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RESEARCH ARTICLE

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Corporate Governance of Chinese State-Controlled Listed Companies: Evidence from the Exit of Chinese Domestic Venture Capital

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Abstract The existing literature on the corporate governance of Chinese state-controlled listed companies (SCLCs) focuses more on agency costs. There is inadequate attention being paid to its adaptive efficiency through the standard of venture capital (VC). This paper tries to fill this gap on the basis of the evidence from the exit of Chinese domestic VCs. The existing research has proved that the availability of stock market as an exit is essential for the vitality of a country's VC industry. Unfortunately, with the institutional barriers imposed by the control-based model of the SCLCs, the exit ways of Chinese domestic VCs via stock market are still uneven. The implication from this study is that adaptive efficiency and agency costs are equally important factors which ought to be considered when any reform proposals for the corporate governance of the SCLCs are put forward. While either of the two factors is neglected in this process, the overall efficiency is to be jeopardized.

Keywords SCLCs, VCs, exit, adaptive efficiency

1 Introduction

The issue of corporate governance has gained unprecedented attention in the international community after the ravages of the Asian financial crisis. In recent

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years, laying down the more sophisticated governance guidelines has become a vibrant campaign with the favor and participation of various interested groups.[1] Given the on-going lackluster performance of its state-owned enterprises (SOEs) and the substantial competition from its entry into the World Trade Organization (WTO), China has also put considerable emphasis on corporate governance in recent years.[2] At the core of such attention is the debate on how China can design an effective corporate governance system for the SCLCs through the perspective of agency theory.[3] Taking into account of a series of scandals related to the poor governance practices of the SCLCs since the presence of Chinese stock markets,[4] 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 costs.[5] While

[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 et al, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 Journal of Corporation Law 537–608 (2001). In the 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*, at http://www.oecd.org/dataoecd/32/18/31557724.pdf (last visited December 15, 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*, 3 McKinsey on Finance 15–18 (2002).

[2] Shuguang Li, 中国的公司治理及其转型期的改革 (Corporate Government of China and Its Reform during Transition), 21 政法论坛 (Tribune of Political Science and Law) 3 (2003).

[3] Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants*, 52 CESifo Economic Studies 415–16 (2006); Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 China Econ. Rev. 494 (2003).

[4] See Black, Metzger & O'Brien et al, fn. 1 at 600.

[5] The literature in this category includes but is not limited to the following ones. See Leping Shen, 我国企业集团公司治理结构现状分析及对策研究 (Analysis of the Current Situation of Corporate Governance Structure and Counter-Measures of Enterprise Groups), 25 暨南学报(哲学社会科学版) [Journal of Jinan University (Philosophy & Social Science Edition)] 28–29 (2003); Peizhong Gan, 国有股减持中的政府与市场——国有股减持困境的经济法分析 (Government and Market in the Reduction of State Shares—Analysis of the Failed Reform through the Perspective of Economic Law), (4) 法学家 (Jurist) 87–90 (2002); Liufang Fang, 过度管制导致的挫折 (The Setback Stemming from Over-Regulation), at http://www.civillaw.com.cn/ article/default.asp?id=17186 (last visited December 15, 2009).

these literatures have exerted positive influence on the improvement of the SCLCs' governance framework, they have also neglected 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 industries.[8] On the contrary, the external innovation generally takes place in the start-ups set up by entrepreneurs.[9] Those start-ups do not only have impact on existing industries but also develop entirely new industries.[10]

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, it in fact promotes the increase in the magnitude of competition in its economy by bringing in new participants. In turn, the intensified competition provides incentives for large companies to conduct the in-house innovation with enhanced efficiency and initiatives. 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.

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

[7] Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 Nw. Uni. L. Rev. 874 (1997).

[8] Id.

[9] Id.

[10] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 Stan. L. Rev. 1068 (2003).

The existing comparative study on the innovation patterns in the United States, Germany and Japan has provided persuasive evidence to support the above supposition. According to these studies, the overall adaptive efficiency of United States which has been typically considered to promote the external innovation is fairly higher than those in Japan and Germany which have been thought to focus on the in-house innovation.[11] Furthermore, these 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 certainly concerned with the significant enhancement of adaptive efficiency.

In the past decade, western corporate law scholars discovered a strong relation between the corporate governance systems of large public companies and the institutional environment for the vitality of VC markets. For example, Black and Gilson analyzed the importance of a highly developed stock market for the exit of VC;[12] Milhaupt examined how VC failed to fit into the corporate governance system of Japanese large, well-established public companies.[13] These academic products have opened up a new sight 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 Means.[14] 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**.** 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 rarely explored. That is just the research gap which I try to fill in this paper.

In China, the concept of "venture capital" burgeoned in the early 1980s. However, until 1998, the development of VC was just theoretically discussed and

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[11] See Milhaupt, fn. 7; Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks vs. Stock Markets*, 47 J. Finan. Econ. 243–77 (1998).

[12] Id.

[13] Id.

[14] Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property*, Transaction Publishers (New Jersey), at xix-xx (1933), at http://www.google.com/books?hl=zh-N&lr=&id=mLdLHhqxUb4C&oi=fnd&pg=PR8&dq=modern+corporation+and+private+property&ots=QAlWGKPf1M&sig=Gcj-YcCk6A0HqDQAwmEyJWtmmTI#v=onepage&q & f=false (last visited February 14, 2010).

at the pilot trial stage. In 1998, the Central Committee of Chinese National Democratic Construction 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 system.[15] During the past ten years, China had made remarkable progress in the development of its venture capital market.[16] However, the striking expansion of China's VC market cannot cover the embarrassing fact that the exit way of Chinese domestic VC via stock market is still uneven. Given the strong relation between the corporate governance of listed companies and the institutional environment for the vitality of VC markets, I assume that the corporate governance system of the SCLCs has hampered the full availability of stock markets to Chinese domestic VCs as exit channels. In other words, I mean to use the mirror of the exit of Chinese domestic VCs to reflect the negative effects of the corporate governance of the SCLCs on adaptive efficiency.

