it can be regarded blameless in its construction of a national effort to reform legislative disorder.¹⁶⁵ Chapter 3 specifically elucidates this disharmony within the context of convertible preferred stock.

Today, VC has transitioned into a specialized form of investment in the PRC. China is currently the world’s third largest VC hotbed behind the U.S. and Europe.¹⁶⁶ The Torch Program has broken free from CPC bureaucracy in the past decade and functions in

¹⁶² *Ibid* at 195.

¹⁶³ *Ibid*.

¹⁶⁴ Article 1, “Several Opinions on Establishing a Venture Investment Mechanism”, Issued by the Ministry of Science and Technology, the State Development Planning Commission, the State Economic and Trade Commission, the Ministry of Finance, the People's Bank of China, the State Administration of Taxation and the China Securities Regulatory Commission [16 November 1999].

¹⁶⁵ See Keith J Hand, “Understanding China’s System for Addressing Legislative Conflicts: Capacity Challenges and the Search for Legislative Harmony” (2013) 26:1 Columbia J Asian Law 139.

¹⁶⁶ Ernst & Young, “Adapting and Evolving: Global Venture Capital Insights and Trends 2014” (2014).

independently like the SBA.¹⁶⁷ Zhongguancun, its breeding ground, has been dubbed ‘China’s Silicon Valley’ and is responsible for \$3.2 billion in VC deals - approximately 1/3 of China’s VC output.¹⁶⁸

Nevertheless, there is tension experienced by the decline of SOEs and the rise of private enterprise. The practical concern among policymakers is that privately funded companies could burgeon into capitalist giants and threaten the socialist economy.¹⁶⁹ This is but one factor preventing the convergence of the PRC’s market policy with that of the West.

2.7 The Function of Cultural-Cognitive Institutions in Venture Capital Investing

Venture capital is a difficult form of investment, requiring more effort and risk than private equity. The unproven track record of the startup in conjunction with negative cash flow is riskier than a leveraged buyout in which funds are pumped into a mature (albeit ailing) company. A rich body of research from different disciplines finds that factors external to profit affect VC investment.¹⁷⁰ A different body of literature also finds that social traditions shape investment climate.¹⁷¹

¹⁶⁷ Steve Blank, “China’s Torch Program – the glow that can light the world (Part 2 of 5)”, (2013), online: <<http://steveblank.com/2013/04/11/chinas-torch-program-the-glow-that-can-light-the-world-part-2-of-5/>>.

¹⁶⁸ Steve Blank, “Zhongguancun in Beijing – China’s Silicon Valley (Part 4 of 5)”, (2013), online: <<http://steveblank.com/2013/04/13/zhongguancun-in-beijing-chinas-silicon-valley-part-4-of-5/>>.

¹⁶⁹ Ahlstrom, Bruton & Yeh, *supra* note 26 at 252.

¹⁷⁰ Garry D Bruton, David Ahlstrom & Kulwant Singh, “The impact of the institutional environment on the venture capital industry in Singapore” (2002) 4 *Ventur Cap* 197.; Curt B Moore et al, “Institutional Distance and Cross-Border Venture Capital Investment Flows” (2014) *Journal of Small Business Management*, online: <<http://doi.wiley.com/10.1111/jsbm.12079>>.

¹⁷¹ Hwang & Horowitz, *supra* note 37 at 82.

Traditional economics views VCs as rational actors motivated only to seek the highest return on investment.¹⁷² Behavioral economics contend there is more to it than money. VCs are rational actors in pursuit of financial returns, but are also nuanced actors driven by extra-financial motivations.¹⁷³ A VC will sink money into a startup for monetary gain, but the magnitude of uncertainty and the option to invest in mature companies show that factors like challenge, creative output and adventure compel investment participation.¹⁷⁴

2.7.1 Risk Tolerance

Risk taking is one component of the aforementioned factors. American entrepreneurs and investors have a reputation for being risk-takers that precedes them – the legacy of frontier culture’s ‘rugged individualism’. The “coexistence of danger and opportunity”¹⁷⁵ guided by error and persistence pervades the psychology of risk taking. A failed venture can ‘rise from the ashes’ by revamping its strategy and learning from past mistakes. Indeed, the ‘phoenix effect’ is welcomed by some VCs who prefer to invest in startups that have previously ‘crashed and burned’.¹⁷⁶ Failure is regarded as a learning mechanism and a positive reflection of endurance in American startup culture.

In principle, China’s culture discourages failure. Confucian philosophy’s emphasis on conformity and obedience has fostered a risk-adverse culture. Growing up, Chinese children

¹⁷² *Ibid.*

¹⁷³ *Ibid.*

¹⁷⁴ *Ibid.*

¹⁷⁵ Mike Elvin, *Financial risk taking: An Introduction to the Psychology of Trading and Behavioural Finance* (West Sussex: John Wiley & Sons, Incorporated, 2004).

¹⁷⁶ *Ibid.*, at 171.

are taught “the bigger the tree, the more likely to be blown by the wind”.¹⁷⁷ Society’s mentality is to suppress creative thinkers exhibiting the most individual initiative. For these reasons, the tendency of Chinese investors has traditionally been to finance low-tech companies during the expansion stage instead of high-risk investments during the startup stage.¹⁷⁸ Failure results in a loss of esteem and is a source of shame.

2.7.2 Chinese Entrepreneurship

The development of Zhongguancun in the 1980s and 1990s largely contributed to the emergence of private entrepreneurs in China. Roberts and Sarnoff find that the decrease of government control made private startups more competitive than state-owned firms.¹⁷⁹ Ahlstrom and Bruton analyze the development of Chinese entrepreneurialism through the scope of culture and its impact on VC productivity.¹⁸⁰ The authors conclude that ‘guanxi’ (personal networks of trust based on obligation and the return of favors) dictates business strategy. Ties to ethnicity, attendance at the same schools and shared experiences cultivate guanxi relationships.¹⁸¹ Although these particular ties tend to inform American networks, social capital in the U.S. is largely created on an ad-hoc basis. Americans welcome business with strangers (another reflection of frontier culture) whereas the Chinese generally reject it.

¹⁷⁷ Peggy H Fu, “Developing Venture Capital Laws in China: Lessons Learned from the United States, Germany, and Japan” (2001) 23 LA Int’l Comp L Rev 487, at 525.

¹⁷⁸ Garry D Bruton & David Ahlstrom, “An institutional view of China’s venture capital industry” (2003) 18:2 J Bus Ventur 233, online: <<http://www.sciencedirect.com/science/article/pii/S0883902602000794>>.

¹⁷⁹ David Roberts, Edward B Sarnoff, *Entrepreneurs in High Technology: Lessons from MIT and Beyond* (Oxford University Press, 1991).

¹⁸⁰ David Ahlstrom & Garry D Bruton, “Learning from successful local private firms in China: establishing legitimacy” (2001) 15:4 Acad Manag Exec 72.

¹⁸¹ Thomas Gold, Doug Guthrie & David Wank, “An Introduction to the Study of Guanxi” in *Social Connections in China: Institutions, Culture, and the Changing Nature of Guanxi. Structural Analysis in the Social Sciences* (Cambridge University Press, 2002).

Parlayed to the investment world, the emphasis on *guanxi* creates a fundamental distrust in VCs or anyone without connection to the founders.¹⁸² It also creates hesitance to give one's own money to a stranger.¹⁸³

Liao and Suhmon recognize entrepreneurialism as a trait of Chinese communities, but one informed by collectivism instead of individualism.¹⁸⁴ The authors further measure the extent to which collectivism affects individual action in concluding that Chinese culture, while not opposed to entrepreneurship, is generally unsupportive of it. Liao and Suhmon, however, also suggest that there is a “subculture” of Western entrepreneurialism operating in spite of the dominant culture. These perspectives emphasize the degree of flux in which today's Chinese population is caught. Some individuals abide by the traditional understanding of achievement stressing harmony, seniority and the need not to rise, but to fit in. Young adults, especially, are steered towards careers in established companies rather than in undeveloped startups.¹⁸⁵ The few anomalies that make their way to startup hubs seemingly understand the value of individualism in contrast to the rest of Chinese culture which, by large, adheres to a collectivist mentality.

Many of these ‘invisible’ social institutions noticeably impact the operation of VC laws in China and convertible preferred stock utility. Not only is China experiencing tension between socialist and market forces, but also between Eastern and Western cognitive institutions operating as an additional undercurrent within the total analysis of VC systems.

¹⁸² Fu, *supra* note 176.

¹⁸³ *Ibid.*

¹⁸⁴ Debbie Liao & Philip Sohmen, “The Development of Modern Entrepreneurism in China” (2001) 1:Spring Stanford J East Asian Aff 27 at 30.

¹⁸⁵ Steve Blank, “China Startups – The Gold Rush and Fire Extinguishers (Part 5 of 5)”, (2013), online: <<http://steveblank.com/2013/04/14/china-startups-the-gold-rush/>>.

