

ESTUDOS DE PÓSGRADUAÇÃO

RETHINKING THE CORPORATE GOVERNANCE OF CHINESE STATE-CONTROLLED LISTED COMPANIES THROUGH THE PERSPECTIVE OF VENTURE CAPITAL

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I. Introduction

The issue of corporate governance has gained unprecedented attention in the international community after the ravages of the Asian financial crisis. In recent years, laying down the more sophisticated governance guidelines has become a vibrant campaign with the favor and participation of various interested group¹.

Given the on-going lackluster performance of its state-owned enterprises (SOEs) and the substantial competition from its entry into the World Trade Organization (the WTO), China has also put considerable emphasis on corporate

1 For instance, the government of South Korea has taken a series of steps to reform the corporate governance of chaebol since 1998. The Organization of Economic Cooperation and Development (OECD) also released "OECD Principles of Corporate Governance" in 1999 in order to provide member and non-member countries with specific guidelines in improving the legal, institutional and regulatory framework that underpins corporate governance. In addition, intermediaries, such as McKinsey & Company, are also urging the overhaul of corporate governance in emerging and transitional economies. See Bernard Black, Barry Metzger, Timothy J O'Brien and Young Moo Shin, "Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness" (2001) 26 *Journal of Corporation Law* 537-608. In this report, with the request of the South Korean government, Professor Black and his colleagues proposed a systematic legal reform framework to the Ministry of Justice of South Korea for the purpose of improving the porous governance structure of chaebol; OECD, "Principles of Corporate Governance", available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf> (visited on 7 Aug 2009). Since its first issuance, this document was revised in 2003 and 2004. The above hyperlink leads to the 2004 revised version; McKinsey & Company, "Corporate Governance in Emerging Markets" (2002) 3 *McKinsey on Finance* 15-18.

governance in recent years². At the core of such attention is the debate on how China can design an effective corporate governance system for its state-controlled listed companies (the SCLCs) through the perspective of agency theory³. Taking into account of a series of scandals related to the poor governance practices of the SCLCs since the presence of Chinese stock markets⁴, it is not difficult to understand this kind of efforts. Correspondingly, along this Berle-Means path, the existing intellectual products contributed by company law scholars have almost exclusively linked the corporate governance of the SCLCs to the minimization of agency costs⁵. While these literatures have exerted positive influence on the improvement of the SCLCs' governance framework, they have also omitted another crucial value related to their target- adaptive efficiency. As Nobel Prize laureate Douglass North defined, "adaptive efficiency...is concerned with the kinds of rules that shape the way an economy evolves through time. It is also concerned with the willingness of society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of the society through time"⁶.

On the basis of North's description, we can find out that adaptive efficiency is reinforced by an institutional structure that fosters technological innovation. According to taxonomy, technological innovation is usually divided into two kinds: the "in-house innovation" and the "external innovation"⁷. The in-house innovation typically occurs in large, well-established firms and existing industries⁸. To the

2 Shuguang Li, "Company Control of China and the Reform in Its Transition" (2003) 21 *Tribune of Political Science and Law* (Journal of China University of Political Science and Law) 3.

3 Qiao Liu, "Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants" (2006) 52 *CEifo Economic Studies* 415-416; Donald C. Clarke, "Corporate Governance in China: An Overview" (2003) 14 *China Economic Review* 494.

4 See n. 1 above, p. 600.

5 The literature in this category includes but is not limited to the following ones. See Leping Shen, "Analysis of the Current Situation of Enterprise Group Corporate Governance Structure and Counter-measures" (2003) 25 *Journal of Jinan University* (Philosophy & Social Science Edition) 28-29; Peizhong Gan, "Government and Market in the Reduction of State Shares- the Analysis of this Failed Reform through the Perspective of Economic Law" (2002) 4 *Jurists' Review* 87-90; Liufang Fang, "The Setback Stemming from Over-regulation", available at <http://www.civillaw.com.cn/article/default.asp?id=17186> (visited on 7 Aug 2009).

6 Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), p. 80.

7 Curtis J. Milhaupt, "The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate" (1997) 91 *Northwestern University Law Review* 874.

8 Ibid.

contrary, the external innovation generally takes place in the start-ups set up by entrepreneurs⁹. Those start-ups do not only have impact on existing industries but also develop entirely new industries¹⁰.

Since both the in-house innovation and the external innovation contribute to the enhancement of adaptive efficiency, an ideal institutional environment should be compatible with each of them. When an institutional environment principally focuses on financing the in-house innovation, it actually strengthens the vested interest and the monopolistic position of large, well-established companies. It cannot simultaneously facilitate the booming of the external innovation which represents the competition and the challenge to large companies by entrepreneurs. However, when an institutional environment aims to sponsor the external innovation, in fact, it encourages increasing the magnitude of competition in its economy by bringing in new participants. In turn, the intensified competition provides incentives for large companies to more efficiently and more initiatively conduct the in-house innovation. Therefore, theoretically and logically, we can reach the conjecture that an institutional framework with the orientation to the external innovation should be the Holy Grail to promote adaptive efficiency.

The existing comparative study on the innovation patterns of the United States, Germany and Japan has provided persuasive evidence to support the above postulation. According to those studies, the overall adaptive efficiency of the United States which has been considered to typically promote the external innovation is fairly higher than those of Japan and Germany which have been thought to spotlight on the in-house innovation¹¹. Furthermore, those studies have also indentified that a vibrant venture capital (VC) market is the cornerstone of America's success in fostering the external innovation. Therefore, an institutional structure facilitating VC is connected to the significant enhancement of adaptive efficiency.

In the last decade, western corporate law scholars drew a strong linkage between the corporate governance systems of large public companies and the institutional environments for the vitality of VC markets. For example, Black and Gilson analyzed the importance of a highly developed stock market for the exit of VC¹²; Milhaupt examined how VC failed to fit into the corporate governance

9 Ibid.

10 Ronald J. Gilson, "Engineering a Venture Capital Market: Lessons from the American Experience" (2003) 55 Stanford Law Review 1068.

11 See n 7 above, p 874; Bernard S. Black and Ronald J. Gilson, "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets" (1998) 47 Journal of Financial Economics 243-277.

12 Ibid.

system of Japanese large, well-established public companies¹³. These academic products have opened up a new insight to observe and estimate the corporate governance system of listed companies. The value of listed companies' governance framework is not just to minimize agency costs along the path set by Berle and Means¹⁴. It also imposes substantial influence on the legal and other institutional settings for the booming of VC and in turn the enhancement of adaptive efficiency. Therefore, any proposal for reforming the corporate governance of listed companies in a country must be on the basis of a thorough evaluation to that system from the perspectives of both agency theory and adaptive efficiency. Otherwise, it is probable to improve one value at the expense of damaging the other and to make the final result worse off. As I have mentioned before, there have been a lot of efforts to explore the corporate governance of the SCLCs underpinned on agency theory. However, the attempt to examine it from the standard of VC and adaptive efficiency is still absent. That is just the research gap which I try to fill with this article.

In China, the concept of "venture capital" burgeoned in the early 1980s. However, until 1998, the development of VC was just on the theoretical discussion and the pilot trial stage. In 1998, the Central Committee of Chinese National Democratic Constructive Association presented 'Proposal for Developing China's VC Industry' at the Ninth Chinese People's Political Consultative Conference (the CPPCC). Since then, VC has become a frequent practice and a fast growing segment in China's financial system¹⁵. During the last ten years, China had made remarkable progress in the development of its venture capital market¹⁶. However, the striking expansion of China's VC market cannot cover the embarrassing fact that the incentive mechanisms in the operation of Chinese domestic VCs are still underdeveloped in comparison with their American counterparts who have presented a successful and duplicable template for other countries to transplant. Given the strong linkage between the corporate governance of listed companies and the institutional environment for the vitality of VC markets, I assume that

13 Ibid.

14 Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: The Macmillan Company, 1933), available at <http://www.heinonline.org/HOL/Page?handle=hein.beal/mcpp0001&id=1&size=2&collection=beal&index=beal/mcpp> (visited 7 Aug 2009).

