THE DEVELOPMENT OF CHINA'S EQUITY FUNDS

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ABSTRACT

The emergence and evolution of private equity (PE) investment funds in China have been notable in recent decades. This study identifies the pivotal role played by policy reforms, such as the creation of the Small and Medium Enterprise (SME) board and the reformation of equity divisions, in boosting the growth of PE funds. However, the growth of PE market has been accompanied by social issues such as illegal fundraising, operations, and infringements on investor rights. This research conducts an extensive review of the PE market's development, mining insights from both domestic and international economic experts and scholars. It also employs quantitative methods through statistical data analysis to gauge the historical progression and future prospects of PE market in China. The case studies of "Xin Hong Yuan Chuang" provides a qualitative dimension to the study. A comparative framework is adopted to shed light on the similarities and disparities between China's PE market and mature capital markets in Europe, Japan, and the United States. The analysis of these issues serves as a foundation for the strategic recommendations and solutions to enhance the robustness of China's PE sector. It is believed that a more conducive exogenous environment and a comprehensive internal system will pave the way for the PE industry's maturation in China.

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CHAPTER 1

INTRODUCTION

Since the early 1990s, China has been developing basic venture capital (VC) concepts and practices. Venture capital plays a crucial role in financing innovative startups and high-growth potential businesses by providing not only capital but also strategic guidance and network access. VC has significantly contributed to technological advancements and economic growth in many developed countries. However, not until approximately 2000 did the private equity (PE) system truly witness development. In particular, driven by a series of favorable policies, including the launching of the small and medium enterprise (SME) board in 2004, the reformation of the equity division in 2006, the amendment of *Partnership Enterprise Law* in 2007, and the official launching of ChiNext in 2009 after a decade of preparation, PE funds have exhibited a growth spurt. At one point, “nationwide prevailing PE” became a topic of considerable interest in China’s financial and capital markets. However, although PE funds continue to increase substantially, promoting the rapid development of China’s economy, several vicious social problems have arisen, such as illegal fundraising, illegal operations, the infringement of the rights and interests of PE investors, and PE corruption.

This thesis focuses on problems that have emerged in practice. Moreover, I have summarized the gratifying results of China’s PE funds’ actual operations in recent years and identified valuable experiences that can be leveraged in the future. Conversely, I have also analyzed a number of reasons and improper measures that resulted in relevant problems, summarized the lessons from different levels and sectors, and actively drawn on international experience to develop countermeasures and suggestions that address the sound development of PE funds in China.

1.1 Research Background

Although PE funds have been undergoing development in China for nearly 20 years and the PE capital market has recently expanded through supportive government policies, these types of funds are still in the primary stage of extensive development. Studies in related fields generally hold that the lack of a favorable development environment for PE funds, as one of the important branches of the financial industry, is the root cause of the current relevant social problems. In other words, a good exogenous environment and a healthy internal system are the cornerstones of the existence and development of the PE industry. Moreover, a scientific development system is of fundamental meaning and significance for the stable development of a country’s PE funds and the protection of investors’ rights and interests. On the whole, China’s PE fund industry has not yet established a mature development system. Even research on the entire system is still slow-paced, and no such practices exist in some of the key sectors, a lack that has become an intractable hindrance to the sound development of the industry.

Since 2006, through the issuance of many administrative measures and the amendment of a series of laws, including the *Partnership Enterprise Law*, the *Interim Measures for the Administration of Startup Investment Enterprises*, and the *Company Law*, a basic legal framework has been established for PE funds. With respect to funds' organizational form, PE funds in China were mainly in a corporate system before the amendment of the *Partnership Enterprise Law*. After the amendment, these funds have become primarily limited partnerships. However, this led to ambiguous functions for limited and general partners and eventually resulted in suppressed incentives and limited partnership-related constraints on fund managers. The outcome was the stifling of fund managers' ability to identify and create value in investment portfolio companies. Thus, "rent dissipation" became prevalent, which has restricted the development of China's PE capital market to a certain extent. After years of active reformations, the problem of equity division in China's capital market has been solved, and a multi-level capital market system is being rapidly developed, thereby facilitating investing in and exiting from PE funds—both laudable achievements. Compared to the rapid growth of domestic enterprises and sufficient capital in the market, current financing instruments and financial services fail to meet the needs of today's enterprises, given still low conversion efficiency from savings to investment. This situation has created vigorous market demand and a financing basis for the development of PE funds.