Chapter 3: Convertible Preferred Stock

3.1 Introduction

Chapter 2 outlined the basic structure and fundamentals of the VC industry. Now we venture into the crux of the thesis – understanding the pervasiveness of convertible preferred stock use in the U.S. and its Western influence on Chinese VC investing.

This chapter first examines the structure and development of preferred stock as the result of American flexibility in capital market development. It then presents the legal framework for convertible preferred stock and attempts to explain the reason for the security's pervasiveness within the U.S. VC structure.

The latter half of the chapter examines the development and effect of PRC convertible preferred stock provisions using the U.S. model as a mirror for comparison. Instead of regarding the U.S. structure as one with every answer to VC investing, this chapter aims to sustain the institutional thread of the thesis through an analysis of the dichotomy between legal creativity and legal experimentation - the former (representing the U.S. model) rooted in private initiative of will and the latter (representing the PRC model) rooted in the tension between market efficiency and socialist priorities.

3.2 Structure and Optimality of Preferred Stock

In order to fully grasp the intricacies of convertible preferred stock, it is imperative to first understand the rudimentary structure of preferred stock. Much of this introduction will be elementary to those with a preexisting knowledge of markets. I urge these readers to skip to the next section.

In the capital markets framework, preferred stock ranks lower than bonds but higher than common stock. Its position over common stock makes preferred stock advantageous to investors. Preferred stock pays fixed dividends to its shareholders making it lower risk than common stock that only pays dividends if the company issuing the stock is successful. Furthermore, the seniority of preferred shares over common shares lets them act as an “early warning system” to a preferred shareholder.¹⁸⁶ If a company pays a common stock dividend at any price, the shareholder will be paid a full dividend amount.¹⁸⁷ The investor is effectively guaranteed payment.

In the event an issuing company cannot pay both its preferred and common stock dividends, the seniority of preferred stock gives its shareholders first right to full dividends over common stock shareholders.¹⁸⁸ To be clear, it is predominantly banks and utilities that issue preferred stock (otherwise known as straight preferred stock). Convertible preferred stock (the focus of the thesis) is a byproduct of the VC industry and will be examined in the forthcoming section.

3.3 A Brief History of Preference Shares in the United States

Long before it appeared on Wall Street, preferred stock was used in the early days of the American transportation industry as the result of issuer and investor relations.¹⁸⁹ In order to raise outstanding sums for the construction of extra miles on railroad and canal projects (often exorbitant and beyond the financing capabilities of ordinary investors), companies

¹⁸⁶ Doug K Le Du, *Preferred Stock Investing* (BookLocker.com, Inc., 2007) at 22.

¹⁸⁷ *Ibid.*

¹⁸⁸ *Ibid.*

¹⁸⁹ George Heberton Evans Jr. “The Early History of Preferred Stock in the United States” (1929) 19 *American Economic Review* 1

approached the state with an interest in the railroad for the required amount. The state offering assistance would pass a bill containing a section that required the company to guarantee a preferential dividend to the state.¹⁹⁰ In 1836, Maryland was the first state to legislate a provision for a 6% dividend from the Chesapeake and Ohio Canal in need of \$171 330 to build 78 additional miles.¹⁹¹ To appreciate the impact of this provision, we must remember that the early model of the U.S. corporation was one in which one stockholder received the same dividend as any other stockholder in the company.¹⁹² Thus, by developing a custom-designed ‘preference’ dividend for the state inspired by the circumstances of the time, the legislature diverged from the traditional shareholder arrangement and created a hybrid with both debt and equity characteristics - the former in the borrowing aspect and the latter in the dividend aspect.

The new corporate-friendly laws were a form of frontier residue that “encouraged the release of entrepreneurial energy.”¹⁹³ The results were not all positive, however. Private markets wielded enormous power to unscrupulous investors (more commonly referred to as ‘robber barons’) until the *Interstate Commerce Act of 1887* was federally passed to control business transactions.¹⁹⁴

The second phase of preferred stock development, which began in the 1940s, moved the sale of said stock from the state to individuals.¹⁹⁵ Railroads in poor condition undertaking construction often underestimated the cost of renovation programs. When it came time to raise the outstanding funds, the states would either outright refuse aid or wait to fund the

¹⁹⁰ *Ibid* at 45. The dividend was calculated at 6%.

¹⁹¹ *Ibid* at 44.

¹⁹² *Ibid*.

¹⁹³ Norman K Risjord, *The Civil War Generation* (Rowman & Littlefield, 2002) at 284.

¹⁹⁴ *Ibid*.

¹⁹⁵ *Ibid* at 50.

projects only with assurance of public interest as reflected through stock subscriptions.¹⁹⁶ Because the railroad could not raise funds from the sales of its ordinary stock, it would issue preferred stock to shareholders with assurance of a percentage dividend.¹⁹⁷ Again, the nexus between the novelty of development and situational need is significant within the framework of the developing capital market system. For the first time, companies allotted different classes of stock to shareholders, a practice that eventually spread into other industries and enterprises over time creating the modern preferred stock industry. Practitioners have since added ‘bells and whistles’ to preferred stock making it an umbrella term for straight preferred stock, convertible preferred stock, and participating convertible preferred stock, among others. To excel the venture capital perspective, the thesis will only examine convertible preferred stock and (although briefly) participating convertible preferred stock.

3.4 Convertible Preferred Stock

3.4.1 General

Recall the characteristics of a startup: brand new, high risk, not yet profitable.¹⁹⁸ The founders’ idea could be worth billions, or nothing at all. There is no way of telling since the venture has no demonstrated financial traction. All it has are the skills of the parties involved: research, marketing, financial expertise, distribution relationships, manufacturing, and so forth. These contributions are all evenly critical to the future success of the company, yet cannot be monetarily priced. Inevitably, founders and investors will apportion different value to their participation in the company. This is where the role of equity comes in. Instead

¹⁹⁶ *Ibid.*

¹⁹⁷ *Ibid* at 57.

¹⁹⁸ See the explanation of startups in 2.2.1.2, above.

of using money to value input, startup actors use equity as currency in the form of preferred stock or other securities.

Both sides take a chance with the venture – the founder with the idea and personal livelihood; the VC with other individuals' money. However, by providing the funding, connections and financial guidance, the VC is in a position to demand protective measures. Convertible preferred stock is one such measure that ensures the investor comes out on top no matter what happens to the company.

If the company performs well and reaches IPO, or a certain profit milestone, the convertible aspect results in an automatic conversion of preferred stock into common stock.¹⁹⁹ If the company underperforms and does not reach its projected milestone, the preference aspect offers allows the investor to recoup some losses by way of dividends, priority in liquidation all the while giving the VC added control.²⁰⁰ The next few subsections function to elucidate these basic operations of the security before introducing its role in solving problems faced by a portfolio company.

3.4.2 Payment of Dividends

When automatic conversion occurs upon the company reaching a stipulated point of financial success (be it IPO or profit margin), the investor can stand to earn a windfall depending on the value of common shares.

¹⁹⁹ Gilson & Schizer, *supra* note 3.

²⁰⁰ See, generally, Arnold R Cowan, "Tax Options, Clienteles, and Adverse Selection: The Case of Convertible Exchangeable Preferred Stock" (1999) 28:2 Financ Manag 15.

Imagine that an investor purchases 100 shares of convertible preferred stock from an issuer for \$700 per share. The total investment would amount to \$70,000. Let us also assume this class of preferred stock pays \$30 in dividends for a 4.3% dividend yield and additionally gives a conversion privilege which allows conversion of each share of preferred stock into 60 shares of common stock. It is exactly this conversion privilege that can potentially provide a windfall earning for the investor. If the common stock skyrockets to, for example, \$40 per share, the investor could take the 100 shares of preferred stock and convert them each into 60 shares of common stock. This would provide the investor with 6000 shares of common stock. Upon immediate sale, the common stock could be sold for \$240,000 (6000 x \$40) giving a threefold return on the initial investment of \$70,000. However, the investor must avoid conversion at times when the price of the common stock would result in loss. If 6000 common shares were sold at a price of \$10 per share this would result in a \$10,000 loss for the investor, plus the loss of the preferred stock dividend.

In the event that the company does not meet its contractually stipulated success point, the transmutable aspect of convertible preferred stock ultimately allows the investor derive an income from the dividend.²⁰¹ However, for dividend preferences to function effectively in VC investing, the dividend preference itself must be cumulative.²⁰² This allows preferred dividends to accrue even if not presently paid and constructs a barrier to paying a common

²⁰¹ Gilson & Schizer, *supra* note 3 at 882.

²⁰² *Ibid.*

dividend over time.²⁰³ Empirical research also suggests that these cumulative dividends are added to a liquidation claim thereby allowing the VC to secure more returns.²⁰⁴

3.4.3 Priority in Liquidation

Portfolio companies are either home runs or complete failures.²⁰⁵ In the latter scenario, the assets of the company are distributed to creditors and shareholders in order of priority. Once the creditors are paid, the convertible preferred shareholders are given priority over common shareholders in obtaining liquidation value. Liquidation preferences are also triggered in the event of a merger or sale of the portfolio company.²⁰⁶ In this case, the VC actually has a better claim over the assets of the company since creditors have no involvement. Even if the company is ‘empty’ (presumably having spent all start-up cash and sold off basic operating equipment), the preferred stockholder (in our case, the investor) can potentially still recoup some of the investment upon the sale of the company.