15 Rob Dixon, John Ritchie and Di Guo, "The Impact of Governance Structure and Financial Constraints on Risk Tolerance of VCs: An Empirical Work on China's Venture Capital Industry", available at http://www.cass.city.ac.uk/emg/seminars/EMGpapers1stOct/Dixon_Guo_Ritchie.pdf (visited on 7 Aug 2009).

16 In 2003, the total amount of VC in China was RMB 32.534 billion. Three years later, this number increased to RMB 58.385 billion. See China Venture Capital Research Institute Limited, *China Venture Capital Yearbook* (2007) (Beijing: Democracy and Construction Press, 2007), p. 107.

the corporate governance system of the SCLCs has hampered the presence or the full function of legal and other institutions in China which are related to the incentive tools of American VCs. In other words, I want to use the mirror of the successful institutional environment for American VCs' incentive measures to reflect the negative effects of the corporate governance of the SCLCs on adaptive efficiency. Here, it is to be noted that some of the incentive mechanisms analyzed below, such as staged financing, board representation, convertible preferred stocks and stock options, usually belong to commercial secrets between VCs and their portfolio companies. Therefore, it is unrealistic to directly acquire the contracts and agreements which stipulate those issues as my evidence. In this case, I can only seek indirect proofs regarding those incentive tools through carrying out interviews and retrieving secondary sources. Even so, in certain aspects, I just have access to the operation of government VCs (GVCs). Consequently, in several places below, I use GVCs as the sample to conduct my analysis. On the one hand, I think that GVCs can basically represent Chinese domestic VCs taking into account of their dominant position in this sector¹⁷. On the other hand, the unavailability to complete information also reflects the fact that every research has its own limitation.

This article consists of five parts. Part II examines the status quo of corporate governance in the SCLCs to show that a control-based model is its feature. Part III briefly introduces the successful incentive structure of American VCs. With the American practice as its mirror, Part IV proves the linkage between the underdevelopment of incentives in the operation of Chinese domestic VCs and the control-based model. Conclusions follow in Part V.

II. The Status Quo of Corporate Governance in the SCLCs

The current SCLCs are the transformative results of traditional SOEs¹⁸. Therefore, their corporate governance cannot be understood thoroughly apart from their history¹⁹. Prior to the corporatization of SOEs after the first company law of the People's Republic of China (the PRC) was enacted in 1993, the governance systems of SOEs had gone through two stages. First, from the establishment of the PRC to the middle of 1980s, the function of SOEs was merely satisfying the

17 According to statistics, 89.2% Chinese domestic VCs were GVCs in 2002. See Songqi Wang, *China Venture Capital Development Report (2003)* (Beijing: Economics and Management Press, 2003).

18 See Clarke, "Corporate Governance in China" (n.º 3 above).

19 Cindy A. Schipani and Junhai Liu, "Corporate Governance in China: Then and Now" (2002) 1 *Columbia Business Law Review* 6.

production plans made by government agencies and guaranteeing social stability. Not only did the state own all the assets of SOEs, but it also completely held their managerial powers. The governance structure of SOEs was an integral layer of the governmental hierarchy²⁰. Hence, SOEs were not real business entities from the scratch and they were just a type of government affiliates. Second, from approximately 1984 to 1993 when the first Company Law of the PRC was promulgated, the contracting system was dominant in the movement of SOEs' reform. In accordance with the contracting model, the goal of reform was to grant SOEs the status of legal persons and to make them be responsible for their own profits and losses²¹. This strategy revealed that the Communist Party of China (the CPC) and the Chinese government wanted the enterprises which they owned to be operated efficiently through authorizing them managerial autonomy to some degrees. However, the state's consideration behind the above expectation was not to render SOEs solely concerned with the maximization of wealth. Conversely, it just intended to implement its policies better with the support of robust SOEs²². Therefore, it meant that there were no possibilities for the state to abandon control on SOEs even if it had tactically authorized a share of power to them. The personnel power as the core component of the governance framework of SOEs was tightly held in the hands of the local CPC committees²³.

The failure of the contracting model induced the national debate on the transformation and diversification of public ownership of SOEs into different forms at the end of the 1980s²⁴. However, this move was halted by the Tiananmen Square protests in 1989. In the following three years after this demonstration, the speed of SOE reform was slowed down and the voice of restoring the centrally planned economy resurged²⁵. Confronted with the circumstances, Mr. Deng Xiaoping

20 The Fifteenth CPC Central Committee, "Decisions on SOEs Reform", available at <http://cpc.people.com.cn/GB/64162/71380/71382/71386/4837883.html> (visited on 7 Aug 2009). In this Decision, the CPC Central Committee declared administrative ranks should not be granted to SOEs and their leaders any more. It demonstrated that leaders of SOEs used to be state cadres.

21 The Twelfth CPC Central Committee, "The Decision of the CPC Central Committee on the Reform of the Economic System", available at http://news.xinhuanet.com/ziliao/2005-02/07/content_2558000.htm (visited on 7 Aug 2009). After this Decision was published in 1984, the slogan of "separation between the state ownership and the SOE management authority" and the phrase "legal person" become popular among Chinese.

22 See Clarke, "Corporate Governance in China" (n 3 above), p 494-495.

23 See n 21 above.

24 Shutang Gu and Siquan Xie, "Revisiting the Reform Process of SOEs" (2002) 9 *Economic Review* 3.

25 Hongbo Xie, "From the Planned Economy to the Market Economy-The Transformation of the Economic Framework in China" (2008) 5 *Macroeconomic Management* 24.

called for the CPC and the whole nation to further emancipate their minds and put forward the economic reform with great courage during his inspection trip to South China in 1992²⁶. Under his theory, the market economy did not solely belong to capitalism and it was compatible with the needs of socialist economic division and productions²⁷. The supports from Mr. Deng Xiaoping provided fresh political impetus to the transformation of SOEs in China. In late 1992, the Fourteenth National Congress of the CPC put the establishment of the market economy into its charter²⁸. Soon afterwards, the Fourteenth CPC Central Committee passed “Decisions on the Establishment of the Socialist Market Economy” in 1993 in which the setting up of a modern corporate system in SOEs was an urgent and important objective²⁹. A series of policy signals for the corporatization of SOEs from the CPC and its paramount leaders promoted the enactment of the first Company Law of the PRC at the end of 1993 (the Company Law 1993). After that, on the legal foundation laid by the Company Law 1993, two new approaches were put into practice for the reform of SOEs. First, small and less important SOEs were privatized and diversified into other business forms. The overall amount of SOEs has been drastically diminished³⁰. Second, recapitalization with the governance system of modern corporations was encouraged for big and key SOEs instead of total privatization³¹. Some of them were listed on the emerging domestic stock markets in order to raise as much money as possible³². These listed companies whose predecessors were the traditional SOEs have constituted the cornerstone of the whole state-owned economy in China. On the basis of the traditional policy-implementation orientation to SOEs which has been analyzed above, I presume that the state must tightly control these pivotal listed companies through the specific governance institutions which have been stipulated by the Company Law of the PRC³³. In other words, the corporate governance of the

26 Xiaoping Deng, “The Comments Made by Deng Xiaoping during His Inspection Tour to South China”, available at <http://cpc.people.com.cn/GB/33837/2535034.html> (visited on 7 Aug 2009).

27 Ibid.

28 Available at http://news.xinhuanet.com/ziliao/2003-01/20/content_697129.htm.

29 The Fourteenth CPC Central Committee, “Decisions on the Establishment of the Socialist Market Economy”, available at <http://www.people.com.cn/GB/shizheng/252/5089/5106/5179/20010430/456592.html> (visited on 7 Aug 2009).

30 Bin Liang, *The Changing Chinese Legal System, 1978-Present-Centralization of Power and Rationalization of the Legal System* (New York: Routledge, 2008), p. 30.

31 Ibid.

32 Those enterprises are generally called “the SCLCs” (the SCLCs) in official documents and academic literature in China.

33 The Company Law 1993 was revised in 2005 and the latest Company Law came into effect in

SCLCs in China is still the control-based model as traditional SOEs, which is the result of path dependence. Next, I will illustrate this model from the aspects of three principal corporate governance institutions applied in China-the shareholder meeting, the board of directors and the supervisory committee.