The financing capacity of global PE funds can be estimated at more than US $2 trillion, an enormous sum to which all countries must attach sufficient importance. In particular, the Asia-Pacific region has become a highly sought-after market for PE funds. More specifically, China's market has become the focus of capital, with PE funds spreading across China in recent years. At the same time, local Chinese PE funds continue to seek value creation opportunities and strive to gain a foothold in the high-yield PE market. However, given their limited marketplace experience and imperfect policies and laws, China's local PE funds have always been inferior to foreign ones. A wide gap exists between these funds and foreign-funded PE funds in terms of market share, profitability, and influence. A review of the development process of China's PE funds indicates that to meet the objective demands of actual economic development for financial reforms, China also carried out explorations of local PE funds at an accelerated pace on the basis of totaling the gains and losses related to the development of VC funds effectively. Starting in 1985, China's VC funds have undergone approximately four stages: enlightenment, slow development, irrationally rapid expansion, and appropriate adjustments. Currently, these funds have embraced a stage of relatively rational development under government guidance. Continuing such explorations for more than 20 years is a difficult task. At the micro level, the industry has also engaged in numerous rewarding explorations for the market-oriented development mode of China’s PE funds. Since approximately 2006, interested investors have made positive attempts through forms such as trust equity investment plans, limited partnership equity funds, and industrial investment funds and have experienced a series of gratifying achievements. However, because the pilot operation lasted for only a short time, the form of operation that may be more suitable for the development of PE funds in China has yet to be proven. Perhaps only when the prominent problem of the structural supply-demand imbalance in the financial market is solved in a step-by-step fashion can we find the answer.

On the one hand, a large number of enterprises in China, particularly small- and medium-sized ones, are full of growth potential but lack appropriate capital. China is faced with the system defects of indirect financing and structural defects of direct financing, which has led to a less multi-level capital market, difficulties faced by private capital in entering the banking system, and inefficient capital operations, among many other problems. Enterprises typically resort to securities markets, capital markets, or banking systems for financing. For most Chinese enterprises, however, banks have been the first choice of financing for a long time. China’s major financial institutions (shareholding commercial banks, four major state-owned commercial banks, and policy banks) hold approximately 80% of all financial assets and play a major role in loan origination and deposit inducement in China. However, subject to the specific institutional and economic development paths, in the current economic context, banks’ loan origination process is notably affected by their policy biases, resulting in bank funds mainly flowing to industries and regions on which the government focuses. By contrast, general SMEs, particularly private ones, have difficulty obtaining bank loans. Moreover, from the perspective of securities market financings, only approximately 2,000 companies and enterprises listed in Shanghai and Shenzhen can achieve expanded financing. In other words, a very high threshold prevents most enterprises from gaining access to the securities market by being listed, given that obtaining a listing is considerably difficult for many SMEs. Therefore, SMEs can obtain financing only from other capital markets that can be divided into two forms: public offerings and private offerings. A public offering indicates that enterprises finance by issuing bonds. Given the current strict approval and qualification requirements, only large companies are eligible for bond issuances, as testified by the fact that the corporate bonds issued every year amount to only tens of or several billion yuan. Consequently, private offerings represent the only true financing alternative for SMEs.

On the other hand, China's foreign exchange reserves have grown rapidly in the past 10-plus years. Although the export-oriented development mode has expanded wealth, it has also resulted in hidden dangers related to internal and external economic imbalances. When external demand shrinks because of an international financial crisis, for some time, domestic surplus funds are expected to face difficulties in finding suitable investment opportunities. As a result, many bubbles will be created passively. At the end of 1996, China's foreign exchange reserves topped US $100 billion for the first time; this figure soared to US $200 billion at the end of 2001 and US $818.9 billion at the end of 2005. At the end of February 2006, China's foreign exchange reserves had surpassed those of Japan, identifying China as having the largest global foreign exchange reserves at US $853.6 billion. By the end of October 2006, China's foreign exchange reserves exceeded US $1 trillion. In late August 2008, data released by the People's Bank of China indicated that the balance of China's foreign exchange reserves was US $1,905.585 billion, up 19.86% from the prior year and marking a new peak. Although the accelerated growth of China's foreign exchange reserves has abated slightly in recent years, the overall expansion trend has not fundamentally reversed. Relevant statistics indicate that the increase in China's foreign exchange reserves in the first half of 2013 was US $219 billion. Such massive foreign exchange reserves have aggravated the mobility of excess capital in China's market. At the same time, these reserves have intensified the imbalance between domestic and international economic development to a certain extent. Finding a better market for investments has become a common topic for various funds.