3.4.4 Allocation of Control

Convertible preferred stock also functions to give the VC investor or fund enhanced control rights. Preferred shareholders may be given voting rights on certain issues as well as the opportunity to designate directors to the board. In this way, the investor or fund can effectively monitor the portfolio company and keep a close eye on the initial investment. A

²⁰³ *Ibid.*

²⁰⁴ Steven N Kaplan & Per Stromberg, “Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts” (2003) 70 *Rev Econ Stud*, online: <<http://search.proquest.com/docview/204333653?pq-origsite=summon>>.

²⁰⁵ See Deborah Gage, “The Venture Capital Secret: 3 Out of 4 Start-Ups Fail”, (2012), online: *Wall Str J* <<http://www.wsj.com/articles/SB10000872396390443720204578004980476429190>>. Ongoing research from Shikhar Ghosh, Senior Lecturer at Harvard Business School, as reported to The Wall Street Journal indicates that approximately 75% of startups fail. This rate is higher than the industry failure rates cited by the National Venture Capital Association at 25% to 30%.

²⁰⁶ Gilson & Schizer, at 884.

provision in the articles of incorporation for a portfolio company may stipulate convertible preferred stock to give the VC investor protection through voting rights equal to those of the founder in the following form: “on any matter presented to the stockholders of the corporation for their action or consideration at any meeting of stockholders of the corporation, each holder of outstanding shares of Series A Preferred Stock shall be entitled to cast the number of votes equal to the number of whole shares of Common Stock into which the shares of Series A Preferred Stock held by such holder are convertible as of the record date for determining stockholders entitled to vote on such matter”.²⁰⁷ Since investors generally have a business acumen superior to that of the founders, voting rights provide the investor with control and, consequently, protection from unfavorable decisions made by the founders.

3.4.5 Convertible Preferred Stock in Venture Capital Investing

3.4.5.1 Corporate Governance

Every financial contract is afflicted with problems of uncertainty, information asymmetry and opportunism.²⁰⁸ The very nature of VC investing predicated on early investment in high technology companies further heightens these problems. Similar to the pre-investment uncertainties experienced by seed ventures, beginner companies have an uncertain future based on a lack of performance.²⁰⁹ The technology, albeit cutting-edge, is unproven to generate profit. Added uncertainty concerns the effectiveness of management whose future

²⁰⁷ NVCA (2006: 250)

²⁰⁸ Ronald J Gilson, “Engineering a Venture Capital Market: Lessons from the American Experience” (2003) 55 Stanford Law Rev at 1076.

²⁰⁹ *Ibid.*

choices largely determine the trajectory of the company.²¹⁰ These same issues contribute to the information asymmetry between founders and investors. The high technology of which the investor has little knowledge of or experience with places the founder at an advantage to misappropriate company funds.²¹¹ Even if the VC firm employs persons with scientific backgrounds, the knowledge divide between the founding entrepreneur and the investor persists to the extent of the founder's specific product knowledge.

Critically, neither dividend, liquidation and control preferences solve these problems. All a dividend preference provides is earlier payment of preferred stock dividend over a common stock dividend.²¹² In the VC universe, this is relatively insignificant since portfolio companies are not yet profitable and cannot pay preferred share dividends, let alone common stock dividends.²¹³

Liquidation preferences do not reduce start-up risks either. Liquidation steps, triggered only if the portfolio company fails, have no relevance to problems between founders and investors that arise when the company is active.

Control allocation through voting rights does play a role in reducing information asymmetry, yet does not fully account for the reduction of knowledge disparity between founders and investors.

²¹⁰ *Ibid.*

²¹¹ *Ibid* at 1077.

²¹² Gilson & Schizer, *supra* note 3, at 882.

²¹³ *Ibid.*

Other securities and contract provisions can duplicate the effects of convertible preferred stock in the allocation of control.²¹⁴ For instance, different classes of common stock can be combined in the design for a variety of control rights.²¹⁵ Alternatively, a covenant determining the rights of common and preferred shareholders can be used to specifically determine board representation as well as representation between different classes of stock.²¹⁶

3.5 The Success of Convertible Preferred Stock in the United States

Expressing the success of convertible preferred stock in the U.S. is difficult since it is a culmination of legal and institutional variables that contribute to its widespread use. However, one thing remains clear. Convertible preferred stock is predominantly a U.S. investment vehicle used to fund U.S. companies.²¹⁷ As the preceding section just explained, the key attributes of convertible preferred stock – dividend payment, priority in liquidation and corporate governance – play a limited role in the VC context. Instead, academics argue that it is two modes of tax practice that inform the widespread use of convertible preferred stock in U.S. VC investment: a basic avoidance of a tax imposition and the reduction of tax liability in management compensation plans.

I will further supplement the doctrinal tax analysis with institutional insights previously unconsidered by existing literature.

²¹⁴ *Ibid.*

²¹⁵ Giacinta Cestone, “Venture Capital Meets Contract Theory: Risky Claims or Formal Control?” (2014) 18:3 *Review of Finance*, 1097.

²¹⁶ Gilson & Schizer, *supra* note 3 at 886.

²¹⁷ *Ibid* at 881.

3.5.1 Avoidance of Tax Imposition

In perspective, the VC model finds success in a structure where the founders pay less for their equity than later investors.²¹⁸ Lebrun argues that, if received in common stock, this ‘discount’ would give rise to significant tax liabilities, particularly for founders who pay less for stock than investors.²¹⁹ In the event of liquidation, the assets of the company would be distributed to shareholders on a pro rata basis, thereby giving the founders an excess amount of assets in proportion to the investment.²²⁰ The U.S. has addressed both problems through innovative practice by issuing common stock to founders and convertible preferred stock to investors. In contrast to common stock, preferred stock shields the founders (who purchased their shares for less than investors) from a tax imposition.

3.5.2 Reduction of Taxation Liability in Management Compensation Plans

In the context of a portfolio company, an executive compensation plan is a percentage of stock options given to an executive employee atop a yearly salary. The stock options themselves carry the right to buy shares of the company at predetermined price that can be sold at a point later in time.

The use of stock options provides an alternative to cash incentives.²²¹ The success of a plan is predicated on the idea that a structure offering more incentives attracts managers with stronger skills and so reduces the information asymmetry prevalent in startups.²²² Put another way, a scheme offering meaningful compensation will create competition between

²¹⁸ Kenneth Lebrun, “Making a Private Equity/Venture Capital Investment in Japan: Implementing Techniques Commonly Used in U.S. Transactions” (2002) 23:2 Univ Pennsylvania J Int Law, online: <<http://scholarship.law.upenn.edu/jil/vol23/iss2/1>>.

²¹⁹ *Ibid.*

²²⁰ *Ibid* at 217.

²²¹ *Supra* note 140.

²²² *Ibid.*

contenders for executive and managerial positions in startups. Successful applicants chosen from a top pool of talent will use their skills and qualifications to meet investor needs by ensuring funds are allocated for the right purposes and to meet founder needs by ensuring the startup is well-managed and meeting stages of business planning.²²³ Thus, convertible preferred stock options are designed to save investors in the worst case scenario. If the startup fails, the founders will feel the most pain.

From an institutional point of view, the advertisement of executive stock option plans and subsequent draw of numerous applicants reflects the practice of economic actors autonomously gravitating towards the most competitive scheme. Autonomy, likewise, also vests in the unrestrained freedom of the private startup to determine how much it values executive skills and qualifications in determining the amount of ownership in the compensation plan. In this system, both players entirely operate outside the scope of government ownership or interference until the executive's gain on the stock is realized and the individual must pay capital gains tax. The taxation practices applicable are unique to the American system. Because of the difference in rights between the two-class share structure, preferred shares issued in a plan provide a basis for lowering the valuation of the common shares beneath them.²²⁴ Common stock is valued at a liquidation-based value (as low as 1/10) of the preference shares during the earliest rounds of startup financing.²²⁵ The significant reduction in investment tax at an ordinary income rate (instead of the current tax rate) is contended to be the primary reason for the success of convertible preferred stock in U.S. VC investing.²²⁶ Regulatory opposition to this practice is minimal. The IRS entirely refrains from

²²³ *Supra* note 134.

²²⁴ Gilson & Schizer, *supra* note 3; Sandler, *supra* note 33 at 208.

²²⁵ *Ibid.*

²²⁶ Gilson & Schizer at 886.

intervention presumably because an employer will deduct an employee's tax leaving the Treasury at no significant advantage.²²⁷ The only form of regulatory opposition comes from the SEC that imposes a stock charge if the value disparity remains active at the point of exit.²²⁸ Thus, the executive enjoys a deferred tax rate until the stock is sold as well as a preferential tax rate.²²⁹ The reduction of tax liability in the compensation plans of managers further incentivizes the scheme to attract top talent and therefore reduce the informational asymmetries dominant in the startup stage.