A. The Shareholder Meeting

In China, the shareholder meeting which is viewed as a supreme power organ of a corporation occupies the central position in corporate governance³⁴. In terms of the latest Company Law of the PRC which came into effect in 2006 (the Company Law 2006), the shareholder meeting holds the following comprehensive decision-making powers: (1) to determine corporate operation guidelines and investment plans; (2) to elect and replace directors and shareholder supervisors and determine their remuneration; (3) to review and approve the report submitted by the board of directors; (4) to review and approve the report submitted by the supervisory committee; (5) to review and approve the corporate fiscal budgets and final account report on an annual basis; (6) to review and approve the corporate plans regarding allocating profits and making up for losses; (7) to determine the increase and decrease of the corporation's registered capital; (8) to determine the issuance of corporate bonds; (9) to make decisions regarding corporate mergers, divisions, dissolution and liquidation; and (10) to amend the Articles of Incorporation³⁵. By this enumeration, we can find out that the shareholder meeting of a corporation in China keeps substantial managerial powers some of which are reserved to the board of directors in the United States and other western countries. This arrangement has given rise to the probability that the majority shareholder can control the operation of the corporation to considerable degrees through the governance institution of the shareholder meeting in China.

As I have mentioned above, the current SCLCs in China are the transformative results of traditional SOEs. Even if they have privatized a portion of shares to the public during the process of corporatization, the ownership structure of these enterprises still characterizes the substantial concentration of the state shares. Given the limits of available data, I am not able to show the ownership constitution of each SCLC in China to prove the above proposition. However,

2006. However, its overall structure with the three main sections of the shareholder meeting, the board of directors and the supervisory committee has remained in the new Company Law to which the author will make reference in the following analysis.

34 Lin Ye, "The Distribution of Corporate Powers", available at <http://www.civillaw.com.cn/article/default.asp?id=37502> (visited on 8 Aug 2009).

35 Article 38 of the Company Law 2006.

Table 1 provides the empirical evidence regarding the biggest shareholders of the SCLCs in the sector of steel. I believe that these enterprises can be used as a sample to reflect the concentrated state shares in this kind of listed companies in China to a large extent. In the light of the data in Table 1, all of the biggest shareholders of the twelve SCLCs producing steel and iron were state holding corporations which are solely held by the state³⁶. The appointments to the top tier corporate leadership positions in these state holding corporations are made by state-owned asset management commissions and CPC committees³⁷. Moreover, almost all of the candidates for these positions have the backgrounds of working in related government agencies³⁸. Therefore, state holding corporation leaders are seldom held accountable for the economic performance of the enterprise and its subsidiaries as long as it does not deteriorate massively³⁹. Their obligations are to guarantee the implementation of state and local policies in those entities. With the tier of state holding corporations as their biggest shareholders, the state has tightly gripped the SCLCs through the shareholder meeting. Even if the equity division reform in 2005 has made state shares tradable on the secondary market, it has not shaken the state's position in the SCLCs as the largest shareholders due to the hamper from political considerations and vested interests⁴⁰.

Table 1: The Biggest Shareholders in The SCLCs in the Sector of Steel in China in 2001

Corporation Name	Name of the Biggest Shareholder	Amount of Shares Held by the Biggest Shareholder	Ratio to the Total Shares (%)
Anyang Iron and Steel Incorporated	Anyang Iron and Steel Group Corporation Limited	870490259	64.70

36 Christopher A. McNally, "Strange Bedfellows: Communist Party Institutions and New Governance Mechanisms in Chinese State Holding Corporations" (2002) 4 Business and Politics 97.

37 Can Yi and Yumin Zhang, "Research on the Corporate Governance of Wholly State-owned Corporations" (2007) 7 Journal of Southwest University for Nationalities (Humanities and Social Science) 89.

38 See n.º 36 above, p. 104.

39 Ibid., p. 102.

40 Lin Ye, "The Distribution of Corporate Powers", available at <http://www.civillaw.com.cn/article/default.asp?id=37502> (visited on 10 Aug 2009).

Baoshan Iron and Steel Incorporated	Bao Steel Group Corporation	10635000000	85.00
Guangzhou Iron and Steel Incorporated	Guangzhou Iron and Steel Group Corporation Limited	352969735	51.44
Handan Iron and Steel Incorporated	Handan Iron and Steel Group Corporation Limited	996553100	67.04
Hangzhou Iron and Steel Incorporated	Hang Steel Group Corporation	479587500	74.32
Hongxing Iron and Steel Incorporated	Jiuquan Steel Group Corporation Limited	515000000	70.74
Laiwu Iron and Steel Incorporated	Laiwu Iron and Steel Group Corporation	715182000	82.09
Lingyuan Iron and Steel Incorporated	Lingyuan Group Corporation	178500000	57.58
Ma Anshan Iron and Steel Incorporated	Ma Steel (Group) Holding Corporation	4082330000	63.24
Nanjing Iron and Steel Incorporated	Nanjing Iron and Steel Group Corporation Limited	357600000	70.95
Tangshan Iron and Steel Incorporated	Tangshan Iron and Steel Group Corporation Limited	915772382	67.64
Wuhan Iron and Steel Incorporated	Wuhan Steel Group Corporation	1770480000	84.69

Source: The Analysis on the Ownership Structure of The SCLCs in the Sector of Steel in China⁴¹

B. The board of directors

According to the stipulation of the Company Law 2006, the board of directors plays the role as the executive branch of the shareholder meeting in a corporation. It is mainly responsible for the enforcement of the operation decisions made by the latter⁴². The state has achieved its controlling over the board of directors by means of their personal arrangements. Generally speaking, the chairman and the vice chairman of the board of directors and the director who

41 Jinghe Zhu, Huaili Yuan and Guoren Liu, "The Analysis on the Ownership Structure of The SCLCs in the Sector of Steel in China" (2002) 12 Economic Review 34.

42 Article 47 of the Company Law 2006.

is concurrently the chief executive in a SCLC are actually determined by local CPC committees⁴³. After that, this decision is forwarded to local governments and their state-owned asset management commissions⁴⁴. Next, state-owned asset management commissions require state holding corporations who are the biggest shareholders to convene the shareholding meeting of the SCLCs and appoint the candidates on the shortlist⁴⁵. Moreover, in terms of local government regulations, it is a prevalent requirement that the chairman of the board of directors should act as vice CPC secretary and then the vice chairman should act as CPC secretary in this sort of listed companies⁴⁶. In addition, a large portion of directors in a SCLC are former officials in disbanded component government departments⁴⁷.

With regard to the independent directors in the SCLCs, they also represent the voice of the state. In the light of “Guidelines on the Establishment of the Institution of Independent Directors in Listed Companies” (the Guidelines on Independent Directors 2001) issued by the China Securities Regulatory Commission (the CSRC) in 2001, independent directors are elected by the shareholding meeting⁴⁸. Therefore, in the SCLCs, the state as the largest shareholders through the tier of state holding corporations actually dominates the selection of their independent directors⁴⁹. Consequently, independent directors keep tight ties with governments and act on behalf of the state.

C. The supervisory committee

In China, the principal function of the supervisory committee in a

43 Liaoning Securities Supervisory Bureau, “Analysis on the Behavioral Changes of the Majority Shareholders and the De Facto Controllers of Listed Companies and the Corresponding Supervisory Approaches after the Equity Division Reform”, available at <http://www.csrc.gov.cn/n575458/n870331/n10217417/10264959.html> (visited on 8 Aug 2009); People’s Daily Online, “Behind the Dismissal of Qiao Hong: No Contest for the Successor of Maotai”, available at <http://finance.people.com.cn/GB/67815/71134/5870908.html> (visited on 8 Aug 2009). The appointment procedure is also applicable to the listed companies invested by the central government which are the minority of all of the SCLCs.

44 Ibid.

45 Ibid.

46 See n.º 36 above, p. 105. In practice, it is also common that the chairman of the board of directors act as that corporation’s party secretary.

47 Xinhuanet, “Black Record of Chinese Listed Companies in 2005”, available at http://news.xinhuanet.com/stock/2006-01/06/content_4015864.htm (visited on 8 Aug 2009).