At present, another unavoidable focus of China's capital market is the loss of high-quality resources under the supply-demand imbalance. On the one hand, capital providers have sufficient funds, but few projects are available for investment. On the other hand, those demanding capital are short of funds. They want to borrow but have no reliable and stable sources from which to borrow. Although multinational PE funds are optimistic about China's PE market, a large number of well-known Chinese PE fund companies have gone to overseas markets, enabling foreign investors to earn substantial investment returns from the Chinese PE market. For example, in October 2002, three foreign investment companies, including Morgan Stanley, acquired the shares of Mengniu Dairy for a total investment of 500 million yuan. Subsequently, Mengniu earned a significant return of HK $2.6 billion after listing. In 2003, CDH Investments and Singapore Investment Corporation invested US $18.5 million in Li Ning Company Limited, and the 2004 equity value of this investment was worth up to US $200 million after the company listed on the Hong Kong Exchanges and Clearing Limited (HKEX). The return was approximately tenfold.

The key reason for the aforementioned major problems is that China lacks a channel for effectively moderating the surplus and deficit of funds, which is also a specific embodiment of the serious lack of a multi-level capital market in China. Wu Xiaoling, the former vice president of the People's Bank of China, clarified at the Financial Development Forum in the Tianjin Binhai New Area in June 2006 that China's capital market characteristic of being less multi-leveled is its fatal defect. Public offerings and listings have become the only choice for numerous enterprises of different types and sizes in the capital market. The situation has substantially restricted the country's efforts to promote independent innovation and propel the implementation of development strategies for SMEs. In addition, these efforts rarely occurred during the development of capital markets throughout the world. On September 20, 2007, Wu Xiaoling further stated her point of view at the International Seminar on China's Private Equity Funds. At present, foreign PE funds are pouring into China, whereas Chinese companies must detour to overseas markets. The financial lag will restrict the competitiveness of Chinese enterprises on the international stage, and Chinese-funded institutions will never be competitive if China is not relieved from such financial constraints.

Privately offered funds are important institutional investors in capital markets. On the one hand, privately offered funds pool a large amount of wealth characterized by considerable funds and a strong ability to bear risk. On the other hand, experts in investment analysis manage such funds, making them conducive to identifying corporate value. Regarding private securities investment funds and PE funds, developing the latter is imperative. To alleviate this crisis, Wu Xiaoling proposed a solution whereby various forms of PE funds organically connect enterprises at different development levels with multi-level capital markets for cooperation and mutual promotion by taking advantage of their convenience, flexibility, and unique investment fields. Doing so would not only substantially improve resource allocation and risk diversification in capital markets but also enable these funds to play meaningful roles in promoting industrial innovation and transformation.1 China's financial reform was viewed as extremely urgent, and accelerating the development of the PE fund market is an important direction of financial reform.

1.2 Significance Of The Research

To date, many countries have recognized the positive role of PE funds in promoting national economic development. The development path of the PE fund industry in the United States (hereafter US) and Europe indicates that governments provided irreplaceable incentives and support for the development of the PE industry. In relation to

[1] Zhai Wenchao: "Research on the Relationship between Developing China's PE Funds and Promoting the Growth of China's SMEs" [D], Capital University of Economics, 2010

China, the role of the government in the future should be based on providing support and guidance rather than intervention. As the government continues to introduce reforms to improve the basic macro environment of the PE industry, the belief is that China's financial market will operate more efficiently and smoothly, and China's economic operation efficiency and global influence will be considerably enhanced.