3.5.3 Exit

The portfolio company need not be listed to exit. However, both the founder and investor stand to earn a windfall if the company goes public.

As we saw in Chapter 2, the transparency objectives of the SEC and relative legislation has resulted in healthy stock markets. Another benefit of transparency requirements is reflective in the strengthening of informational efficiency that assists with convertible preferred stock conversion to common stock upon exit. Although conversion is a choice exit practice among VC founders and investors, there are no government regulations or stock exchange rules demanding conversion. Specifically, it is the creative development and use of participating convertible preferred stock (PCP stock), crucial in signaling the VC firm's quality to uninformed shareholders, that is responsible for widespread conversion practices when the exit is through an IPO.²³⁰ By signaling quality, PCP stock reduces information asymmetry

²²⁷ Sandler at 209.

²²⁸ *Ibid.*

²²⁹ Gilson & Schizer at 876.

²³⁰ Sridhar Arcot, "Participating convertible preferred stock in venture capital exits" (2013) 29:1 J Bus Ventur 72, online: <<http://www.essec.edu/faculty/showDeclFileRes.do?declId=11123&key=Publication-Content>>.

between the venture and investors at the time of exit and subsequently encourages conversion practices.

3.6 China's Development of Convertible Preferred Stock Conditions

Convertible preferred stock has occupied a shifting space within PRC law. VC regulations expressly provide for it (and so it operates legally), yet there is no explicit two-share structure contemplating preferred stock as there is in the U.S. Uniform Commercial Code (UCC). For most Western practitioners, it may seem counterintuitive to have a VC provision without an express two-stock structure in the Company Law. However, the authority of various government organs to promulgate laws has legalized convertible preferred stock depending whether the investment is in an SOE, domicile venture or a venture with foreign elements. The rest of this section contemplates start up and exit modes in PRC VC critically assessing the implementation of convertible preferred stock provisions in light of the state's planned system and the ability of other securities and contractual provisions to replicate the effect of preferred stock.

3.6.1 Provisions for State-Owned Enterprises (SOEs)

SOEs are not, by the U.S. definition, a form of VC investment given their status as a government entity. Since the U.S. pioneered VC as a private equity investment and the U.S. definition is globally accepted, this analysis proceeds on the basis that SOEs are not VC companies per se. However, as we saw in Chapter 2, the CPC has traditionally treated SOEs as a form of VC instrument and so this portion of the thesis will examine relative SOE provisions.

The Company Law 1993 as it then was only permitted the distribution of profits in proportion to shareholdings.²³¹ As such, shareholders could only receive a fixed dividend disproportionate to individual level of shareholdings.²³² The law also failed to provide a legal basis for stock options that, as demonstrated, are nearly synonymous with convertible preferred stock in the VC world. In response to an outcry for change, the CPC introduced a stock option pilot scheme as an incentive mechanism in an effort to further SOE development.²³³ The attempt to conjoin state goals of control with the intensity of a private equity model of allotting control to managers failed miserably. Unlike the U.S. stock option model which functions to incentivize the manager with competitive options and optimal returns, the pilot scheme introduced by the CPC functioned to restrict managers salaries. When the SOE awarded managers with stock options under the scheme, a state-owned assets administration company would purchase the company's stocks with the managers' salaries.²³⁴ Payout from the stock options was entirely contingent on the manager's performance. If the manager met her performance criteria, the stocks would be granted on a yearly basis within a fixed return period.²³⁵ However, if the manager's performance was unsatisfactory, the amount due from the stocks would be expropriated by the assets company.²³⁶ The structure compelled an unwillingness on the part of managers to commit their salaries to the penalizing scheme and, ultimately, rendered the compensatory nature of the stock options pointless. Suffice it to say, domestic VCs also developed a dependency on common stock given the lack of investment alternatives. Even today, this practice is not

²³¹ Zhang, *supra* note 7.

²³² *Ibid.*

²³³ Decisions on SOE Reform 1999.

²³⁴ Zhang at 68.

²³⁵ *Ibid.*

²³⁶ *Ibid.*

likely to be broken since SOEs receive bailouts from the government that limits their need for an alternative risk mitigating security.²³⁷

Although the Company Law 2006 now permits stock options, issuing authorities are still apprehensive about its application given the CPC's continuous legal experimentation for increased control. Stock options (especially those in the form of convertible preferred stock) function to level the power between the state owner, managers and other shareholders through voting rights and other mechanisms. Proof of the state's discontent with an equality arrangement of this nature was demonstrated in the 2008 State-owned Assets Supervision and Administrative Commission's (SASAC) suspension of all stock options in state-owned companies.²³⁸ When the suspension was lifted, many Chinese VC managers reported seldom using stock options because their seniors (government officials) also seldom used the options in an act to align themselves with the response of the state.²³⁹ Thus, the actions of the CPC in providing SOE provisions for convertible preferred stock demonstrate a crab walk – the state concedes to the demand for convertible preferred stock and implements provisions, retracts the provisions as a response to the need for more control, and finally concedes again when it is too late for any meaningful impact.

Although SOEs reflect a strategy of the past in the PRC's current economic climate, it would be misleading to dismiss the need for convertible preferred stock in SOEs altogether without looking at the *Third Plenary Decision of the 18th CPC Congress* issued in 2013 which includes a rubric for resolving the imbalance between SOEs and the private sector through

²³⁷ *Ibid.*

²³⁸ *Ibid* at 69.

²³⁹ *Ibid.*

greater private investment. Given the CPC's incremental approach to governing through 'crossing the river by feeling the stones', it may be years before the rubric takes effect. Until then, convertible preferred stock will not operate in SOE investing.

3.6.2 Private Ventures

Outside of the SOE sphere, ideological commitments to the limitation of autonomous economic activity have dwindled with the CPC's commitment to SME growth. However, the power of numerous state organs to issue laws has resulted in a hodgepodge of VC laws that present practical challenges to both domestic and foreign ventures. The literature (albeit brilliant to the study of convertible preferreds in China) has struggled to locate the numerous provisions available to portfolio companies.²⁴⁰ I aim to unify the literature with a discussion of all relevant startup and exit laws in the subsequent sections.

3.6.2.1 China-domiciled Venture Enterprises

In 2006, the State Development and Reform Commission in conjunction with other state bodies issued the *Interim Measures for the Administration of Startup Investment Enterprises* ("Interim Measures").²⁴¹ For Chinese VC investors, this is the most prolific of instruments to date. The Interim Measures expressly authorize a startup investment enterprise to "make investments in the unlisted enterprise by way of its stock rights, preferred stocks, convertible

²⁴⁰ Jing Li, "Venture Capital Investments in China: The Use of Offshore Financing Structures and Corporate Relocations" (2012) 1:1 Mich. J. Priv. Equity Venture Cap 1.

²⁴¹ Order No. 39 of the National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People's Bank of China, State Administration of Taxation, State Administration for Industry and Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission, and State Administration for Foreign Exchange.

preferred stocks and other quasi stock rights,”²⁴² the effect of which gives Chinese startups identical access to the use of U.S.-style equity securities. Moreover, the measures encourage the formation of compensation programs to “establish a performance incentive mechanism”²⁴³ for managers. When compared to the previous absence of provisions that made it questionable as to how far an agreement between two private actors would be enforced, the legal machinery now has a basis from which to make decisions upholding the validity of early stage contracts. Investors can rely on the provisions instead of persuading a decision maker that their preferred stock contract gives them rights superior to a founder despite their shares only amounting to a minority stake in the company’s equity.

Implicit in the measures is a further consideration: the rigid dichotomy between markets and state loosens upon the CPC’s visualization of prodigious economic activity. In exchange for market expansion, the state permits the expansion of individual autonomy to engage in private enterprise. This autonomy, nonetheless, remains qualified by conditions sourced from the party’s desire to control market reform. Article 9(5) provides that every startup enterprise must have at least 3 managers with a minimum of 2 years of startup experience. The correct administrative department then babysits each startup by conducting an annual inspection to ensure the requirement is complied with.²⁴⁴

In contrast to American practice in which the terms of each series contract are determined by the choice of its participants, the Interim Measures demonstrate a limitation of private initiative by dictating the terms by which participants are to run a startup. The state’s

²⁴² Art. 15. A ‘startup enterprise’ is defined as an “organization registered and established within the People’s Republic of China for the purpose of mainly engaging in startup investment activities” under Art. 2.

²⁴³ Art. 18

²⁴⁴ Art. 27. All articles in Chapters II and III must be complied with.

involvement reaches beyond the American norm of routinized company formation requiring only the selection of a legal form and incorporation.²⁴⁵ Thus, in substance, the Interim Measures' underlying policy conflicts with the fundamental private equity principles to which VC belongs: the presumption of private initiative is displaced by the public initiative of the socialist state. On this analysis, the unplanned character of venture financing is manipulated into planned formations to suit the control objectives of the party-state.