48 Article 4 of the Guidelines on Independent Directors 2001.

49 Jianmin Su, Yanbin Yao and Yuehui Su, “Analysis on the Problems of Independent Directors in China” (2007) 14 Finance & Economy 79; Xiangping Cao, “Reasons for the Dysfunction of Independent Directors in China” (2008) 1 China National Conditions and Strength 47.

corporation is to monitor the behaviors of directors and managers in the interests of shareholders⁵⁰. The members of the supervisory committee in the SCLCs tend to be drawn from two sources. First, state holding corporations as the largest shareholders select external shareholder supervisors through the shareholder meeting⁵¹. Generally, these external shareholder supervisors are retired government officials, famous economists and accountants who have close relationship with the authorities. Second, within corporations, the secretaries of corporations' disciplinary committees of the CPC and worker representatives constitute internal shareholder supervisors⁵².

The two sources clearly convey the two main purposes of the supervisory committees of the SCLCs. First, the committee is applied to further internalize the oversight of competent government departments over how the SCLCs are operated, thus assuring the maintenance and increase of state assets and the implementation of state policies⁵³. Second, the disciplinary committees of the CPC within corporations can play the traditional role as the primary organs of managerial discipline through their personnel overlap with the supervisory committees⁵⁴. Therefore, this corporate institution in charge of management supervision in the SCLCs is also firmly held by the state. Even if it has not obviously taken effect in practice, it is another issue which is not essentially relevant with my analysis in this article⁵⁵.

Just as Donald Clarke claimed, "China's legal system cannot be understood apart from its history and that history - whether imperial or modern - is overwhelmingly a story of centrality of the state."⁵⁶ It is also applicable to the corporate governance of the SCLCs. Through the retrospect to the governance structures of their predecessors, we are able to truly understand why the corporate governance of the SCLCs is a control-based model for the purpose of implementing state policies. In other words, without looking back to the historical path, it is

50 Article 54 of the Company Law 2006.

51 Jian Zhao, "Consideration on the Improvements of the Supervisory Committee of Chinese Listed Companies" (2003) 11 *China Economists* 113; Jianwei Li, "On the Improvements of the Supervisory Committee of Chinese Listed Companies through the Perspective of Its Relationship with Independent Directors" (2004) 2 *Law Science* 76.

52 Linqing Wang, "The Tragedy of the Supervisory Committee of Chinese Listed Companies: Curious Performance in the Past Eleven Years", available at <http://www.civillaw.com.cn/article/default.asp?id=25935> (visited on 8 Aug 2009).

53 See n.º 36 above, p. 106.

54 Ibid.

55 Kaifu Li, "Brief Analysis on the Shortcomings and Improvements of the Supervisory Committee of Chinese Listed Companies" (2005) 130 *Law Review* 123-127.

56 Donald Clarke, "Lost in Translation? Corporate Legal Transplants in China", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913784 (visited 8 Aug 2009).

not explicable that “the policy of corporatization does not involve a renunciation by the state of its ambition to remain the direct owner of enterprises in a number of sectors”⁵⁷ because “this ambition makes no sense if profits are the only objective.”⁵⁸ Consequently, to a large extent, this control-based model has given rise to the underdevelopment of incentives in the operation of Chinese domestic VCs, which I will demonstrate in the remaining parts of this article.

III The Incentive Structure of American VCs

In the cycle of venture capital, incentive mechanisms are principally applied to the section regarding injecting venture funds into selected start-ups⁵⁹. For the sake of the success of the joint venture established by both venture capitalists and entrepreneurs, three aspects must be well-devised in this period⁶⁰. First, venture capitalists must determine that with what type of organization they plunge venture funds into targeted enterprises. Under the condition that they are allowed to participate in the VC sector, investors who are rational persons will show different extent of willingness to make investments into this industry when they face different organizations adopted by venture capitalists to structure venture funds⁶¹. In turn, the different magnitude of investment made by investors has substantial influences on the sufficiency of money supply for entrepreneurs. Second, in order to persuade themselves to contribute money to start-up firms which are associated with high uncertainty and great information asymmetry⁶², venture capitalists must work out the organizational and contractual mechanisms which they will apply to their portfolio companies for the purpose of minimizing risks and accomplishing harvests of investment. Third, venture capitalists must ensure that the management of start-ups have incentives to perform their best for the success of the venture and to accept the reduced control over the entity in return for the pecuniary and non-pecuniary supports from VC⁶³. Essentially, the three aforementioned issues collectively refer to the selection and application of

57 See Clarke, “Corporate Governance in China” (n.º 3 above), p. 497.

58 Ibid.

59 Paul Gompers and Josh Lerner, *The Venture Capital Cycle* (Massachusetts: The MIT Press, 2nd edn, 2004), p. 6-7.

60 See n.º 7 above, p. 885.

61 Chengyu Liu and Yalun Yan, “The Analysis on the Organizational Forms of Venture Capital”, available at <http://www.is-law.com/OurDocuments/VC0002BE.pdf> (visited on 12 Apr 2009).

62 George G. Triantis, “Financial Contract Design in the World of Venture Capital” 2001 (68) *University of Chicago Law Review*.

63 Gregory G. Oehler, “The Wider Implications of ‘Implicit’ Contracts in Venture Capital Partnerships” (2005) 1 *NYU Journal of Law & Business* 492-493.

organizational and contractual incentives in the operation of VC.

With regards to the above three questions, the practice of American VCs has presented persuasive answers to them. As for the selection of organizational forms, most American VC funds are structured as limited partnerships⁶⁴. Under this structure, venture investors serve as limited partners⁶⁵. In terms of the legal rules governing limited partnerships in America, limited partners enjoy limited liability if they can abstain from exercising control over the critical elements of venture funds' business⁶⁶. Correspondingly, the virtually complete management power over venture capital is granted to the venture capitalists who serve as general partners⁶⁷. On the one hand, the allocation of control between limited partners and general partners shows the fact that investors need to rely on the skills and expertise of venture capitalists to make investments⁶⁸. On the other hand, it also ensures that venture capitalists possess sufficient discretion to maximize investors' benefits with their knowledge and experiences⁶⁹. For the sake of minimizing agency costs resulting from the control allocation, limited partnerships use compensations to guarantee the interests of general partners in line with those of limited partners. The bulk of general partners' compensations comes from the fixed share of ultimately realized profits of limited partnerships⁷⁰. As a result, this compensation scheme creates incentives for venture capitalists to maximize investment returns of venture funds. In addition, limited partnerships have limited lives, typically ten years, after which the partnerships must be dissolved and their assets must be returned to investors⁷¹. Apparently, the fixed termination provides a mechanism to estimate

64 David Rosenberg, "The Two 'Cycles' of Venture Capital" (2003) 28 *The Journal of Corporation Law* 421.

65 Christopher Gulinello, "Venture Capital Funds, Organizational Law, and Passive Investors" (2006) 70 *Albany Law Review* 304.

66 See n.º 64 above, p. 421. The limited partnership agreements stricken by venture capitalists and venture investors are typically subject to Delaware law. Pursuant to Article 17-303(a) of Limited Partnerships of Delaware, "a limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, in addition to the exercise of the rights and powers of a limited partner, he or she participates in the control of the business", available at <http://delcode.delaware.gov/title6/c017/sc03/index.shtml> (visited on 22 Apr 2009).

67 See n.º 65 above.

68 See n.º 10 above, p. 1089.

69 Ibid.

70 David Rosenberg, "Venture Capital Limited Partnerships: A Study in Freedom of Contract" (2002) 2002 *Columbia Business Law Review* 365.

71 Ronald J. Gilson, "Globalizing Corporate Governance: Convergence of Form Or Function" in Jeffrey N. Gordon and Mark J. Roe (ed), *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004), p. 148.

the abilities of venture capitalists with their overall performance by the time of liquidation for prospective investors⁷². Therefore, in order to keep staying in the VC sector, venture capitalists have incentives to lead the venture funds at hand to success before their dissolution comes. As to the tax deduction, in contrast with the dual taxation applicable to corporations, limited partnership income is not subject to taxation at the entity level⁷³. The integration of the above features into limited partnerships makes them best boost the investment willingness of venture investors in comparison with alternative organizational forms. In 1980, 42.5% of the investments made by venture capital in America were from the ones structured as limited partnerships. This number substantially increased to 81.2% in 1995⁷⁴.