1.2.1 Helping Promote Institutional Change In Various Types Of Enterprises

Statistics by relevant research PE fund institutions show that global PE funds raised US $215 billion from capital markets in 2006, of which more than US $150 billion went to buyout-based PE funds. During the same year, total investments into global PE funds reached US $738 billion, double the figure for 2005. Among these investments, 13 PE trades were more than US $700 million, deal by deal. Institutions such as Blackstone, Ruler, Carlyle, Bain Capital, Apollo, TPG Capital, Goldman Sachs, and Merrill Lynch appear in several large-scale investments as well as mergers and acquisitions (M&A) transactions, providing experience to China's corporate system reform. For many state-owned enterprises, transforming without being externally promoted is rather difficult. Simultaneously, because many industries in China are subject to regulations that restrict foreign investments, many obstacles exist to obtaining government approvals for the operating mechanism that relies on foreign capital to improve state-owned enterprises. At this time, the Chinese PE fund that operates in a specified manner may become an intermediate force acceptable to all parties. On the one hand, enterprises are "outsiders" that can affect the forced vibration as outsiders; on the other hand, enterprises are also "insiders" in the Chinese economy and will not be suppressed or rejected by various conservative forces and exclusion-oriented interest groups in the society.

Given the increasing competition in China's PE investment industry, particularly the fierce competition in the pre-initial public offerings (IPO) sector, PE investment institutions can adopt differentiated competitive strategies, attach greater importance to early-stage projects, and be involved more often in first-round investments of SMEs. SME investment projects, characterized by significant uncertainty and risk, also feature strong return potential, which can help open up investment projects in central and western regions to avoid fierce competition in the eastern coastal areas. However, the key to the implementation of a differentiation strategy in the PE industry is to focus on talent training because talent represents the core competitiveness of the PE investment industry, particularly when evaluating early-stage projects.

1.2.2 Helping Improve The Overall Operating Efficiency Of The Chinese Economy

The development of the foreign PE industry indicates that this industry is cyclical and fluctuates with the economic cycle. China has recovered from the global economic crisis of 2008 and maintains its current status. China's PE industry also witnessed rapid development through the economic recovery and the launching of ChiNext. At the same time, along with the emergence of inflation, China's economy may also undergo an adjustment phase in the future, the IPO market may experience a low tide period, and valuations will also be adjusted downward. Therefore, in the future, the current boom in the PE investment industry will also be adjusted, and many projects will not be able to exit through an IPO. Regarding project investment during this booming period of the industry, a project's risk management should be strengthened; in other words, rational attention must be given to risks, even in a booming market. At the same time, the after-service of an investment portfolio needs to be strengthened to achieve the long-term stable development of investment projects. Thus, even if future economic shrinkage has a negative effect, investment projects that do not result in serious losses to investment institutions will help realize the long-term development of investment institutions, thereby driving the overall relatively stable growth of the Chinese economy.

Similar to PE funds across the world, China's PE funds also need to capture opportunities for efficiency improvements in the investment process. To a large extent, the inefficiency of individual Chinese enterprises must inevitably lead to inefficiency in the Chinese economy as a whole, and efficiency improvements of individual Chinese enterprises are translated into efficiency improvements for the Chinese economy as a whole.

1.2.3 Helping Enhance China's Influence In The Global Economy

The US is widely regarded as a model for VC markets. When compared to other countries with considerably sized VC industries, including Canada, Israel, the United Kingdom (hereafter the UK), and Sweden, all the aforementioned countries share similar economies, cultures, and legal systems. They all feature the cultural tradition of entrepreneurship and risk-taking; sound legal systems that can protect the interests of investors and startups well; supportive rather than intervening governments; an abundance of high-tech talent and free-flowing labor markets; loose tax systems; strong R&D teams, including universities or national research institutions; and active IPO markets. Although a large gap exists between the West and the East in terms of social systems, legal systems, and cultural traditions, China can still draw on the development experiences of Europe and America, make the utmost effort in developing the PE fund market with Chinese characteristics, and promote steady economic and social transformation in the country.