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 explains the importance of stock markets as exit channels to the vitality of a country's VC industry. Part IV analyzes how the corporate governance of the SCLCs has hindered the full availability of stock markets to Chinese domestic VCs as exit channels. Then conclusion part follows in Part V.

2 The Status Quo of Corporate Governance in the SCLCs

The current SCLCs are the transformation results of traditional SOEs.[17] Therefore, their corporate governance cannot be understood thoroughly apart from their history.[18] Prior to the corporatization of SOEs after the Company Law of the People's Republic of China (PRC) was enacted in 1993, the governance systems of SOEs had gone through two stages. First, from the establishment of PRC to the middle of 1980s, the function of SOEs merely satisfied the

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

[16] In 2003, the total amount of VC in China was RMB 32.534 billion *yuan*. Three years later, this number increased to RMB 58.385 billion *yuan*. See China Venture Capital Research Institute Limited, 中国风险投资年鉴 (China Venture Capital Yearbook), Democracy and Construction Press (Beijing), at 107 (2007).

[17] See Clarke, fn. 3.

[18] Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, (1) Colum. Bus. L. Rev. 6 (2002).

production plans made by government agencies and guaranteed 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 hierarchy.[19] 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 Company Law of China was promulgated, the contracting system was dominant in the movement of SOEs' reform. In accordance with the contracting model, the reform aimed at granting SOEs the status of legal person and to make them be responsible for their own profits and losses.[20] This strategy revealed that the Communist Party of China (CPC) and the Chinese government wanted the enterprises 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 profits. On the contrary, it just intended to implement its policies better with the support of robust SOEs.[21] Therefore, it meant that there were no possibilities for the state to abandon control of SOEs even if it had tactically authorized a share of power to them, in which the personnel power as the core component of the governance framework of SOEs was tightly held in the hands of the local CPC committees.[22]

The failure of the contracting model induced a national debate on the transformation and diversification of public ownership of SOEs into different forms at the end of the 1980s.[23] However, this move was halted by the Tiananmen Square protests in 1989. In the following three years, the speed of SOEs' reform was slowed down and the voice of restoring the centrally-planned economy resurged.[24] Confronted with the circumstances, Deng Xiaoping called

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[19] The 15th CPC Central Committee, 中共中央关于国有企业改革和发展若干重大问题的决定 (Decisions of the CPC Central Committee on Several Important Issues of SOEs Reform and Development), at http://cpc.people.com.cn/GB/64162/71380/71382/713 86/4837883.html (last visited December 15, 2009). In this Decision, the CPC Central Committee declared administrative organs should not be granted to SOEs and their leaders any more and it demonstrated that the leaders of SOEs used to be cadres.

[20] The 12th CPC Central Committee, 中共中央关于经济体制改革的决定 (The Decision of the CPC Central Committee on the Reform of the Economic System), at http://news.xinhuanet.com/ziliao/2005-02/07/content_2558000.htm (last visited December 15, 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" became popular in China.

[21] See Clarke, fn. 3 at 494–95.

[22] See the 12th CPC Central Committee, fn. 20.

[23] Shutang Gu & Siquan Xie, *Revisiting the Reform Process of SOEs*, 9 Econ. Rev. 3 (2002).

[24] Hongbo Xie, 从计划到市场 —— 我国社会主义经济体制的嬗变 (From the Planned Economy to the Market Economy—The Transformation of the Economic Framework in China), 5 宏观经济管理 (Macroeconomic Management) 24 (2008).

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 1992.[25] According to his theory, the market economy did not solely belong to capitalism and it was compatible with the needs of socialist economic division and productions.[26] The support from Deng Xiaoping provided fresh and vigorous 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 charter.[27] 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 objective.[28] A series of policy signals for the corporatization of SOEs from the CPC and its paramount leaders promoted the enactment of Company Law of China 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 many other business forms. The overall amount of SOEs has been drastically diminished.[29] Second, recapitalization with the governance system of modern corporations was encouraged for big and key SOEs instead of total privatization.[30] Some of them were listed on the emerging domestic stock markets in order to raise as much money as possible.[31] 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-oriented SOEs as has been analyzed above, I presume that the government must control these pivotal listed companies tightly through the specific governance institutions

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[25] Deng Xiaoping, 邓小平南巡讲话 (The Comments Made by Deng Xiaoping during His Inspection Tour to South China), at http://cpc.people.com.cn/GB/33837/2535034.html (last visited December 15, 2009).

[26] Id.

[27] See http://news.xinhuanet.com/ziliao/2003-01/20/content_697129.htm (last visited December 15, 2009).

[28] The 14th CPC Central Committee, 中共中央关于建立社会主义市场经济体制若干问题的决定 (Decisions on the Establishment of the Socialist Market Economy), at http://www.people.com.cn/GB/shizheng/252/5089/5106/5179/20010430/456592.html (last visited on December 15, 2009).

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

[30] Id.

[31] Those enterprises are generally called the "SCLCs" in official documents and academic literature in China.

which have been stipulated by the Company Law of China.[32] In other words, the corporate governance of the 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 shareholders' meeting, the board of directors and the supervisory committee.

2.1 The Shareholders' Meeting

In China, the shareholders' meeting which is taken as a supreme power organ of a corporation occupies the central position in corporate governance.[33] In terms of the latest Company Law of China which came into effect in 2006 (the Company Law 2006), the shareholders' 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 annually; (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 incorporation.[34] By this enumeration, it can be seen that the shareholders' meeting of a corporation in China enjoys 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 shareholders can control the operation of the corporation to considerable degrees through the governance institution of the shareholders' meeting in China.

As I have mentioned above, the current SCLCs in China are the transformation 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

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[32] The Company Law of 1993 was revised in 2005 and the latest Company Law came into effect in 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, which the author will make reference to the following analysis.

[33] Lin Ye, 公司权力的分配 (The Distribution of Corporate Powers), at http://www.civillaw.com.cn/article/default.asp?id=37502 (last visited December 16, 2009).