In order to minimize the high risk and agency costs concomitant with start-up firms which they invest in, American venture capitalists commonly rely on staged financing, board representation, stock options and convertible preferred stocks⁷⁵. Staged financing refers to the fact that the initial VC investment is generally not sufficient to satisfy the monetary needs of portfolio firm's entire business plan⁷⁶. The subsequent injection of funds will occur only if some landmarks which are spelled out in the business plan are achieved⁷⁷. Obviously, the mechanism of staged financing guarantees that venture capitalists can be efficiently responsive to the high risk and high uncertainty associated with start-up companies by granting them the right to withdraw⁷⁸. In the meanwhile, their option to abandon also makes a negative signal for the potential investors to avoid the losses from investing in the "black hole" project⁷⁹. Although staged financing shifts the decision about the continuation of the venture project from entrepreneurs to venture capitalists, it can not solve the daily monitoring of the conducts of portfolio firm's managers⁸⁰. In response to this kind of shortcoming, venture capitalists are usually given the disproportionate representation or even control of the portfolio company's board of

72 Ibid.

73 See n.º 70 above, p. 377.

74 The Research Center of People's University of China on the Development of Venture Capital, *China Venture Capital Yearbook (2002)* (Beijing: Democracy and Construction Press, 2003), p. 69.

75 See n.º 7 above, pp 885-887.

76 See n.º 10 above, p. 1074.

77 Ibid.

78 Ibid., p. 1079.

79 Ibid., p. 1080.

80 Jincai Wang, "The Legal Institution Construction for the Development of Chinese Venture Capital Industry" in Siwei Cheng (ed), *The Strategic Thinking on the Formation and Development of Chinese Venture Capital Industry* (Beijing: Democracy and Construction Press, 2002), p. 242.

directors⁸¹. With this power, venture capitalists are able to effectively monitor the day-to-day exercising of discretion by managers who are delegated this privilege due to the incompleteness of contracts⁸². Stock options as the principal part of managers' compensation are also a means used by American venture capitalists to address agency costs⁸³. It is undoubted that entrepreneurs have strong incentives to strengthen the performance of the portfolio company and to increase the value of shares which they own. Likewise, by accepting low cash salaries in return for stock options, other management members also make their earnings largely dependent on the performance of the portfolio company which they collectively operate with entrepreneurs⁸⁴. In addition to tying managerial compensation to the success of the venture, stock options can maintain the continued commitment of the management team to the firm as well because their equity stake will be forfeited if they quit prior to some specified dates⁸⁵. The last tool on which American venture capitalists principally rely is convertible preferred stocks. With the VC investment made as a purchase of this type of securities, venture capitalists profit from the sale of the potential common stocks when their investment is fruitful, and they bear disproportionately less risk than that stood by entrepreneurs when the projects turn out to be failures⁸⁶. Moreover, convertible preferred stocks also include the terms of liquidation preference, redemption rights and anti-dilution protection⁸⁷. The liquidation preference provides priority to venture capitalists in the process of allocating liquidated assets when the venture goes busted⁸⁸; the redemption right reinforces the liquidity of venture capitalists in the event of barely passable performance by the portfolio company⁸⁹; and the anti-dilution protection ensure that venture capitalists can protect their interests against the subsequent contingencies with value-dilutive effects⁹⁰.

Finally, American venture capitalists resort to the combination of stock

81 William B. Bratton, "Venture Capital on the Downside: Preferred Stock and Corporate Control" (2002) 100 Michigan Law Review 897.

82 Oliver Williamson, "Corporate Governance" (1984) 93 The Yale Law Journal 1197-1230.

83 See n.º 10 above, p. 1084.

84 Ibid.

85 See n.º 7 above, p. 887.

86 Klaus M. Schmidt, "Convertible Securities and Venture Capital Finance" (2003) 58 The Journal of Finance 1139.

87 See n.º 7 above, p. 887.

88 Ibid.

89 Ibid.

90 William A. Klein and John C. Coffee, Jr., *Business Organization and Finance: Legal and Economic Principles* (New York: Foundation Press, 2004), 9th edn, pp 290-291.

options and exit mechanisms for the purpose of stimulating the management's willingness to perform their best for the success of the venture and to accept the reduced control over the entity in return for the monetary and non-monetary supports from VC⁹¹. Given the exit of VC is also the ending section of its circle, I will separately elaborate on it in another article.

As opposed to their prevalence in the operation of American VCs, those incentive mechanisms are fairly underdeveloped in Chinese domestic VCs. In the following section, I will attempt to prove that this underdevelopment is largely ascribed to the control-based model.

IV The Underdevelopment of Incentive Mechanisms in Chinese Domestic VCs: The Shadow of the Control-based Model

At the first glance, the underdevelopment of incentive mechanisms in Chinese domestic VCs seems to be mostly attributed to the long-term lack of legal provisions in China⁹². However, on second thought, an informed and curious youngster might wonder why the Chinese legislature did not revise relevant laws to legitimize the application of those incentive measures during such a long time and at the same time why some legally permissible incentive tools, such as staged financing, did not positively function as well? More notably, since the Chinese legislature has filled the legal loopholes in recent years, why have Chinese domestic VCs still been reluctant to apply those incentives to their operation? For these questions, I believe certain domestic venture capitalists may argue that they need time to get familiar with the above mechanisms. But in the information era featured with the quick sharing of knowledge, the time of familiarity simply sounds like a lame excuse. Therefore, we must explore the underlying factors which have given rise to this sort of underdevelopment. In the following part, I will try to prove that the control-based model concerned in this article is the one among those factors.

A. Limited Partnership

As to the proposals in favor of the establishment of limited partnership by legislation in China, they had been put forward by a group of Chinese scholars and progressive government officials since the 1990s.⁹³ In a lecture addressing the audience of the People's University of China, Professor Jiang Ping, former Principal of the China University of Political Science and Law, confirmed that

91 See n.º 10 above, p. 1086.

92 This issue will be analyzed below.

93 Pin Jiang, "The Contemplation around Limited Partnership", available at <http://www.civillaw.com.cn/article/default.asp?id=8085> (visited on 12 May 2009).

the drafting team indeed thoroughly designed the chapter entitled “Limited Partnership” when they drew up the Partnership Enterprise Law of the PRC (the Partnership Law) in 1997⁹⁴. However, this chapter was deleted after the final draft of the Partnership Law was presented to the Standing Committee of the National People’s Congress (the NPC) for the final approval⁹⁵. According to the explanation from a senior member of the NPC, the reason for relegating that chapter was the inexistence of limited partnership in Chinese commercial practice at that time⁹⁶. Then, he said that the legislature would consider adding limited partnership into the Partnership Law if this organization was applied by practitioners afterwards⁹⁷. On the basis of the above statement from the authorities, Professor Jiang commented that it was impossible to expect the real appearance and survival of limited partnership in business practice if it was not stipulated by laws beforehand because China stringently complied with the principle of legality in the area of enterprise law⁹⁸. I think Professor Jiang’s remark is correct and pertinent in that it has been verified by the following empirical evidence- the case of Sinotrust⁹⁹.