“As companies such as Ruler and Blackstone have completely become global enterprises, China’s PE funds must go global after being developed to a certain level to seize the value creation opportunity in the global economy. The Chinese economy, as the first player in the future world, must develop its corresponding global economic influence and action capability. In this regard, China’s industries and enterprises must gradually go global, similar to Lenovo. Moreover, such mouthpieces of global influence and action capability should exist in the PE industry.”2

1.3 Motivation Of The Research

1.3.1 Assembling Research On PE Investments At Home And Abroad To Present The Literature Review

As PE investment funds have rapidly developed since the middle of the last century in the developed capital markets of Europe and America, research in the 1990s on relevant economic sectors and academic communities ushered in an upsurge, which mainly focused on the following aspects: first, the scope of investments; second, on the motivation and influential factors of fund development; third, on investment target assets; fourth, on the supervision of target assets; and fifth, on investment realizability.

Then, the theoretical basis of PE investments was introduced, including definitions of concepts, classifications, and characteristics. At the same time, the scope of the research was also defined herein.

Unlike public funds, PE funds primarily refer to medium- or long-term investment instruments for special individuals or institutional investors that are privately raised, invest in the equity of unlisted enterprises, and finally realize returns by selecting appropriate exit paths. According to the development stages of enterprises in which PE funds are invested, these funds can be interpreted in both broad and narrow senses. In a narrow sense, PE funds mainly invest in enterprises in the medium or late stages of development that are relatively well-established and have stable capital flows. In a broad sense, PE funds mainly invest in unlisted enterprises at various stages of development. They also invest in enterprises in their early stage of development, similar to VC funds. In this dissertation, PE funds are defined as collective investments and financing instruments that invest in unlisted equities for the ultimate purpose of earning profits. Since statistics on PE investments in developed countries in Europe and America are aimed at PE funds in a broad sense, for the convenience of this research, PE funds in a broad sense are also mainly adopted for statistical purposes, including VC and PE funds in a narrow sense. According to the funds’ investment stage, PE in a narrow sense can be divided into growth capital, M&A capital, mezzanine capital, turnaround capital, pre-IPO, and private investment in public equity (PIPE), among others.

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[2] Huang Yaling: “Literature Review of PE Funds” [J], Studies of International Finance, 2009(3), pp.88−96

1.3.2 Studying The Development Experience Of The PE Investment Industry In The US

At present, no clear provision exists concerning private funds in the US. A private fund was first defined as a "transaction by an issuer not involving any public offering," namely, a private offering transaction, in Section 4(2) of the *Securities Law of 1933*. Thereafter, Rule 506 under Regulation D, which went into force in 1982, specified the standards of private offerings as follows: 1. the number of investors: up to 35; 2. qualification requirements for investors: sophisticated investors with financial and commercial knowledge and experience who can evaluate projects' feasibility and risk factors; 3. information disclosure: an issuer should provide sufficient information to investors within a reasonable period prior to securities offerings; 4. fundraising method: raising funds through solicitations or advertising is prohibited; 5. duty of care: an issuer should exercise reasonable care to ensure that investors abide by resale restrictions; and 6. exemption: an issuer that is entitled to an exemption should file a notice with the US Securities and Exchange Commission within 15 days after the first sale of securities in the offering.

After more than half a century of development, the US has established a standardized and scientific operation mechanism for the PE industry, which is characterized as follows. First, PE funds mainly raise funds from large institutional investors, with pension funds accounting for the largest proportion, followed by endowment funds, banks, and insurance companies. Individual investors have little impact on the PE market. Second, funds in the US are the largest in the world. According to *Private Funds Statistics 2014*, the US had 8,635 private securities funds (hedge funds) or 35% of all such funds globally and total assets of US $6.09 trillion or 61.14% globally as well as 8,407 PE funds or 34% of such funds globally and total assets of US $1.89 trillion or 18.98% globally. Unlike private funds in China, private funds in the US are mainly private securities funds (hedge funds).

In contrast to China's private fund market, the private fund market in the US is dominated by private securities funds for the following reasons.

First, the US has well-developed and standardized secondary capital markets. Compared to those in China, the secondary capital markets in the US are characterized as follows:

(1) by a reasonable structure of investors and investors' preferences for professional institutional investors on the basis of the trustee and trustworthiness culture in the US, which promotes the development of a large number of private securities funds during the entrustment stage, and

(2) by a variety of investment tools used by professional institutions to diversify their investments and leverage effects by virtue of diversified hedge funds, gain high returns through derivatives and complete financial products,

and develop more creative and flexible asset portfolios. Hence, investors prefer to entrust professional private fund institutions with making investments.