[34] Art. 38 of Company Law of PRC 2006.

enterprises still characterizes the substantial concentration of 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, Table 1 provides the empirical evidence regarding the largest 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 light of the data in Table 1, all of the largest shareholders of the twelve SCLCs producing iron and steel were state holding corporations which are solely held by the state.[35] The top tier corporate leadership positions in these state

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

Corporation name	Name of the biggest shareholders	Amount of shares held by the biggest shareholders	Ratio to the total shares (%)
Anyang Iron and Steel Incorporated	Anyang Iron and Steel Group Corporation Limited	870,490,259	64.70
Baoshan Iron and Steel Incorporated	Bao Steel Group Corporation	10,635,000,000	85. 00
Guangzhou Iron and Steel Incorporated	Guangzhou Iron and Steel Group Corporation Limited	352,969,735	51. 44
Handan Iron and Steel Incorporated	Handan Iron and Steel Group Corporation Limited	996,553,100	67. 04
Hangzhou Iron and Steel Incorporated	Hang Steel Group Corporation	479,587,500	74. 32
Hongxing Iron and Steel Incorporated	Jiuquan Steel Group Corporation Limited	515,000,000	70. 74
Laiwu Iron and Steel Incorporated	Laiwu Iron and Steel Group Corporation	715,182,000	82. 09
Lingyuan Iron and Steel Incorporated	Lingyuan Group Corporation	178,500,000	57. 58
Ma Anshan Iron and Steel Incorporated	Ma Steel (Group) Holding Corporation	4,082,330,000	63. 24
Nanjing Iron and Steel Incorporated	Nanjing Iron and Steel Group Corporation Limited	357,600,000	70. 95
Tangshan Iron and Steel Incorporated	Tangshan Iron and Steel Group Corporation Limited	915,772,382	67. 64
Wuhan Iron and Steel Incorporated	Wuhan Steel Group Corporation	1,770,480,000	84. 69

Source: The Analysis of the Ownership Structure in the Sector of Steel in China.[36]

[35] Christopher A. McNally, *Strange Bedfellows: Communist Party Institutions and New Governance Mechanisms in Chinese State Holding Corporations*, 4 Bus. & Pol. 97 (2002).

[36] Jinghe Zhu, Huaili Yuan & Guoren Liu, 中国钢铁业上市公司股权结构分析 (The Analysis on the Ownership Structure of the SCLCs in the Sector of Steel in China), (12) 经济纵横 (Economic Review) 34 (2002).

holding corporations are made by state-owned asset management commissions and the CPC committees.[37] Moreover, almost all of the candidates for these positions have the backgrounds of working in related government agencies.[38] Therefore, state holding corporation leaders are seldom held accountability for the economic performance of the enterprise and its subsidiaries as long as they do not deteriorate massively.[39] Their obligations are to guarantee the implementation of state and local policies in those entities. With the tier of state holding corporations as their largest shareholders, the state has tightly controlled the SCLCs through the shareholders' 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 barriers from political considerations and vested interests.[40]

2.2 The Board of Directors

According to the stipulations of the Company Law 2006, the board of directors plays the role as the executive branch of the shareholders' meeting in a corporation. It is mainly responsible for the enforcement of the operation decisions made by the latter.[41] The state has achieved its control 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 other directors may be concurrently the chief executive in a SCLC, and their appointments are actually determined by the local CPC committees.[42] After that, this decision is forwarded to the local governments and concerning state-owned asset management commissions.[43] Next, the state-owned asset management commissions require the state holding corporations as the largest shareholders convene the shareholding

[37] Can Yi & Yumin Zhang, 国有独资公司治理模式研究 (Research on the Corporate Governance of Wholly State-Owned Corporations), (7) 西南民族大学学报 (人文社科版) [Journal of Southwest University for Nationalities (Humanities and Social Science Edition)] 89 (2007).
[38] See McNally, fn. 35 at 104.
[39] Id. at 102.
[40] See Ye, fn. 33.
[41] Art. 47 of Company Law of China, 2006.
[42] Liaoning Securities Supervisory Bureau, 全流通环境下上市公司控股股东或实际控制人行为模式变化及监管对策分析 (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), at http://www.csrc.gov.cn/n575458/n870331/n10217417/10264959.html (last visited December 16, 2009); People's Daily, 乔洪任免事件背后：茅台不存在接班人之争 (Behind the Dismissal of Hong Qiao: No Contest for the Successor of Maotai Group), at http://finance.people.com.cn/GB/67815/7 1134/5870908.html (last visited December 16, 2009). The appointment procedure is also applicable to the listed companies invested by the central government which are the minority of all the SCLCs.
[43] Id.

meeting of the SCLCs and appoint the candidates on the shortlist.[44] 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 companies.[45] In addition, a large portion of directors in a SCLC are former officials in disbanded government departments.[46]

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 CSRC in 2001, independent directors are elected by the shareholders' meeting.[47] Therefore, in the SCLCs, the state as the largest shareholders through the tier of state holding corporations actually dominates the selection of their independent directors.[48] Consequently, independent directors keep close relationship with the governments and act on behalf of the state.

2.3 The Supervisory Committee

In China, the principal function of the supervisory committee in a corporation is to monitor the behaviors of directors and managers in the interest of shareholders.[49] 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 shareholders' meeting.[50] Generally, these external shareholder supervisors are retired government

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[44] Id.

[45] See McNally, fn. 35 at 105. In practice, it is also common that the chairman of the board of directors acts as that corporation's party secretary.

[46] Xinhuanet, 2005 上市公司黑色档案 (Black Records of Chinese Listed Companies in 2005), at http://news.xinhuanet.com/stock/2006-01/06/content_4015864.htm (last visited December 16, 2009).

[47] Art. 4 of the Guidelines on Independent Directors of 2001.