Sinotrust as a VC fund came into existence on the 12th July 2001 in Beijing, which was collectively established by Beijing Sinotrust Limited Liability Company (the Sinotrust Ltd), General Company of Xinjiang Shi Hezi Economic and Technological Development Area (the General Company) and Xinjiang Tianye Group (the Tianye). In terms of the contract entered by the three investors, Sinotrust adopted the organizational form of limited partnership pursuant to the Regulatory Measures on Limited Partnership in the Zhong Guancun Technological Park enacted by the Beijing Municipal People’s Government. The General Company and the Tianye served as limited partners, who were obligated to contribute 99% capital and enjoined 80% profits. The Sinotrust Ltd served as the general partner, who were obligated to contribute 1% capital and reaped 20% profits. In addition, the Sinotrust Ltd was also responsible for the operation of Sinotrust. With regard to their respective exposure to debts, the risk of the two limited partners was limited to their capital contribution and the general partner was liable with all of its assets. Up to this point, Sinotrust seemed to be a classic story of limited partnership. Given it was the first domestic VC in the form of limited partnership

94 Ibid.

95 Ibid.

96 Ibid.

97 Ibid.

98 Ibid.

99 Securities Daily Online, “2007: The First Year of Chinese LP”, available at http://zqrb.ccstock.cc/html/2007-11/18/content_5314.htm (visited 12 May 2009).

in China, Sinotrust was regarded to be the pioneer by the media. However, beyond everyone's prediction, the Tianye as the biggest investor of Sinotrust announced unilateral withdrawal less than half a year after its establishment. This piece of bad news so heavily hit Sinotrust that it had got to halt its operation. Then, why did the Tianye suddenly withdraw from Sinotrust? That was because the CSRC required it to do so. According to the CSRC's explanation, they thought that it would bring intolerant risks to the Tianye's shareholders if it acted as a general partner. However, as I have mentioned above, the Tianye served as a limited partner in Sinotrust. Hence, did the CSRC make a mistake? The answer is "No". The reason for this disparity was that the Zhong Guancun Technological Park was not authorized to issue business licenses to limited partnership even if it recognized this organizational form within its borders. Consequently, Sinotrust must file the application for the business license with the Beijing Administration for Industry and Commerce (the BAIC). However, the BAIC reviewed its application only in accordance with the Partnership Law rather than the Regulatory Measures on Limited Partnership in the Zhong Guancun Technological Park which is only a local regulation. Since limited partnership was not permitted by the Partnership Law at that time, the BAIC just issued a business license of general partnership for Sinotrust. Thus, although the Tianye was a limited partnership *de facto*, it was a general partner *de jure*. In the meanwhile, the standard adopted by the CSRC to judge the status of Tianye was also to find out its business license type. As a result, the Tianye was forced to depart from Sinotrust now that it was officially deemed as a general partner.

It is clear that the Sinotrust case is consistent with Professor Jiang's judgment. Then, a question arises: couldn't the members of the NPC foresee the result which Professor Jiang predicted? It is obviously unfair to suspect the capability of the Chinese legislature in this manner. Hence, another question comes: how do we perceive the paradox made by the senior member of the NPC about the deletion of the "Limited Partnership" section? As far as I am concerned, I prefer to interpret his explanation as an attitude rather than an answer. This attitude implicated that the authorities was indifferent to limited partnership and further to VC and high potential start-ups. Also, I think that it is not difficult to understand this sort of nonchalance because the state's focus was inevitably on those giant enterprises under its control of which the state-controlled listed companies were typical.

Given the unavailability of limited partnerships prior to the revision of the Partnership Law in 2006, corporations became the absolutely dominant organization for Chinese domestic VCs to structure VC funds during that period¹⁰⁰.

100 See n.º 15 above, p. 12.

Incident to the adoption of corporations, those VC funds had to stand dual taxation¹⁰¹. In addition, corporations also provided large room for VC investors to interfere with the specific operation of the funds which ought to be solely in the charge of venture capitalists¹⁰².

At the beginning of 2006, the CPC Central Committee and the State Council made the strategic decision on the establishment of an innovative society¹⁰³. In order to cater to this political slogan, the Standing Committee of the NPC amended the Partnership Law by adding the provisions of limited partnerships¹⁰⁴. This change seemed to be a progress. However, due to the inertia of their serving the state's need to control SOEs, especially state-controlled listed companies, the legislature has eroded the freedom of limited partnership contracts. Pursuant to the Article 61 of the Revised Partnership Law, the number of limited partners is limited to 49¹⁰⁵. This mandatory cap has significantly restricted the fundraising capability of this organizational form in China¹⁰⁶. In addition, even if limited partnerships have been in place, the Chinese authorities have stated that corporations ought to continue to be the dominant organization for GVCs to structure VC funds¹⁰⁷. Through the perspective of the control-based model, it is easy to understand this statement as the reflection of state entrepreneurship because the status of shareholders is much more convenient for them to directly intervene into the running of VC funds than the identity of limited partners. Consequently, given

101 The Article 1 of the Enterprise Income Tax Law of the People's Republic of China. It says "the enterprises and other organizations which have incomes (hereinafter referred to as the enterprises) within the territory of the People's Republic of China shall be payers of the enterprise income tax and shall pay their enterprise income tax according to the present law. The sole individual proprietorship enterprises and partnership enterprises are not governed by the present law."

102 Refer to the analysis of the operation of GVCs in the second chapter. Also see People's Daily Online, "The National Development and Reform Commission Fully Supports Corporations: The Debate over the Patterns of Private Equity", available at <http://www.022net.com/2008/5-27/424960372650604.html> (visited 6 Jun 2009).

103 Jintao Hu, "The Speech in the National Scientific and Technological Meeting", available at <http://politics.people.com.cn/BIG5/1024/4011536.html> (visited 5 Jun 2009).

104 Yixun Yan, "The Explanation to 'The Partnership Enterprise Law of the People's Republic of China (Draft for Revise)'", available at <http://vip.chinalawinfo.com/newlaw2002/SLC/SLC.asp?Db=lfbj&Gid=1090520821> (visited 6 Jun 2009).

105 The Article 61 of the Revised Partnership Enterprise Law of the People's Republic of China. It says "a limited partnership enterprise shall be established by not less than 2 but not more than 50 partners, unless it is otherwise provided by law. A limited partnership enterprise shall have at least one general partner."

106 Junhai Liu, "It Is Necessary to Establish Limited Partnership", available at <http://www.civillaw.com.cn/article/default.asp?id=8800> (visited 6 Jun 2009).

107 See n.^o 102 above.

the fact that GVCs constitute the overwhelming majority of Chinese domestic VCs, limited partnerships are almost excluded from the Chinese VC practice.

As to those minority private domestic VCs in China, they are actually entitled to taking advantage of limited partnerships. However, as I have analyzed above, due to the effect of attention diversion of the control-based model, limited partnerships were put on hold for quite a long time by the Chinese legislature. Instead, corporations became the dominant organization applied by domestic VCs to structure VC funds. One of the main shortcomings concomitant with corporations is the high probability for VC investors to interfere with the concrete operation of VC funds for which venture capitalists ought to be solely responsible. Therefore, with years of this sort of inappropriate behavior, VC investors have naturally applied this ritual to limited partnerships when the novel organizational instrument is suddenly available for them. Consequently, the substance of limited partnerships has been distorted by Chinese domestic VCs. I think that the following case of East Sea VC can empirically prove this proposition¹⁰⁸.

In August 2007, East Sea VC (the East Sea) was jointly founded by James & Hina Capital Management Limited Company (the James), seven privately held enterprises and a natural person in Wenzhou. Pursuant to the Revised Partnership Law, the East Sea adopted limited partnership as its organizational form. This movement made it the second domestic VC fund in the form of limited partnership in China since the amendment of the Partnership Law¹⁰⁹. The James served as the general partner and all the other investors played the role of limited partners. From its inception, the media and the Chinese VC sector placed a lot of spotlight on the East Sea and hoped to witness its miracle in the short run. However, almost out of everyone's expectation, the East Sea only existed for seven months before it came to an end.

Based on the comments from the participants of the East Sea, the main reason for its failure is the disagreement on the investment judgments between the limited partners and the general partner. As I have described above, in a limited partnership, general partners are responsible for making investment decisions and limited partners only wait for recouping their capital and harvesting profits. However, the East Sea changed this mode with a so-called "joint meeting" consisting of the limited partners as the supreme authority¹¹⁰. That means that the

108 Zheshang Online, "The Investigation into the Suspension of the East Sea VC", available at <http://biz.zjol.com.cn/05zjman/system/2008/04/22/009445487.shtml> (visited 6 Jun 2009).

109 The first VC fund in the form of limited partnership after the revise of the Partnership Law is the South Sea VC. The detailed information on its operation is not available yet.