By all indications, the PRC has taken years of U.S. startup practice development and nutshelled it into one set of regulations. While the theoretical import of law may have been successful, its practical application has been slow.²⁴⁶ Part of the explanation for this is that the Interim Measures tell founders and investors what to do, but not how to do it. Requiring a set of senior managers results in better supervision of a startup, but Chinese managers with little or no previous experience in using convertible preferreds are in a limited position to use the security.

Another practical observation is the inherent challenge of finding quality personnel for a company. Even in the U.S., it is difficult to find competent managers to run a startup.²⁴⁷ It takes years of skill development to know how to efficiently guide a very nuanced and unstable company. There is also an element of patience needed to wait for the startup to

²⁴⁵ In the U.S., the basic requirements for startup formation are to choose a legal entity for the company (in the majority of cases a C-Corporation) and to incorporate in any state.

²⁴⁶ Lin Zhang, *China's Venture Capital Market: Current Legal Problems and Prospective Reforms* (Waltham, MA: Elsevier, 2015) at 50. Zhang states "Chinese domestic venture capital is yet to apply these new rules to its investments". There are no current empirical studies on the use of convertible preferred stock.

²⁴⁷ Orcutt & Shen, *supra* note.

mature. A manager does not get paid until it does. Therefore, managerial staff must be motivated by stock options. As we know, Chinese actors still prefer cash compensation.

The other explanation for the slow application of the Interim Measures results from a misunderstanding of the concept of monitoring. Founding entrepreneurs view the investor as a boss instead of a collaborator.²⁴⁸ Other times, they view investors as a source of income and ignore the board and management entirely.²⁴⁹ The division in approach appears to be the result of division in the psychology of actors: a choice between a hierarchical structure leftover from a state-planned economy, or an adventitious choice to be different if the option is available. Either way, the exchange of knowledge between startup actors, so deeply nurtured in American practice, is weak and overlooked. By their divisiveness, Chinese startup actors underline apprehension with the American VC methodology that values portfolio companies as vehicles for equitable contribution. The cause is a difference in value perception. As we know, parties involved in a startup can perceive their contributions to the company in different values. Pricing these values according to monetary terms is difficult (if not impossible) and so equity becomes the currency for trust.²⁵⁰ Chinese startups have yet to understand themselves as clusters of unorganized independent thinkers (weeds, by Rainforest logic) and still tend to prefer high salaries or cash compensation instead of stock options. Only those who have a grasp on the understanding of human relationships within the startup become the beneficiaries of innovation creation.

²⁴⁸ Blank, *supra* note.

²⁴⁹ *Ibid.*

²⁵⁰ Hwang & Horowitz, *supra* note 37.

A subsequent set of guidance measures from the State may solve the information deficit in part by providing logistical direction for equity compensation plans and the issuance of convertible preferred stock. Yet, my opinion is that the PRC can become a more receptive transplant if it breaks the path dependency of its VC participants. While there is an apparatus for attracting managers with stronger skills, the State needs to create an entrepreneurial ecosystem without regulatory hurdles to spur use of relevant laws. I will elaborate on this idea in my Chapter 4 recommendations.

3.6.2.1.1 Tax Considerations for Startup Investment Enterprises

As with the Interim Measures, the disparity between legislation and reality continues in the taxation realm. The EITL's emphasis on high technology has resulted in tax policies sensitive to onshore startups, yet unrealistic in application. In line with the *Circular of State Administration of Taxation on Implementation of Income Tax Preferences for Startup Investment Enterprises*,²⁵¹ startup enterprises can avoid the standard 25% capital gains tax imposed by the EITL and instead deduct 70% of investment income provided that the investment is made in a non-listed high-tech SME.²⁵² By American practice standards, the Circular is nonsensical. It is counterintuitive to have a startup investing in SMEs when the goal is for the startup to become an SME itself. Part of the problem is the emphasis on maturity. A 'startup investment' is defined under the Interim Measures as "stock right investments...in expectation of capital gains mainly by stock right transfer after the invested enterprise becomes *mature or relatively mature*".²⁵³ The administration has mistakenly

²⁵¹ GSF [2009] No.87.

²⁵² Art. 2.

²⁵³ *Ibid.*

defined a startup as a formal VC vehicle. Alternatively, it may be argued that the administration has correctly defined a startup by its own political rhetoric emphasizing later stage investments. However viewed, it misunderstands the character of informal VC. Any equity investment into a vehicle other than itself, no matter how nominal, subjects a startup to fiscal hardship it likely cannot overcome. Singling out SMEs without addressing formational vehicles is toxic to the VC ecosystem that the party-state is, ironically, trying to create.

Taxation policies on employee stock plans are equally unhelpful. The SAT's *Notice on Individual Income Tax Issues Concerning Stock Incentives*²⁵⁴ provides a computation formula favorable only to stock appreciation rights, stock options and restricted stock awarded by listed companies.²⁵⁵ All startups are unlisted and so the Notice confines its application of benefits to listed companies, but not to early stage companies hungry for tax concessions. Insofar as institutional tensions operate, the Notice is an uncoordinated effort to tie taxation laws with market development suggesting that the socialist discourse competes with the need for market efficiency. Startups are, as a result, disincentivized from using the Interim Measures that further jeopardizes the long-term success of the PRC VC industry. Comparatively speaking, the refined U.S. tax practices concerning individual stock plans described in *supra* 3.5 are premised on mature VC practices. This is not to say the Interim Measures cannot operate without practices on that level of sophistication. Rather, the difficulties indicate that convertible preferred stock and management equity programs will

²⁵⁴ Guo Shui Han [2009] No. 461.

²⁵⁵ Individual income tax = (incentive income divided by number of months) x applicable tax rate – quick deduction) x number of months. See “China Clarifies Tax Treatment of Equity Incentive Compensation”, (2009), online: *Jones Day Comment* <[http://www.jonesday.com/files/Publication/cd8db95d-b2f0-4a41-8d91-d9f450583083/Presentation/PublicationAttachment/91ddf4db-96f3-45d3-8317-de8681e7a6ff/China Clarifies Tax.pdf](http://www.jonesday.com/files/Publication/cd8db95d-b2f0-4a41-8d91-d9f450583083/Presentation/PublicationAttachment/91ddf4db-96f3-45d3-8317-de8681e7a6ff/China%20Clarifies%20Tax.pdf)>.

not be used to the same extent as in the U.S. until the PRC gains experience with private modes of investment.

3.6.2.2 Foreign Invested Enterprises (FIEs)

Legislation concerning convertible preferred stock use in onshore vehicles is currently the best it has ever been, yet still transitory and unformed. An alternative is to add a non-Chinese investor to qualify the venture as a FIE and establish a management compensation plan with the use of convertible preferreds. FIE laws are triggered when 25% of a Chinese company's equity is held by foreign investors.²⁵⁶ The company can either be formed as an offshore holding or a Foreign-Invested Joint Stock Company (FIJSC). Before continuing with the analysis of both, it must be noted that the UCL permits two types of corporate entities: LLCs and JSCs.²⁵⁷ Only JSCs can issue shares to the public.²⁵⁸ A portfolio company should be set up with the intention to list on the (Chinese) stock exchange to avoid costs for restructuring on the eve of IPO and thus as a JSC (or, in our case, a sub-type FIJSC). Such other FIEs as Cooperative Joint Ventures (CJVs), Equity Joint Ventures (EJVs) and Wholly-Owned Foreign Enterprises (WFOEs) – set up as LLCs - are outside the scope of this thesis.

3.6.2.2.1 Foreign-Invested Joint Stock Companies (FIJSCs)

The FIJSC is the only FIE that has equity in the form of shares. An FIJSC must have a minimum of two (and less than two hundred) initial shareholders (or promoters) and at least

²⁵⁶ Art. 2, *Provisional Regulations of the Ministry of Foreign Trade and Economic Cooperation on the Establishment of Investment Companies by Foreign Investors*.

²⁵⁷ Article 3.

²⁵⁸ Company Law 2006. Chinese JSCs are comparable to an American C-Corporation that can have an unlimited number of stockholders and are a separate taxable entity from its shareholders.

one foreign investor.²⁵⁹ Following the 2014 enactment of the *Administrative Provisions on the Registration of the Registered Capital of Companies*, capital requirements can be set out by the articles of association.²⁶⁰ Thus, the FIJSC is more appealing to early stage companies and SMEs than the option of a Foreign-invested Holding Company requiring a capital contribution of US \$30M or a Foreign-invested Venture Capital Enterprise requiring \$1M USD from each investor.

Although the FIJSC demonstrates breakthrough for investor autonomy, it is ill equipped for the application of convertible preferreds to startups due to the deficiencies in the UCL that underpins it. A JSC is defined as a company whose capital is divided into equal shares with each shareholder's interest relative to the number of shares held.²⁶¹ Put another way, separate classes of stock are not permitted. If the objective is to issue convertible preferred stock, the FIJSC can only navigate around this prohibition if the foreign entity is listed. Then, it is free to offer a stock option plan to Chinese nationals as long as it obtains exchange control approval.²⁶² Problematically, many FIJSCs are private companies and must rely on the separation of cash flow and control rights from equity ownership to protect investors. The drawback is that these provisions fail to solve the information asymmetry between founders and investors.