[48] Jianmin Su, Yanbin Yao & Yuehui Su, 我国独立董事制度的现实性问题分析 (Analysis on the Problems of Independent Directors in China), 14 金融经济 (Finance & Economy) 79 (2007); Xiangping Cao, 我国独立董事功能缺失的原因 (Reasons for the Dysfunction of Independent Directors in China), (1) 中国国情国力 (China National Conditions and Strength) 47 (2008).

[49] Art. 54 of the Company Law of PRC 2006.

[50] Jian Zhao, 完善我国上市公司监事会制度的思考 (Consideration on the Improvement of the Supervisory Committee of Chinese Listed Companies), 11 经济师 (China Economists) 113 (2003); Jianwei Li, 论我国上市公司监事会制度的完善 —— 兼及独立董事与监事会的关系 (On the Improvement of the Supervisory Committee of Chinese Listed Companies through the Perspective of Its Relationship with Independent Directors), (2) 法律科学 (Science of Law) 76 (2004).

officials, famous economists, lawyers and accountants who have close relationships with the authorities. Second, within those corporations, the secretaries of corporations' disciplinary committees of the CPC and worker representatives constitute internal shareholder supervisors.[51]

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 policies.[52] Second, the disciplinary committees of the CPC within those corporations may play the traditional role as the primary organs of managerial discipline through their personnel overlap with the supervisory committees.[53] 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 essentially not relevant with my analysis in this paper.[54]

Just as Donald Clarke claimed, "China's legal system cannot be understood apart from its history and that history, whether it is imperial or modern, is overwhelmingly a story of centrality of the state."[55] 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 reviewing the historical path, it is 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"[56] because "this ambition makes no sense if profits are the only objective."[57] This control-based model has aligned the interests of the state with the SCLCs. Therefore, the state has the incentive to use its power to transfer as many resources as possible to these listed companies and to protect them from potential competition. Consequently, it has significantly hindered the

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[51] Linqing Wang, 上市公司监事会之殇 ——11 年目睹之怪状 (The Tragedy of the Supervisory Committee of Chinese Listed Companies: Curious Performance in the Past 11 Years), at http://www.civillaw.com.cn/article/default.asp?id=25935 (last visited December 16, 2009).

[52] See McNally, fn. 35 at 106.

[53] Id.

[54] Kaifu Li, 简论我国公司监事会制度的不足与完善 (Brief Analysis on the Shortcomings and Improvement of the Supervisory Committee of Chinese Listed Companies), 130 法学评论 (Law Review) 123–27 (2005).

[55] Donald Clarke, *Lost in Translation? Corporate Legal Transplants in China*, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913784 (last visited December 16, 2009).

[56] See Clarke, fn. 3 at 497.

[57] Id.

full availability of stock market as exit channel to Chinese domestic VCs, which I will demonstrate in the remaining parts of this paper.

3 The Essentiality of Stock Markets to the VC Industry

In order to explain the essentiality of stock markets as an exit channel to the VC industry, it begins with two questions. First, why does VC need to exit from successful venture enterprises? Second, what is the optimal exit channel for the principal participants of successful ventures? As for the first question, Bernard Black and Ronald Gilson have made a plausible explanation through the two dimensions below.[58] First of all, the economies of scope between financial contributions and non-financial ones supplied by VC for portfolio companies require its exit.[59] Practically, venture capitalists provide both capital and non-capital inputs for their portfolio companies.[60] The non-capital inputs, such as management assistance and reputational capital, are especially valuable to startup companies.[61] As the early-stage companies gradually become mature, the relative value of those non-pecuniary contributions decreases.[62] Therefore, by the time of the success of the portfolio companies, the transfer of non-financial contributions to new startup companies is more efficient and beneficial for VC.[63] But because non-financial contributions are linked to financial ones, redeploying the former inevitably requires the simultaneous redeployment of the latter: the exit of VC.[64] Secondly, the relationship between VC investors and venture capitalists also requires the exit of VC.[65] As capital contributors, VC investors need to rely on a benchmark to estimate the capability of venture capitalists who act as their agents.[66] Exit with the payment of capital proceeds for VC investors just provides such a criterion for the purpose of measuring venture capitalists' skills.[67] In addition, by means of successful exit, venture capitalists accumulate valuable track records for their futuristic fundraising as well.[68] The explanation to exit through the perspective of the relationship between VC investors and venture capitalists also includes a standard to guide us to answer the second

[58] See Black & Gilson, fn. 11 at 252–57.
[59] Id. at 255.
[60] Christopher B. Barry, *New Direction in Research on Venture Capital Finance*, 23 J. Finan. Management 3–15 (1994).
[61] Id.
[62] See Black & Gilson, fn. 11 at 255.
[63] Id.
[64] Id.
[65] Id.
[66] Id.
[67] Id.
[68] See Gilson, fn. 10 at 1092.

question: the optimal exit channel. In the light of my above analysis, the profitable exit is desired by both VC investors and venture capitalists. Naturally, one characteristic of the optimal exit channel ought to be the highest level of profitability compared with the other available approaches. However, the standard of profitability itself is not enough to help us identify the most efficient exit approach without combing with entrepreneurs' recouping of control over venture enterprises. As existing statistics have indicated, the likelihood of failure for high technology startups is fairly high.[69] Thus, many entrepreneurs may not quit their decent jobs to start such a venture if they do not put a large private value under their control.[70] Even if entrepreneurs strongly desire to control the enterprise, they generally have to hand it to venture capitalists as an incentive mechanism when they seek financial inputs.[71] But at the time that venture capitalists choose to exit as the startup companies turn out to be successful, handing over the control to entrepreneurs is more efficient than other choices because those entrepreneurs have proved their managerial skills and have been more familiar with those entities.[72] In addition, the opportunity to regain control also provides an incentive for them to make hard efforts which are necessary for success.[73] Thus, besides mere profitability, the most efficient exit channel must guarantee the reversion of control to entrepreneurs as well.