110 Jinrongstreet Online, "The Mystery of the Suspension of the East Sea VC", available at <http://www.jinrongstreet.com/show.asp?id=1239> (visited on 6 Jun 2009).

general partner must obtain the approval from the joint meeting before it could invest in a project. Consequently, fundamental discrepancy on some projects occurred between the general partner and the joint meeting, which ultimately led to the dissolution of the East Sea at its early stage. After its termination, in an interview with a local newspaper, Hu Xucang, Chairman of the joint meeting of the East Sea, said that limited partnership also needed to fit into the local practice that VC investors in Wenzhou collectively shared the power to make investment decisions.

Even if the East Sea is only an individual case in Wenzhou, I think that it also represents the miniature of the Chinese domestic VC industry. The long-term absence of limited partnership in China largely owing to the negative effects of control-based model has given rise to the undue intervention of general VC investors into the specific operation of VC funds and in turn has deformed the practice of limited partnership in China, which has been typically reflected by the statement of Hu Xucang. Therefore, to a large degree, the case of East Sea has proved my hypothesis that the erroneous practice of limited partnership is linked to the control-based model.

To sum up, with the empirical evidence subsumed in this section, I believe that I have established the connection between the underdevelopment of limited partnership in the Chinese domestic VC industry and the control-based model. The immediately next section of this part will focus on the linkages between the control-based model and the staged financing and board representation of Chinese domestic VCs.

B. Staged Financing and Board Representation

The evidence on the use of staged financing in Chinese domestic VCs emanates from my interview with a venture capitalist of a provincial GVC in China. In terms of his explanation, staged financing is a common tool applied by GVCs to their portfolio companies. However, he adds that it is more of a formality than a utility because most projects invested by GVCs are actually determined by senior government officials, which means that GVCs must continuously inject money into those “lucky dogs” for the purpose of pandering to their seniors’ vanity even if the portfolio companies do not fulfill the milestones necessary for the next round of financing. The root of the inappropriate intervention into the operation of GVCs by government officials is the inertia of state entrepreneurialism which has been principally maintained through the control-based model¹¹¹. Therefore, the substantive malfunction of staged financing in GVCs can be linked to the control-based model in this sense. Although the proof about the use of staged

financing in private domestic VCs is not available to me, I believe that the case of GVCs can basically reflect the profile of this mechanism in the Chinese domestic VC industry taking into account of their dominant role in the aspect of amount.

With regard to board representation, my interviewee confirms that GVCs always insist on acquiring board membership of portfolio companies. However, he says that the implication of board representation is more of satisfying the psychic demand of governmental officials for the status of decision makers than obtaining information from the funded firms and monitoring their performance. I think that it is not difficult to understand his statement on the basis of my above analysis. On the one hand, the government official's psychology of being centered in a business is the inevitable byproduct of state entrepreneurism. On the other hand, it is predictable that few venture capitalists in GVCs would like to really perform the surveillance duty in those "guanxi" firms with the dread of displeasing their seniors. As I have explicated above, to a large extent, the twofold cases are ascribed to the influence of the control-based model. Also, by and large, the situation of board representation in GVCs can represent its status quo in the whole Chinese domestic VC industry because of GVCs' majority position.

C. Convertible Preferred Stocks

The first Company Law in China was promulgated for the purpose of the corporatization of traditional SOEs in 1993¹¹². Through corporatization, the CPC and the Chinese central government intended to privatize small and medium-sized SOEs and to reform and keep the control of big and key ones with the institutions of modern corporate governance. This objective determined that the Company Law 1993 included plenty of mandatory provisions which should have been discretionary ones in terms of the spirit of modern company law¹¹³. Given those gigantic SOEs are the predecessors of most state-controlled listed companies, their control-oriented governance framework is actually the equivalent of the successive control-based model. Therefore, in this sense, the control-based model is connected with the rigid character of the Company Law 1993.

One aspect of the rigidity of the Company Law 1993 was its provision regarding the distribution of profits among shareholders. In accordance with its Articles 33 and 177, profits were only divided pro rata among shareholders on the

112 Baoshu Wang, "It Is Important to Understand the Spirit of the New Company Law", available at <http://www.civillaw.com.cn/article/default.asp?id=24654> (visited on 13 Jun 2009).

113 Junhai Liu, "Institutional Innovations of the New Company Law", available at <http://www.civillaw.com.cn/article/default.asp?id=25323> (visited on 13 Jun 2009); Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991).

basis of their shareholdings. As a result, this stipulation denied the existence of convertible preferred stocks because the owners of this type of securities receive a fixed-rate dividend which is not set in terms of their shareholdings. In the next decade prior to the revision of the Company Law 1993 in 2005, a bunch of progressive government officials and scholars appealed to the Chinese legislature for amending the above two articles and adding some new ones for the purpose of legalizing the use of preferred stocks¹¹⁴. However, the target of all those proposals were the common shares held by the state in state-controlled listed companies, which meant that they suggested substituting preferred stocks for those common ones¹¹⁵. Consequently, their petition did not obtain a positive response from the authorities because decision makers thought that preferred stocks which are featured with restricted voting rights would undermine the state's control over state-controlled listed companies in comparison with common stocks. Therefore, before the latest amendments of the Company Law 1993 were effective in 2006, common stocks naturally became the predominant investment means of Chinese domestic VCs if it was not the only.

With the rapid development of China's market economy and the increasing weight of privately held enterprises in the whole society, more and more interested groups criticized the Company Law 1993 for its stiffness¹¹⁶. Ultimately, after two minor bumps separately in 1999 and 2004, the NPC overhauled it in 2005 to satisfy the needs of other participants of the economy¹¹⁷. On the aspect of profit distribution, pursuant to the Articles 35 and 167 of the Company Law 2006, the way of dividing profits among shareholders is not only on the basis of shareholdings. Other means permitted by the articles of incorporation are also accepted by the new Company Law. This change has laid the legal ground for the use of convertible preferred stocks. Immediately after this modification, echoing to the encouragement of innovation from the CPC and the central government¹¹⁸, ten ministries and committees of the State Council jointly enacted a regulation entitled

114 Fuhua Liu, "Preferred Stocks- An Alternative of the State's Ownership" (1998) 3 Reform of Economic System 88-91; Zixiang Hu, "A Feasibility Research on the Change of Stateowned Stock to the Priority Stock" (1996) 3 Jiangnan Tribune 60-62; Xiaobo Feng and Huanchen Wang, "Brief Research on the Application of Preferred Stocks in the Reduction of State-held Shares" (2001) 6 Research on Economics and Management 43-45; Chunping Wang, "The Conversion of State-held Stocks to Preferred Stocks- A New Way for the Reform of SOEs" (2002) 11 Coal Economic Research 22-23.

115 Ibid.

116 See n.º 113 above.

117 Ibid.

118 Xiangjun Guo and Jianjun Liu, "Interpreting 'Interim Measures for the Administration of Startup Investment Enterprises'" (2006) 3 Securities Market Herald 12.

“Interim Measures for the Administration of Startup Investment Enterprises”¹¹⁹. In this regulation, VCs are eventually allowed to take advantage of convertible preferred stocks¹²⁰. This should have been a boost for Chinese domestic VCs. Unfortunately, due to the effect of path dependence on common stocks, they have not shown many interests in this issue as opposed to their foreign counterparts. According to my interview with the venture capitalist of the provincial GVC, he admits that domestic VCs, including both GVCs and private ones, prefer common equity to convertible preferred stocks because it has been the common practice for them all the way. Therefore, through his statement, I think that we can clearly see the continuous influence of path dependence.

Someone may argue that Chinese domestic VCs are likely to gradually adopt convertible preferred stocks since the law and regulation have been in place. It is just a matter of time. In my opinion, the function of convertible preferred stocks will be largely discounted at least with GVCs even if they broadly apply this kind of security to their investment in the future. My prediction is built on the fact called “soft budget constraints” related to SOEs, especially those giant state-controlled listed companies¹²¹. Soft budget constraints means that managers of state-controlled listed companies are expected to receive additional financial supports from governments in case of big losses because their enterprises are under the control of the state¹²². In turn, this kind of implicit contract provides an insurance for the management to behave without due diligence¹²³. In GVCs, the phenomenon of soft budget constraints also pervasively exists. An executive officer of a GVC explained the non-avoidance of soft budgets in GVCs by saying that:

“All of our shareholders are governments or government tied, so most of time our work is to support their policies. But testing policies are risky, and it’s costly, right? So it is reasonable that we get compensations (refinancing) for the cost.”¹²⁴.