3.6.2.2.2 Offshore Investment Structures

²⁵⁹ 'Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors' (MOFCOM, 2006).

²⁶⁰ Article 12.

²⁶¹ Article 3.

²⁶² Circular 78; *Circular of the SAFE on Issues concerning the Administration of Foreign Exchange Used for Domestic Individuals' Participation in Equity Incentive Plans of Companies Listed Overseas* (Circular Hui Fa [2012] No. 7).

In light of the challenges with a FIJSC, an alternate option is to structure the company as an offshore holding and so avoid legislative pitfalls. Offshore investment structures are more advantageous than Foreign-funded Business-starting Investment Enterprises (FBIEs) that are permitted to use convertible preferred stock provisions under the Interim Measures, but require high minimum total contributions.²⁶³

There are two structures for offshore investment: the offshore Special Purpose Vehicle (SPV) and the Variable Interest Entity (VIE). A SPV in the Chinese VC investment context refers to an offshore enterprise (generally located in a tax haven) directly established or indirectly controlled by an onshore Chinese subsidiary.²⁶⁴ The equity stake of the onshore company is held by the SPV placing Chinese investors at an advantage to benefit from foreign laws friendly to preferred stock.

The more complicated VIE structure allows a Chinese entity, either wholly or partially foreign owned, to have control over a Chinese operating company (the SPV) permitted to operate in restricted sectors. The only major difference is that the VIE uses contracts instead of equity to structure the SPV.²⁶⁵ Both are alternate routes to the same solution – a ‘round trip’ investment in which a Chinese national invests in a domestic company through the use of an offshore vehicle. Importantly, SAFE’s newly released *Circular Relating to Foreign Exchange Administration of Offshore Investment, Financing and Return Investment by Domestic Residents Utilizing Special Purpose Vehicles* permits plans “using equities or

²⁶³ *Provisions Concerning the Administration of Foreign-funded Business-starting Investment Enterprises*. Article 6(2) requires a minimum total contribution of \$10M USD.

²⁶⁴ *China’s State Administration of Foreign Exchange (SAFE) Circular Relating to Foreign Exchange Administration of Offshore Investment, Financing and Return Investment by Domestic Residents Utilizing Special Purpose Vehicles (Hui Fa [2014] No. 37) Article I*

²⁶⁵ Li, *supra* note.

options” for employees of non-listed SPVs.²⁶⁶ The Circular’s language provides that any equities, including convertible preferreds, are permitted as long as registration formalities are met. Again, however, there is a tension between market autonomy and market control. Permission of equity plans can be viewed as a positive step towards the presumption of legality of complex investment structures and the ability of nationals to exercise benefits on the mainland with recourse from the State. By the same token, the registration requirement for approval of a structure native to the private contracting realm demonstrates the official license participants in offshore investments need from the State to become market actors. If we further recall that that there are no registration requirements for non-listed employee stock option plans in the U.S it becomes clear that the Circular blurs securities distinctions between private and public investment sectors. State organs are involved beyond situations where the protection of the public and markets at large is concerned.²⁶⁷ The practical outcome of these tensions is the inability of foreign investors to circumvent Chinese law. With the promulgation of the Circular, investors must comply with the mandatorily applicable legislation instead of the laws of the tax haven if using equity plans.

3.6.2.2.3 Tax Considerations for Offshore Investment Structures

The EITL imposes a default 10% tax rate to income obtained through investment by foreign entities.²⁶⁸ Offshore holdings can also benefit from China’s Double Taxation Avoidance Treaties (DTATs) that provide reduced or zero capital gains tax. To qualify for DTAT relief, the beneficial owner of the China income must control the Chinese entity and must have a

²⁶⁶ Article 6.

²⁶⁷ Listed companies in the U.S. must file SEC form S-8.

²⁶⁸ EITL of the PRC for Enterprises with Foreign Investment and Foreign Enterprises (Adopted at the Fourth Session of the National People’s Congress and adopted at the 5th Session of the 10th National People’s Congress of the People’s Republic of China. Promulgated on January 1, 2008).

“reasonable business purpose”.²⁶⁹ The SAT has clarified that the test is met if the company is pursuing a foreign IPO.²⁷⁰ Orienting offshore tax laws as foreign investor friendly signify the State’s inclination to accelerate FIEs within the regulatory safety of tax laws.

The exercise of stock options now permitted by Circular 37 is virtually untested and presumably falls under the ambit of the *Notice on Individual Income Tax Issues Concerning Stock Incentives*.²⁷¹ As with tax practices for domiciled ventures, practices for offshore structures fall far from the level of sophistication used by American practitioners as the Party-State experiments with regulations.

3.6.2.2.4 Summary

Ultimately, the decision to form a FIJSC or offshore holding depends on the exit trajectory of the company. If the exit is planned in the U.S. or other foreign jurisdiction and meets the ‘reasonable business purpose test’, it is more tax efficient to structure the company as an offshore holding. If the exit strategy is to list in China, the FIJSC is the better option. Although the SPV and VIE can more readily make use of convertible preferred stock than the FIJSC can, these vehicle types are subject to trial and error enforcement by the State given their novelty.

²⁶⁹ John Gu et al, “M&A: Hopes for further clarification of Chinese indirect offshore disposal tax rules”, online: *Int Tax Rev* <<http://www.internationaltaxreview.com/Article/3406632/M-A-Hopes-for-further-clarification-of-Chinese-indirect-offshore-disposal-tax-rules.html>>.

²⁷⁰ *Ibid.*

²⁷¹ *Supra* note 157.

To summarize the differences between domicile and foreign venture enterprises, China has attempted to make it easier for onshore startups to invest with convertible preferred stock to reduce the reliance on offshore structures, but has complicated matters with impracticable measures that conflict with the unsupervised nature of VC investment.

Foreign venture enterprises provide a better alternative provided the investor comply with the additional hurdle of registration. The difficulties with both modes of investment begs the question why convertible preferred stock provisions are promulgated in the first place. As stated in the introduction to this thesis, the State's desire for a robust VC market results in incremental passing of laws on an experimental basis. Once satisfied the relevant law achieves the objectives of market and party goals, the CPC adjusts it to better suit investor demands. Constant pilot provisions are, however, detrimental to the application of convertible preferred stock provisions. Chapter 4 will outline solutions to this issue in light of China's shifting economy.

3.6.3 Exit

By now the reader should appreciate the nexus between convertible preferred stock and a healthy stock market – convertible preferred stock is convertible only when transparency conditions are enforced. Studies of exit mechanisms conclude that exit through the PRC stock markets is unviable due to disclosure deficiencies and bureaucratic intermingling.²⁷² IPO is most effective via foreign exchange listing. The safest mode of exit is through acquisition of the company, generally by a foreign buyer.²⁷³

²⁷² Bruton & Ahlstrom, *supra* note.

²⁷³ *Ibid.*

The 2009 launch of ChiNext and the CRSC's recent enhanced disclosure initiatives have alleviated some of China's IPO problems. New studies conclude that small and profitable Chinese portfolio companies effectively use ChiNext to exit.²⁷⁴ Large and foreign VC backed companies, conversely, continue to list on the NASDAQ or NYSE.²⁷⁵ Contributing factors to foreign listings are ChiNext's longer lock up period,²⁷⁶ issues with yuan conversion,²⁷⁷ and profitability requirements.²⁷⁸ Nevertheless, ChiNext has responded to investor demands through recognition of convertible preference shares on its list of eligible securities.²⁷⁹ The biggest hindrance to the use of convertible preferred stock in domicile exits is the gap between legislation and practice. For instance, the Notice concerning taxation liability for domiciled venture enterprises (*supra* 3.6.2.1.1) does not apply if the company is listed, even if the options were granted before listing. Until the State resolves disparities of this nature, convertible preferred stock will operate suboptimally in Chinese VC investments.

²⁷⁴ Güçbilmez, *supra* note.

²⁷⁵ *Ibid.*

²⁷⁶ Pre-IPO shares are non-transferable for 12 months after listing. *Cf.* 180 days in the U.S. See D.J. Bradley, B.D. Jordan, H.-C. Yi, I.C. Roten, "Venture capital and IPO lockup expiration: An empirical analysis" *The Journal of Financial Research*, 24 (4) (2001), pp. 465–492.

²⁷⁷ See W. Zhang, J. Gao, S. White, P. Vega, "Venture capital and the financing of China's new technology firms" C.A. McNally (Ed.) *China's Emergent Political Economy*, Routledge (2007).

²⁷⁸ ChiNext listing rules require 2 years of profitability including aggregate net profits of 10M RMB, revenue of 50M RMB in the past year and revenue growth of 30% in for either of the 2 years. In contrast, the NASDAQ's 3 tiers, Global Select Market, Global Market and Capital Market, set flexible liquidity and capital requirements based on company size (*see* Nasdaq Initial Listing Guide, available online: <https://listingcenter.nasdaqomx.com/assets/initialguide.pdf>.)