The standards of profitability and control-reversion provide the grounds for us to identify the optimal one among the available exit approaches. Generally speaking, venture capitalists take advantage of four means to achieve the liquidity of capital and non-capital contributions. Those means include bankruptcy, repurchase, acquisition and IPOs.[74] Bankruptcy is the only way for venture capitalists to exit from portfolio companies when they fail.[75] But for the successful ventures with which I am concerned in this paper, it is obviously not a suitable exit channel from the standards of profitability and control-reversion. Repurchase is usually resorted to when the performance of venture enterprises is rather mediocre.[76] Venture capitalists can transfer their resources to more promising entities through requiring entrepreneurs to buy them out. Therefore,

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[69] William A. Salhman, *The Structure and Governance of Venture Capital Organizations*, 27 J. Finan. Econ. 473–522 (1990). In this paper, Salhman pointed out that one-third of venture capital investment ended with losses.

[70] See Black & Gilson, fn. 11 at 259.

[71] Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 Rand J. Econ. 57–76 (1998).

[72] See Black & Gilson, fn. 11 at 259.

[73] Id.

[74] Guanghua Yu, 比较风险资本市场研究的政策意义 (The Policy Implication of Comparative Studies on Venture Capital Markets), (4) 法学家 (Jurist) 14 (2002).

[75] Id.

[76] See Milhaupt, fn. 7 at 887.

this arrangement acts as a protection mechanism for venture capitalists while it also enables entrepreneurs to recoup the control over enterprises. However, when the venture is successful, entrepreneurs need to have huge cashes for the purpose of purchasing the equity held by venture capitalists.[77] But few of them have the ability to achieve this mission.[78] Consequently, in this case, repurchase lacks the feasibility for VC to fulfill the profitable exits. Acquisition frequently means that entrepreneurs lose the control over their enterprises.[79] As I have illustrated above, this fact is fairly difficult for them to accept. In addition, the profitability of acquisition is much lower than that of IPOs.[80] According to the survey in "China Venture Capital Yearbook 2007," the percentage of VC-backed projects exiting by means of IPOs with the profitability above 100% in China was 57.14 in 2006.[81] But that number was just 10.87 for VC-backed projects exiting in the form of acquisition in the same year.[82]

Up to now, I have examined three exit approaches with the criteria of profitability and control-reversion. The result is that none of them is completely consistent with the characteristics of the optimal exit channel for successful ventures. Apart from the above, the last exit means which I have not analyzed is IPOs. In terms of the existing academic findings, IPOs have been viewed as the most efficient choice for venture capitalists to exit from successful portfolio companies.[83] On the one hand, they provide highest returns for venture capitalists, VC investors and entrepreneurs.[84] On the other hand, after IPOs, an implicit contract will be automatically enforced between venture capitalists and entrepreneurs for the purpose of handing over the control right of enterprises from the former to the latter.[85] Therefore, IPOs entirely conform to the two standards of identifying the optimal exit channel.

Now that IPOs can help venture capitalists accomplish golden exit from successful portfolio companies, the full availability of stock markets for them is becoming fairly essential.

4 The Exit of Chinese Domestic VCs through Stock Markets

Theoretically, for Chinese domestic VCs, they may exit from successful portfolio

[77] See Yu, fn. 74 at 14.
[78] Id.
[79] See Yu, fn. 74 at 15.
[80] Id.
[81] See fn. 16 at 263.
[82] Id.
[83] See Yu, fn. 74 at 15.
[84] Id.
[85] See Black & Gilson, fn. 11 at 257–64.

companies through either overseas stocks markets or Chinese domestic ones. However, in practice, they seldom rely on overseas stock markets as their exit channels because of the fact that the overwhelming majority of Chinese domestic VCs are established by governments (GVCs).[86] This fact determines that the choice of listing location of GVC-backed companies is inevitably influenced by governments. For municipal governments, in order to echo the State Council's requirement to promote the development of Chinese domestic stock markets, they usually strongly encourage GVCs to have their portfolio companies listed on the Shanghai Stock Exchange or the Shenzhen Stock Exchange.[87] As for overseas stock markets, local governments just take them as supplementary choices.[88] In addition, for Chinese domestic VCs who have not accumulated reputation in global financial markets, they are also reluctant to depend on overseas stock markets as their liquidity channel because their portfolio companies are short of the attraction to foreign investors in comparison with those backed by American VCs who have already been prestigious worldwide.[89] Consequently, mainly based on the above two reasons, the exit of Chinese domestic VCs is tightly connected to Chinese domestic stock markets.

Currently, Chinese domestic stock markets are comprised of three parts: the main boards, the Small and Medium-sized Enterprises Board (the SME Board) and the newly-established Growth Enterprise Market (the GEM). In terms of official statements, the presence of the three parts has made China achieve the mission of establishing a multi-tier domestic stock market.[90] Next, I will make the analysis of the three boards one by one in order to verify that none of them has assumed the duty to provide a smooth exit channel for Chinese domestic VCs. In turn, this analysis will contribute evidence for me to prove that this kind of

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[86] Lin Zhang, *Adaptive Efficiency and the Corporate Governance of Chinese State-Controlled Listed Companies: Evidence from the Fundraising of Chinese Domestic Venture Capital*, 10 UC Davis Bus. L. J. 151–82 (2010).

[87] Interviewing with a venture capitalist of the provincial GVC in China. In 2004, the State Council promulgated the document entitled 国务院关于推进资本市场改革发展的九条意见 (Nine Suggestions on the Reform and Development of Domestic Financial Markets), at http://www1.peopledaily.com.cn/GB/jingji/1037/2314920.html (last visited December 17, 2009).

[88] Interviewing with the venture capitalist of the provincial GVC. For example, Putian municipal government explicitly holds this view in the document entitled 莆田市人民政府关于充分利用资本市场促进经济发展的意见 (Suggestion of Putian Municipal Government on Fully Taking Advantage of Capital Markets to Boost the Development of Economy), at http://big5.putian.gov.cn/a/20081113/10871.html (last visited December 17, 2009).

[89] Interviewing with the venture capitalist of the provincial GVC.