Consequently, as I understand, the existence of soft budget constraints inevitably lowers GVCs’ level of risk aversion. Therefore, even if convertible

119 Available at http://www.ndrc.gov.cn/zcfb/zcfbl/zcfbl2005/t20051115_49928.htm (visited on 13 Jun 2009).

120 The Article 15 of the Interim Measures for the Administration of Startup Investment Enterprises says “VCs may make investments by the way of stocks, preferred stocks and convertible preferred stocks on the basis of the agreement with venture enterprises.”

121 Donghua Chen, Tiesheng Zhang and Xiang Li, “Implicit Contract without Law- Empirical Evidence from China Capital Market”, on file with the author.

122 Ibid.

123 Ibid.

124 See n.º 15 above, p. 13.

preferred stocks are widely applied by them, I doubt if they can carefully design the clauses of the stock purchase agreement for the purpose of making this security fully function in venture enterprises.

Up to now, I have set up the connection between the control-based model and the underdevelopment of convertible preferred stocks in Chinese domestic VCs. The following section will turn to the last mechanism- stock options.

D. Stock Options

As I have analyzed in the last section, rigidity was the character of the Company Law 1993 as a result of the control-based model. Therefore, stock options as an incentive mechanism were not stipulated by it. In addition, its Article 149 prohibited companies from purchasing their own stocks except for reducing registered capital or merging with other companies which held their shares. Consequently, this provision made it impossible for companies to reserve stocks for the purpose of stock options.

With the deep development of SOEs' reform, the CPC and the Chinese central government realized that it was necessary to introduce stock options as an incentive mechanism to supplement the governance institutions featured with control¹²⁵. In 1999, the Fifteenth CPC Central Committee passed the document entitled "Decisions on SOEs Reform"¹²⁶. In this document, the CPC Central Committee cautiously permitted the pilot trial of stock options in SOEs¹²⁷. Since then, some attempts were carried out mainly in state-controlled listed companies located in several big cities¹²⁸. However, because of the above legal barrier and the governments' affinity to control, this endeavor was not successful¹²⁹. Here, I take the "Wuhan model" as an example for illustration¹³⁰. In this model, if a state-controlled listed company decided to award "stock options" to a manager, Wuhan State-owned Assets Administration Company would purchase the company's stocks from the secondary market with the manager's salaries. After that, this amount of stocks would not be awarded to the manager in a lump sum. Instead, within a fixed return period, those stocks would be granted to the manager on a yearly basis. If the performance of the manager was not satisfactory in a certain year within the return period, the due stock amount in that year would be

125 Peizhong Gan, "The Legal Analysis of Manager Stock Options" (2002) 20 Journal of China University of Political Science and Law 49.

126 See n.º 20 above.

127 Ibid.

128 See n.º 125 above, p. 49.

129 Ibid.

130 Ibid.

expropriated by Wuhan State-owned Assets Administration Company. From the Wuhan model, we can clearly figure out that its so-called “stock options” were far different from the real ones. It was more of a penalty and restriction on managers than an incentive. Hence, it inevitably went to a failure.

The unsuccessful trial of stock options in state-controlled listed companies made governments daunted. This passive attitude also negatively influenced the homogeneous enterprises of state-controlled listed companies- GVCs. My evidence on this assumption mainly comes from the Zhong Guancun Technological Park. In 2000, the Standing Committee of the Eleventh Beijing People’s Council passed the local regulation entitled “The Regulation of the Zhong Guancun Technological Park”¹³¹. In this regulation, enterprises in the Zhong Guancun Technological Park are allowed to use stock options¹³². Traditionally, the Zhong Guancun Technological Park is the turf of GVCs. Therefore, regardless of the legal barriers and the specific design of its provisions, if GVCs hold an active attitude toward stock options, this mechanism must have been a common practice in this area. However, till 2005, the first dispute on stock options just happened in the Zhong Guancun Technological Park¹³³. Especially, the defendant enterprise did not have the background of GVCs’ support. Thus, to a large extent, I believe that the first case did not show the so perfect design of stock options by GVCs that there was not a dispute related to them in the Zhong Guancun Technological Park within five years since it was available, but did show the rare use of this tool by them.

Another proof about the underdevelopment of stock options in GVCs comes from their venture capitalists’ salaries. Table 2 shows the salaries of senior managers in a Beijing GVC in 2002. From this table, we can find out that stock options were not an element of their salaries. Since internal incentive is not adopted by GVCs, it is almost unrealistic to expect them to use stock options as an incentive for outsiders.

Table 2: Salaries of Senior Managers in a Beijing GVC in 2002
Unit: RMB Yuan

131 Available at <http://www.bjdch.gov.cn/n1569/n2458434/n2462161/2573918.html> (visited on 14 Jun 2009).

132 See its Article 12.

133 ChinaByte, “Fomer Employees Have Filed a Lawsuit against ZOL”, available at <http://www.chinabyte.com/net/217581260803932160/20050226/1915458.shtml> (visited on 14 Jun 2009).

Position	Chairman of the Board of Directors	CEO	Vice CEO	Investment Manager	Senior Project Manager	Project Manager
Total Salary	129500	119448	115668	103156	85488	66688
Fixed Allowance	36000	32400	32400	28800	21276	18000
Floating Allowance	24000	21600	21600	19200	14400	12000
Basic Salary	24444	24048	20988	17676	19116	9600
Bonus 1	440	440	240	440	440	360
Bonus 2	728	752	360	272	368	408
Housing Allowance	3120	2880	2880	2640	2160	1920
Snack Allowance	3600	3600	3600	3600	3600	3600
Dining Allowance	2640	2640	2640	2640	2640	2640
Laundry Allowance	2400	2160	2160	2160	2160	2160
Sole Child Allowance	NA	NA	60	60	NA	60
Nursery Allowance	NA	NA	NA	NA	NA	480

Source: Study on Contracts of Venture Capital in China¹³⁴

Even if the Company Law 2006 has permitted the use of stock options, the Chinese authorities are still very cautious about this incentive tool. In 2008, the State-owned Assets Supervision and Administration Commission (the SASAC) even suspended all the schemes of stock options in state-controlled listed companies in order to strengthen its control.¹³⁵ This passive attitude of governments toward stock options inevitably has an impact on GVCs. Just as my interviewee- the venture capitalist of a provincial GVC says, they seldom use stock options in their investment because their seniors who are quasi government

¹³⁴ Changmin Ouyang, "Study on Contracts of Venture Capital in China", available at <http://cjin.lib.hku.hk/kns50/detail.aspx?QueryID=3&CurRec=1> (visited on 14 Jun 2009).

¹³⁵ Some state-controlled listed companies carried out stock options without obtaining approval from the SASAC in advance. The SASAC thought that its control over those enterprises had been challenged. Therefore, it took a tough action to suspend all the schemes of stock options in state-controlled listed companies. See Caijing Online, "The China Mobile and the China Unicom Challenge the SASAC in the Aspect of Stock Options", available at <http://www.caijing.com.cn/2009-02-04/110052821.html> (visited on 14 Jun 2009).

officials are reluctant to do so.

To sum up, the linkage between the control-based model and the underdevelopment of stock options in GVCs really exists. Again, given their dominant position in China, I think that GVCs can basically reflect the case of stocks options in the overall Chinese domestic VCs.

V Conclusion

The American VC template presents five valuable points in the aspect of incentive for China- limited partnerships, staged financing, board representation, convertible preferred stocks and stock options. Unfortunately, with the institutional barriers imposed by the control-based model of the SCLCs, the above five factors are still underdeveloped in Chinese domestic VCs. The implication from this study is that adaptive efficiency and agency costs are equally important factors which ought to be considered when we put forth any reform proposal for the corporate governance of the SCLCs. In case of neglecting either of them in this process, the overall efficiency must be jeopardized.