²⁷⁹ Section 3.1.5 Ground Rules for the SME-ChiNext Index. Shenzhen Securities Information Co. Ltd. May 2014.

Chapter 4: Recommendations

4.1 Introduction

This thesis has taken us through the history of VC and current status of VC markets, the VC lifecycle and has also introduced convertible preferred stock as a security central to VC investment in the U.S. The PRC has, undoubtedly, engineered an American-style VC system on home soil and has selected to implement convertible preferred stock, the quintessential security for risk reduction in startup practice. Thus, the fundamental question no longer is *if* convertible preferred stock can be engineered in China's current VC market, rather *how* it can be used effectively.

A future with the security will require the implementation of such key structural changes as decreased government intervention, uniform laws, proper exit mechanisms, a two-share structure, and the elimination of path dependence. This chapter advances these recommendations in consideration of U.S. laws and practice that currently provide the optimal framework for VC.

4.2 Startup-friendly Government

The success of a VC industry is predicated on mobilizing a startup and seeing it through to exit. On one hand, China's government galvanizes startups through allocation of funds for startup resources. On the other hand, it inhibits startup growth by passing laws entirely divorced from investment reality.

The ideal formula for the CPC is a focus on informal VC, investment in government-backed VC funds and adjustment of legislation. The State arrived at a similar conclusion in January 2015 when it announced a 40 billion RMB (6.5 billion USD) government sponsored VC fund to support startups in emerging markets. Monetarily, the effort surpasses that even of the Obama administration. One of the goals of the fund is to “promote China’s economy to evolve towards medium and high ends,”²⁸⁰ a positive suggestion the CPC has responded to entrepreneurial needs and has further recognized the startup industry as a key component to SME formation. A possible result of the fund to look forward to is the offset of risk intolerance in domestic VC investment. As mentioned elsewhere in this thesis, Chinese VCs have a lower risk tolerance than their American counterparts. The availability of more funds will provide a safety cushion for VCs who will be supported with more money in the event of investment failure. Monitoring the results of the fund over the next year will be essential in determining if the CPC achieves its startup objectives.

VC laws still need to be streamlined to provide startups with convertible preferred stock provisions free from the pressures of contributing to SME growth. Again, the long-term solution is greater legislative harmony through a major overhaul of legislative institutions.

Ultimately, the best case scenario is a complete erosion of the conflict between political and economic considerations. The CPC would need to maintain a distance between itself and VC development. Since the VC industry grows organically, the government should take a consultative position similar to that of the U.S. government that follows a model summed up as “aid from the state without interference from the state”.²⁸¹ As a support system to the VC

²⁸⁰ Lu & Sweeney, *supra* note 25.

²⁸¹ Arthur Meier Schlesinger, *The Cycles of American History* (Houghton Mifflin Harcourt, 1999).

industry, the CPC would be in the position to adjust controls within startup legislation to reduce the requirements on managers.

4.2.1 Favorable Taxation Laws

In order for convertible preferred stock provisions to operate, corresponding taxation laws must be changed to focus on startup stabilization. For instance, the *Notice on Individual Income Tax Issues Concerning Stock Incentives* for domicile venture enterprises needs redrafting to make available the stock incentive formula to non-listed companies. An adjustment of this kind would provide valuable tax relief for struggling startups attempting to use equity to incentivize employees. Critically, it would not undermine CPC leadership. Wealth is already being transferred to private individuals through stock option plans and capital gains from business. Therefore, permitting private companies to benefit from the formula would not constitute a betrayal of socialist values that already operate symbolically within the EITL. Over a longer period of time, the policy could also engage the implementation of more equity plans in startups, a key component to portfolio company survival.

The other needed change is the removal of article 2 within the *Circular of State Administration of Taxation on Implementation of Income Tax Preferences for Startup Investment Enterprises*. Startups should not be required to invest in SMEs to receive a capital gains tax break but should, instead, be awarded tax incentives given their financial instability. A 70% deduction in income tax could be reabsorbed by the startup (instead of a high-tech SME).

Importantly, there is no need for the same liquidation based value practice as that in the US. which is held to be the reason for the security's exclusive use in American VC investing. Ubiquity is not the goal for China. The aforementioned changes to current tax provisions will provide ample benefits for the use of convertible preferreds.

It should be noted that China's Special Economic Zones provide startups with significant reductions in tax liability. Employees working in a zone can pay tax on stock options in installments. Companies can pay tax installments over 5 years. Zone laws are, however, restrictive and applicable only to foreign investors. In the future, China may consider opening startup tax free zones similar to that recently opened in New York which has a 'no tax for 10 years' policy as long as company is situated within the state, aligns with the interests of a local university and creates new jobs.²⁸² This way, domicile startups could be given equal treatment to their foreign counterparts.

4.2.2 Stock Market Reform

A thriving VC industry is reliant on an active stock market.²⁸³ By now the reader should appreciate the nexus between convertible preferred stock and a healthy market – convertible preferred stock is convertible only when transparency conditions are enforced. Cognizant of this, the CSRC has recently taken a number of drastic steps to achieve greater market transparency. In October 2012, the regulator suspended all IPOs and issued orders requiring underwriters and accountants for IPO applicants to submit complete financial statements.²⁸⁴

²⁸² See "Startup NY", online: <<http://startup-ny.com>>.

²⁸³ Black & Gilson, *supra* note.

²⁸⁴ 'Reforming China's Capital Markets' - China Law & Practice . November/December 2013. Interview with David Fu, Global Law Office, Beijing.

The crackdown on fraud reduced the number of applicants to 666 from more than 800, but consequently also hit investor confidence in private equity and venture capital markets. On November 30, 2013, the IPO suspension was lifted, but accompanied by a double-dose of regulatory provisions. The first of these was the State Council's Pilot Scheme contemplating convertible preferred stock as an apparatus to "further deepen the reform of enterprises into stock companies" through "serious" disclosure obligations.²⁸⁵ The second was the CSRC's *Opinions on Further Promoting the Reform of the System for Offering of New Shares* that revealed a plan for a new registration system. Critically, the new measures emphasize continuous disclosure. There is an onus on the issuer to pre-disclose the prospectus on the regulator's website and to continuously disclose after the pre-disclosure. If there are discrepancies between the first disclosure and subsequent disclosures, the application of the issuer will be suspended and the sponsor representative will be barred from IPO for 12 months. Cases of fraudulent disclosure will be punishable by a 36 month suspension for the issuer. Although the Opinions fail to solve the current backlog of 600 companies already filed for an IPO in addition to the 800 companies re-filing (estimated to take 3 years to clear), a valuable finding is uncovered in favor for a future for convertible preferred stock in PRC IPO exits. Despite having lost companies to the NASDAQ and HKSE during the freeze, the CSRC is committed to the development of China's capital markets in a way that supports China's accelerated reform and long-term investor confidence. Consequently, the move towards a transparency and disclosure-based stock market like that in the U.S. will foster the correct environment for convertible preferreds to function. However, the State's ability to own, control and enforce the stock markets may become the impediment to transparency

²⁸⁵ *Ibid.*

objectives. Time will tell if true progression is made towards an efficient exit framework that can accommodate convertible preferred stock use.

4.2.2.1 Reforming ChiNext

The CRSC's next major strategy should be a reform of ChiNext rules to facilitate the exit of low grossing companies. Currently, ChiNext profitability requirements are strict in comparison to the NASDAQ requirements that permit companies to list without yet being profitable.²⁸⁶ ChiNext listing rules require 2 years of profitability including aggregate net profits of 10 million RMB, revenue of 50 million RMB in the past year and revenue growth of 30% in for either of the 2 years.²⁸⁷ In contrast, the NASDAQ's 3 tiers, Global Select Market, Global Market and Capital Market, set flexible liquidity and capital requirements based on company size. Startups must meet the criteria of 1 of 3 available standards: the equity standard, the market value of listed securities standard, or the net income standard.²⁸⁸ The equity and market value standards have no profitability criteria.

Academics maintain that 'piggybacking' on the U.S. structure is the best method for a non stock market economy to achieve a sound stock market.²⁸⁹ As follows, ChiNext should be restructured to include a threshold similar to the NASDAQ's Capital Market with less onerous requirements.

²⁸⁶ Güçbilmez, *supra* note 209.

²⁸⁷ "Shenzhen Stock Exchange Listing Requirements", online:
<<http://www.szse.cn/main/en/ListingatSZSE/ListingRequirements/>>.

²⁸⁸ Nasdaq Initial Listing Guide, *supra* note 276.

²⁸⁹ Black & Gilson, *supra* note 215.