[90] People's Daily, 创业板：推动自主创新, 服务经济发展 (GEM: Promoting Innovation and Serving Economic Development), at http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/fortune/2009-10/23/content_12304608.htm (last visited December 17, 2009).

inability of Chinese domestic stock markets is largely ascribed to the influences of the control-based model.

4.1 Main Boards

Generally speaking, the main board of a stock market aims to provide a financing channel for well-established companies. Therefore, it usually maintains a set of high listing standards which are difficult to be satisfied by the successful VC-backed companies when those VCs are prepared to exit from them. Consequently, this fact demonstrates that the main board is not specially designed for the fundraising of small-sized and medium-sized companies as well as for the exit of VCs from those firms per se. However, in some cases, when VCs are planning to exit, their portfolio companies have been so fully feathered that they have reached the listing criteria of main boards. Hence, the VCs and their collaborative entrepreneurs may prefer to list their companies directly on main boards in order to raise more money and reap more profits. When it happens, an efficient and fair main board should be able to satisfy such a demand. In other words, a well-devised main board can present equal opportunities for potential qualified companies, including VC-backed ones, to be floated. But because of the control-based model, the quality of equal-opportunity is still absent from the main boards of Chinese domestic stock markets.

Historically, the underlying intention of the CPC and the State Council to establish Shanghai Stock Exchange and Shenzhen Stock Exchange was to facilitate the fundraising for the moribund SOEs.[91] But the authorities could not express this intention in a straightforward manner because they had to nominally accommodate the interests of privately held enterprises under the pressure of fairness and equality.[92] Therefore, in order to ensure as many SOEs to be listed as possible, the authorities put the power of listing approval in their hands from the scratch.[93]

From the inception of the Chinese stock markets to 2000, the Chinese central government implemented a dual-control policy regarding the listing of

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[91] Shanghai Stock Exchange, 上海证券交易所介绍 (Introduction to the Shanghai Stock Exchange), at http://www.sse.com.cn/sseportal/ps/zhs/sjs/jysjs.shtml (last visited December 17, 2009); Shenzhen Stock Exchange, 深圳证券交易所介绍 (Introduction to the Shenzhen Stock Exchange), at http://www.szse.cn/main/aboutus/bsjs/bsjj/index.shtml (last visited December 17, 2009).

[92] In 1988, the amendment of the Constitution of the PRC officially recognized the legitimate status of private-owned economies.

[93] Theoretically, listing standards should also have been discussed as a tactic to protect the interests of SOEs as listing approval policies. But in practice, for the sake of superficial equality, the listing standards of the Chinese main boards are not able to play that role.

enterprises in the Shanghai Stock Exchange or the Shenzhen Stock Exchange.[94] Under the policy, the related units of the State Council determined a listing volume cap and a listing number cap every year.[95] Then, in terms of the two caps, each provincial government was assigned a quota for choosing the enterprises to be listed.[96] Thus, in this listing approval system, provincial governments were the actual decision-makers and they inevitably preferred to select the SOEs located in their areas as the listed candidates.[97] On the one hand, the dual-control policy created the first batch of state-controlled listed companies and their control-based model, which in turn deepened the incentive of the authorities to continuously grip the power of listing approval to preferentially enlarge the category of state-controlled listed companies.[98] On the other hand, the selection of listed companies through an administrative approach determined that the quality of those enterprises was usually paid inadequate attention by decision-makers.[99] Therefore, for the sake of the sustainable development of the Chinese stock markets, it is necessary to reform the dual-control policy.

From 2001 to 2003, the central government and CSRC replaced the dual-control policy with the dual-recommendation policy.[100] According to this policy, provincial governments and qualified securities companies were responsible for selecting the candidate enterprises to be listed in Shanghai Stock Exchange and Shenzhen Stock Exchange.[101] Simply speaking, provincial governments were authorized to decide the shortlist of potential listing companies.[102] Then, those companies stroke contracts with qualified securities companies for pre-listing assistance.[103] Finally, those qualified securities companies recommended the companies whose performance was satisfactory during the assistance period to the CSRC for ultimate approval.[104] From the brief

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[94] Raobin Sun, 关于我国股票发行制度的思考 (Thinking about the Chinese Stock Issuance System), (4) 网络财富 (Internet Fortune) 58 (2009).
[95] Id.
[96] Id.
[97] Zhimin Geng, 论中国股票发行制度变迁的内在机制 (The Internal Mechanism Underlying the Evolution of Chinese Stock Issuance System), 40 郑州大学学报 (哲学社会科学版) [Journal of Zhengzhou University (Philosophy and Social Science Edition)] 76 (2007).
[98] Here, the incentives resulting from the control-based model include but not limited to the better implementation of government policies, the increase of political achievements and the satisfaction of private interests.
[99] See Geng, fn. 97.
[100] Guoqiang Dai, 股票发行审核制度研究 (Exploring the Approval System of Stock Issuance), (8) 特区经济 (Special Zone Economy) 36 (2008).
[101] Id.
[102] Id.
[103] Id.
[104] Id.

description, we can figure out that in comparison with the dual-control policy, the dual-recommendation policy was more concerned with the quality of listed companies by involving securities companies who have professional knowledge to help the candidate enterprises well reach the listing standards. However, because of the SOE-oriented nature of the Chinese stock markets and the various interests resulting from the control-based model,[105] the provincial governments maintained the power to decide the shortlists of enterprises to be listed in accordance with the dual-recommendation policy. In addition, securities companies were also incentivized to actively recommend the enterprises favored by local governments to the CSRC in order to acquire more underwriting opportunities from the local governments in the future. Consequently, under the dual-recommendation system, SOEs still possessed considerable advantages in the process of listing competition.

Since 2004, for the purpose of further improving the quality of listed companies, CSRC have made securities companies liable for their recommendation if those recommended companies are identified to be inconsistent with the listing standards afterwards.[106] But the change did not substantively affect the power of listing selection held by local governments because both the vested interests and potential ones from the control-based model present incentives for the local governments to lobby the central government for keeping this power.[107] Hence, the main boards of Chinese stock markets are still in favor of SOEs.

The introduction of the evolution of Chinese listing approval policies reveals the fact that the control-based model maintains and deepens the SOE-oriented nature of the Chinese main boards to a large degree. This proposition has also been empirically verified by the data concerning the dominant position of state-controlled listed companies in the main boards.[108] Consequently, the two main boards in China are not able to provide a smooth and fair exit channel for Chinese domestic VCs even if their portfolio companies well reach the listing standards. Perhaps, that may explain why only two companies were VC-backed ones among 120 newly-listed companies on the main boards of Shanghai Stock Exchange or Shenzhen Stock Exchange in 2007.[109]

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[105] See fn. 98.

[106] See Dai, fn. 100.

[107] See fn. 98.

[108] Lin Zhang, *The Status Quo of Corporate Governance in Chinese Listed Companies* (on file with the author).

[109] See McNally, fn. 35 at 274; Ceocio Online, 企业上市“运动会” (The “Sports Meeting” of Listing Companies) at http://www.ceocio.com.cn/12/93/124/312/24512.html (last visited December 17, 2009).

4.2 The SME Board

The SME Board which belongs to Shenzhen Stock Exchange was launched by the State Council in May 2005. The SME Board was viewed as the interim form of the GEM by the Chinese authorities.[110] Its mission is to provide an exit channel for Chinese domestic VCs and to establish a convenient fundraising environment for SMEs, especially for high technology ones.[111] Objectively speaking, the presence of the SME Board has alleviated the financing difficulties confronted by SMEs to some degree.[112] However, it also inevitably diverts a portion of capital which should have flowed into the main boards and in turn threatens the vested interests of state-controlled listed companies. For Chinese governments, they are not willing to ignore the competition from SMEs most of which are privately held against state-controlled listed companies in Chinese stock markets because the control-based model has aligned their interests with those of state-controlled listed companies.[113] Consequently, in order to weaken the effect of capital diversion of the SME Board, the central government completely transplanted the listing standards, the listing approval procedure and even the policy of equity division of the main boards to the SME Board.[114] Therefore, this fact has determined that the real function of the SME Board is unlikely to be consistent with its missions mentioned above. Now that this paper only focuses on the exit of Chinese domestic VCs, I will principally analyze how the transplantation has disabled the SME Board from normally functioning in this aspect in the remaining part of this section.

With regard to the listing standards of the SME Board, they include several key accounting indicators for candidate firms. First, the pre-listing shares of the candidate firm must be above RMB 30 million *yuan*.[115] Second, the overall net profits of the candidate company in the past three accounting years must be above RMB 30 million *yuan*.[116] Third, the overall cash flow of the candidate company in the past three accounting years must be above RMB 50 million *yuan* or its overall revenues in the past three accounting years must be above RMB 0.3 billion *yuan*.[117] Fourth, at the end of the last quarter of the immediately previous

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[110] Shenzhen Stock Exchange, 深圳证券交易所设立中小企业板块实施方案 (The Implementation Plan of the Shenzhen Stock Exchange Regarding the Establishment of the SME Board), at http://www.szse.cn/main/sme/sczy/ywgz/200405255828.shtml (last visited December 17, 2009).

[111] See fn. 87.

[112] More than 80% listed companies on the SME Board are privately held. See fn. 16 at 362.

[113] Id.

[114] Id. at 377.

[115] See http://stock.sohu.com/20090401/n263135362.shtml (last visited December 17, 2009).

[116] Id.

[117] Id.

accounting year, the ratio of the candidate company's intangible assets to its net assets is not above 20% and it does not have losses without compensation.[118] The aggregation of those accounting criteria determines that only the capital-concentrated SMEs which are usually from the manufacture industry possess the scale and capability to satisfy the high listing requirements. For numbers of high technology SMEs the feature of which is technology-concentrated, they hardly reach the threshold of the SME Board. Consequently, for the exit of Chinese domestic VCs through the SME Board, the impact of the prohibitive listing standards is twofold. First, Chinese domestic VCs can rarely exit from the high technology companies backed by them via the SME Board. Second, if Chinese domestic VCs hope to rely on the SME Board for the purpose of exit, they must invest into the companies in the manufacturer industry. Taking into account of the fact that VCs are not willing to massively involve into the traditional industry, the ratio of VC-backed listed companies in the SME Board must be low. The existing empirical evidence has confirmed my judgments. According to the data in Table 2, we can clearly find out that the overwhelming majority of the VC-backed listed companies on the SME Board came from the manufacture industry from 2004 to 2007. In the meanwhile, in terms of Table 3, the average percentage of the VC-backed listed companies among all the listed companies on the SME Board was only 26.2 in the above four years. In addition to the listing standards, the listing approval procedure of the SME Board which is featured with administrative selection as described in the previous part can also filter out a portion of VC-backed candidates with high quality and then extend the listing opportunities to some established SOEs which do not acquire the listing quotas on the main boards. Last year, one of my relatives who was a deputy mayor of a city in China told me that a large-scale state-owned steel company located in her county had obtained the approval from the provincial government and CSRC to be listed on the SME Board after it failed to lobby for the entrance ticket of the main boards.

As for the policy of equity division, it once made the exit of Chinese domestic VCs through the SME Board impossible. In accordance with the requirements of the policy, shares held by the state and legal persons were prohibited to be traded on the secondary market. But most Chinese domestic VCs are structured as companies which are deemed as legal persons by relevant Chinese laws.[119] Therefore, the policy of equity division meant that Chinese domestic VCs were not able to achieve exit via the SME Board even if their portfolio companies had been successfully listed on it. In 2005, in order to rescue the Chinese main boards from the brink of collapse, CSRC launched the reform to the policy of equity

[118] Id.

[119] Art. 2 of Company Law of PRC 2006.