4.3 Two-Share Structure

This thesis has continuously indicated that PRC Company Law does not expressly provide for anything more than common stock. A solution to legitimize the use of convertible preferreds in VC financing is to introduce preferred stock to the Company Law. A two-class share structure is not essential for domicile ventures that have express authority to use convertible preferred stock, but would be beneficial to FIJSCs that, as I pointed out in *supra* 3.6.2.2.1, are currently not permitted to issue different classes of stock. Although the literature does not contemplate how a preferred stock structure can be introduced to PRC law, it is observable that the State is taking steps towards crystalizing a preference share structure in the UCL.

In 2014, the *State Department Guidance on Carrying out a Pilot Preference Shares*²⁹⁰ (henceforth “pilot scheme”) was passed authorizing the issuance of preferred shares by PRC-domiciled companies limited by shares on an experimental basis. The scheme expressly defines preferred shares as having “preference to ordinary shareholders in the allocation of profits”,²⁹¹ the effect of which gives the same priority effect in the distribution of dividends as preferred stock in the U.S. In addition, the scheme specifies the rights and obligations of preferred stock shareholders, priority in profit distribution and conversion rights.²⁹² Problematically, it also demonstrates a heavy preference for later stage companies through provisions relative only to listed companies. Issuers publically issuing preferred shares are limited to listed companies prescribed by the regulations made by the CSRC, while issuers non-publically issuing preferred shares are limited to listed companies (including overseas

²⁹⁰ *Guo Fa [2013] No. 46.*

²⁹¹ *Ibid.*

²⁹² *Ibid.*

listed companies registered domestically). Counter to this, the SZSE passed its own implementation rules one month after the pilot scheme providing that “during the pilot period, preferred shares of SZSE shall be mainly issued by means of non-public offerings”.²⁹³ Besides a better grasp of market realities and a faster response to demands for investment flexibility, the implementation rules passed validly under the Pilot Scheme provide a legal basis for convertible preference shares expressly permitted under ChiNext listing rules.²⁹⁴ Following an effective market response to the pilot scheme, the next logical step is for the CPC to revise the UCL to include preference shares.

4.4 The Elimination of Path Dependence

Chapter 3 presented the dependence on common stock inherent to domicile VC practice in China. Common shares are an ideal option for unsophisticated investors like friends and family, but unsuitable for investors seeking control rights essential to curbing startup risks. The question is: can Chinese investors use an alternative to convertible preferreds that could break the dependence on common stock? As previously discussed, North’s theory of path dependency suggests that consistent returns reinforce the direction of an actor’s choices.²⁹⁵ North, however, affirms that these choices can be altered or reversed through exogenous changes that enhance the returns received by the actor.²⁹⁶ William Brian Arthur reinforces

²⁹³ Issued Implementation Rules on Preferred Share Pilot Business

²⁹⁴ The Implementation Rules are “compiled in the light of *The Company Law of the People’s Republic of China, Securities Law of the People’s Republic of China, Guiding Opinions of the State Council on Carrying out the Pilot Program of Preferred Shares* (hereinafter referred as *Guiding Opinions*), *Administrative Measures on the Pilot Program of Preferred Shares* (hereinafter referred as *Administrative Measures*), and relevant regulations”.

²⁹⁵ North, *supra* note 30 at 112.

²⁹⁶ *Ibid.*

North's theory arguing that the change must be an alternative superior to the existing framework for the path dependent behavior to be broken.²⁹⁷

In the U.S., convertible bonds are sometimes used as an informal VC instrument and alternative to common stock. Like convertible preferred stock, convertible bonds are short-term notes that convert into equity. As a loan, the bond is preferential to the earliest stages of financing when a valuation for the company is indeterminable.²⁹⁸ Bonds are distinctly founder-friendly, however. Convertible bondholders receive minimal control rights, if any, which leaves the bulk of the decision-making in the hands of the founders. As we know, bad financial decisions can potentially devastate an infant company. The general goal of the VC is to make money. In attempting to do so, the startup must first be stabilized (presupposing the investor's intentions are to bring the company to IPO).²⁹⁹ This can only be achieved through an allocation of control rights that the investor can use to implement strong managers and reduce the information asymmetry prevalent in startups. Additionally, the use of convertible bonds in VC investment strategy would overlook the Interim Measures passed in 2006 as well as recent developments in FIE laws that permit convertible preferred stock. For these reasons, I argue that convertible bonds are an unsuitable alternative to convertible preferred stock for Chinese domicile strategy and would further be incapable of interrupting the path dependency on common stock.

²⁹⁷ William Brian Arthur, *Increasing Returns and Path Dependency in the Economy* (Ann Arbor: University of Michigan Press, 1994). Also see Jörg Sydow, Georg Schreyögg & Jochen Koch, "Organizational Path Dependence" (2009) 34:4 Acad Manag Rev 689, online: <http://www.wiwi.europa-uni.de/de/lehrstuhl/mm/ufo/lehre/kursuebersicht/StO/Sydow_Schrey__gg_Koch_2009.pdf>.

²⁹⁸ Scott Edward Walker, "Everything You Ever Wanted To Know About Convertible Note Seed Financings (But Were Afraid To Ask)", (2012), online: *TechCrunch* <<http://techcrunch.com/2012/04/07/convertible-note-seed-financings/>>.

²⁹⁹ There are documented instances of VCs liquidating a profitable portfolio company for short-term gain. See Seth Levine, "Beware of Asshole VCs", (2011), online: *Seth Levine's VC Adventure* <<http://www.sethlevine.com/wp/2011/07/beware-of-asshole-vcs>>. Also see Hwang and Horowitz, *supra* note 37 at 241.

My informal theory is that dependence on common stock can be overcome with a two-fold approach: a change in the polity (as elaborated upon in the previous section) and the galvanization of the PRC startup community at large to make use of existing legislation. The latter, I argue, can only be achieved with a focus on changing the psychology of Chinese equity participants. Rainforest theory suggests it takes more than applicable laws to recreate the idiosyncrasies of VC players. Reshaping investment behavior (and interrupting the dynamics of self-reinforcing behavioral patterns) depends on a culmination of supplemental features including networks, trust, role models and motivations.³⁰⁰ These new drivers can create a new external perspective outside the model of path dependence giving actors awareness of path dependent behavior and can further make way for path-altering activities.

China's accelerating entrepreneurial culture is still cemented in an olden understanding of money making. For this mentality to change, the currency of equity must be understood as having equal importance to hard cash by domicile startup actors. Reforming value perception is a difficult task, but one possible in light of China's changing entrepreneurial culture. China does not benefit from a frontier legacy, but does benefit from a transplant legacy eager to learn best practices. Thus, equity and the mechanics of convertible preferred stock investment techniques can be learned from the West through imitation. The CPC itself sponsors a program for Chinese students (who are often referred to as 'sea turtles') to study abroad and return to China with startup knowledge acquired.³⁰¹ Many American VCs run accelerators in China and teach domestic actors the latest incubation strategies. The task of teaching an entire foreign industry the mechanics of Western investment is arduous, yet, as

³⁰⁰ *Ibid* at 238-240.

³⁰¹ Blank, *supra* note.

these examples show, possible through an incremental deposit of innovation wisdom. In line with the reasoning of North and Arthur, reshaping value perception in the creation of conditions for convertible preferred stock use ultimately result in the advantageous alternative to common stock use.

Chapter 5: Conclusion

China's economic growth since the 1978 reforms has been dazzling. Today, the world looks upon the PRC as a rapidly growing powerhouse with an economy projected to overtake that of the U.S. by 2030. This thesis has focused on venture capital, an 'en vogue' industry that China has continuously experimented with in an effort to replicate the profits of the U.S. VC industry. The booming PRC economy has presented various private opportunities in the tech industry for startups. For budding VC actors, the absence of functional convertible preferred stock provisions magnifies the risks associated with uncertainty, information asymmetry and opportunism inherent to early stage companies.

In examining the function of convertible preferred stock (a topic having never enjoyed academic insight on a micro level), the preceding chapters have provided an institutional context through the observation of tensions between economic autonomy and state control. This conflict is operative throughout the VC lifecycle to which preferred stock belongs. What has been extrapolated is that China's implementation of convertible preferred stock provisions has been incremental and deliberate, but often done with little regard for the private market prerequisites that underpin the function of the security.

The future for convertible preferreds in the PRC appears uncertain. To the benefit of the security, the party-state's new focus on startups asserts that domicile VC investment can operate within socialist market framework as a model existing separately from SOE policy. However, foreseeable problems regarding the use of convertible preferred stock have more to do with ideology than economic policy. Innovation requires private initiative and the liberty to experiment. As we've seen, the VC laws currently in place remove convertible preferreds

from the private equity sphere and place them in the public sphere under the control of legislation. In this way, China suffers from the transplant effect further exacerbated by absence of a stock market economy. Yet, what this thesis has found is that these factors do not preclude China from fostering an innovation economy essential to the use of convertible preferred stock provisions. Even if the party-state is reluctant to change or entirely remove the impeding legislation, VC actors can maneuver around it provided they gain an understanding of equity and the long-term value of innovative growth. Until then, convertible preferred stock will be bound by path dependence on common stock and will remain largely underused by domicile actors.

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