Table 2 The Industry Spectrum of Listed Companies on the SME Board

Industry	2004		2005		2006		2007	
	VC-Backed	Non-VC-Backed	VC-Backed	Non-VC-Backed	VC-Backed	Non-VC-Backed	VC-Backed	Non-VC-Backed
Agriculture	0	0	1	0	0	2	0	1
Mining	0	0	0	0	0	0	1	1
Manufacture	9	25	2	7	8	28	20	56
Public utilities	0	0	0	1	0	0	0	0
Construction	0	0	0	0	0	3	1	1
Transportation and storage	0	1	0	1	0	0	0	0
Information technology	0	1	0	0	3	4	4	4
Sales and retails	0	1	0	0	0	1	0	1
Finance and insurance	0	0	0	0	0	0	0	1
Real estates	0	0	0	0	0	0	0	2
Social services	0	1	0	0	0	2	4	2
Media and entertainment	0	0	0	0	0	0	0	1
Others	0	0	0	0	0	1	0	0
Total	9	29	3	9	11	41	30	70

Source: China Venture Capital Yearbook (2008).[120]

Table 3 Numbers of Listed Companies on the SME Board

Year	Numbers of IPOs					
	VC-Backed		Non-VC-Backed		Total IPOs	
	Numbers	Percentage	Numbers	Percentage	Numbers	Percentage
2004	9	24.32	28	75.68	37	100
2005	3	25	9	75	12	100
2006	11	21.15	41	78.85	52	100
2007	30	30	70	70	100	100
Total	53	26.2	149	73.8	202	100

Source: China Venture Capital Yearbook (2008).[121]

[120] See fn. 16 at 367.
[121] Id. at 364.

division.[122] Benefiting from this reform, shares held by legal persons has been allowed to be traded on the SME Board.[123] Objectively speaking, the abolishment of the equity division policy has promoted the exit of Chinese domestic VCs through the SME Board. However, it also reflects that the Chinese stock markets are still SOE-oriented because of the control-based model and Chinese domestic VCs are at most the "free riders" of the policies in favor of state-controlled listed companies. Thus, without resetting the mission of the Chinese stock markets, the effects of any reforms at the technical level are inevitably limited.

To sum up, with the interest-aligned effect of the control-based model, the Chinese SEM Board has almost completely duplicated the main boards. Consequently, it cannot assume the duty to provide a smooth exit channel for Chinese domestic VCs.

4.3 The GEM

After ten years' discussion and waiting, the Chinese GEM was eventually launched by the Chinese central government in May 2009. In comparison with the main boards and the SME Board, the listing requirements and listing approval procedure of the GEM are more suitable for the reality of high technology venture enterprises. For example, in the aspect of accounting conditions, the GEM only requires that candidate enterprises should be continuously profitable in the past two years before listing; the net profits in the period must be above RMB 10 million *yuan*; the trend of profitability is lasting; and the net assets must be above RMB 20 million *yuan* at the end of the last quarter of the immediately previous accounting year.[124] In addition, in the aspect of the listing approval, the pre-approval of provincial governments is excluded.[125] Therefore, GEM is theoretically an ideal exit channel for Chinese domestic VCs. However, due to the negative effect of the control-based model, this function of GEM has not been fully made use of yet. I will try to prove this proposition below.

As we know, the main boards of stock markets provide a fundraising platform for established companies. Different from the main boards, the GEM is principally responsible for the exit of VCs from their successful portfolio firms

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[122] The CSRC, 关于上市公司股权分置改革试点有关问题的通知 (Notice Concerning the Pilot Reform of Equity Division), at http://www.csrc.gov.cn/pub/newsite/scb/gqfzg/200610/t20061031_70021.htm (last visited December 17, 2009).

[123] Id.

[124] See fn. 115.

[125] See http://finance.sina.com.cn/stock/opengem/index.shtml (last visited December 17, 2009).

and the fundraising of companies is just the "side products" of this kind of exit. The rationale underlying the orientation to GEM is that the potential of the VC industry for financing SMEs is much higher than that of GEM. Therefore, by acting as the exit channel of VCs, the GEM can stimulate potentially huge capital flowing into the VC industry and the adequate fundraising of VCs can in turn satisfy the financing demands from thousands of SMEs.[126] Unfortunately, this rationale has not been fully realized by the Chinese authorities because they always focus on the financing function of the main boards as the result of the control-based model. Consequently, this inertia has made them label the GEM as a market of financing as well. It means that the Chinese authorities do not pay much attention to the exit of Chinese domestic VCs via GEM, instead they care more about listing as many enterprises as possible. Even if it is rather limited at the moment because of the very short history of Chinese GEM, the existing empirical evidence can basically prove my above analysis. I checked the ten largest shareholders of the first twenty eight listed companies on GEM. I have found out that the ten largest shareholders of ten companies among the twenty eight listed companies do not include VCs. In addition, most VC institutions are GVCs invested into the eleven ones out of eighteen VC-backed companies just right before their listing for the purpose of being "free riders."[127] Therefore, among the twenty eight listed companies, the authentic exits of Chinese domestic VCs from their successful portfolio firms account for 25% at most.

To summarize, on the basis of the limited empirical evidence, we can figure out that the Chinese authorities put too much emphasis on the financing function of GEM and pay inadequate attention to its role of the exit channel for Chinese domestic VCs. Again, this kind of shortcoming is closely linked to the control-based model.

5 Conclusion

The existing research has proved that the availability of stock markets as exit channel is essential for the vitality of a country's VC industry. Unfortunately, with the institutional barriers imposed by the control-based model of the SCLCs, the exit way of Chinese domestic VCs via stock markets is still uneven. 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

[126] Siwei Cheng ed., 中国风险投资形成发展的战略思考 (The Strategic Thinking on the Formation and Development of Chinese Venture Capital Industry), Democracy and Construction Press (Beijing), at 210 (2002).

[127] See http://www.nbd.com.cn/newshtml/20091030/20091030024557388.html (last visited December 17, 2009).

reform proposals for the corporate governance of the SCLCs. In case of neglecting either of them in this process, the overall efficiency shall be jeopardized.

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