Second, relative to PE funds, hedge funds generally invest in highly liquid assets, such as stocks, bonds, and a small amount of equity. In the face of the unstable global economic environment, investors in the US as the leader of global economic development can make timely changes to investment strategies through their hedge funds, thereby preventing the low liquidity risk of equity funds and the systemic investment losses caused by economic downturns.

Third, relative to China, the US has a relatively relaxed financing environment with three major investment and financing instruments: investment banks, hedge funds, and equity funds. American banks rely on their advantages in historical development and concentrate on equity investments and the size of the PE fund market. PE funds have far inferior financial and human resources relative to investment banks. Therefore, the private fund market in the US is dominated by private securities funds (hedge funds).

1.3.3 Studying The Current Management Mode In China Through The International Experience

We analyze PE capital development in the US to summarize the international experience of PE capital development. PE capital development is of great significance in improving relevant policies and systems related to developing China's PE capital industry and controlling risks in the PE capital industry.

(1) PE capital development requires diversified fundraising channels.

The main source of PE capital is large investment institutions with solid capital strength, such as pension funds, banks, and insurance companies, whereas individual investors are unlikely to become key sources. One of the main reasons for the rapid development of the PE capital industry in the US is that pension funds were allowed to enter the field of PE capital in the late 1970s. During the PE capital-raising process, the US has strengthened regulations over access to and the operation of the PE capital market by selecting appropriate organizational forms, thereby achieving sustainable development of the PE capital market. Limited partnership is the main organizational form of PE capital development in developed countries such as the US. Compared to other organizational forms, the limited partnership is more effective as an incentive and restraint mechanism as well as more conducive to maximizing the interests of PE capital investors. In China, although existing policies allow pension funds to invest in the PE capital industry, the proportion is too low to meet the needs of PE capital development. Thus, the government should further relax the restrictions on investments in the PE capital industry by financial institutions such as pension funds, social security funds, insurance companies, securities companies, and banks; increase the proportion of institutional investors as sources of PE capital; and diversify PE capital-raising channels.

(2) PE capital development requires a good investment environment.

From the aspect of PE capital investment, the experience in developed countries such as European countries and the US indicates that, despite differences in investment priorities, developed countries are similar in that the development of PE capital cannot be separated from a good investment environment. The stages, priorities, and areas of PE capital investment always change with changes in the investment environment. PE capital as an investment tool depends on a good external environment, including a booming economy, a healthy market environment, and a perfect policy support and regulatory system. First, a strong economic base is essential for developing the PE capital industry and is conducive to the innovation of the PE capital investment system, thus resulting in abundant capital investments. Further, the sustainable and healthy development of the PE capital industry can effectively attract various social resources, give full play to professional advantages, and optimize a combination of resources through M&A, restructurings, and reinvestments. These factors will help accelerate the adjustments and upgrades to the industrial structure and promote the sustainable development of the social economy. For example, the NASDAQ market in the US supports the growth of high-tech enterprises in the US. Second, to promote the development of PE capital, relevant laws, and regulations have been issued in many countries and regions to provide support and guidance, thereby creating a good market environment for PE capital investments. For example, some countries provide financial support to emerging industries in the early stages through the combination of government capital and VC, supplemented by appropriate preferential tax policies. Third, the regulatory system is also an important factor for the healthy development of PE capital. A sound regulatory system can effectively avoid the risks of PE capital investments, insider trading, and crises. Consequently, regulatory authorities are required to have keen insights and outstanding risk awareness and take active measures to prevent various risks and crises related to PE capital investments.

(3) PE capital development requires effective post-investment management.

Characterized by comprehensiveness and high practicality, the post-investment management of PE capital can bring not only funds but also advanced management concepts to invested companies. For most entrepreneurs, despite their rich professional technical knowledge, a lack of knowledge and experience in enterprise operations and management may impede the development and growth of their enterprises. In other words, some enterprises do not lack funds, and the main purpose for them to attract PE capital is to obtain strong external and internal governance support for their rapid growth and capital appreciation through the participation of PE capital investment institutions in enterprise management. As a result, the post-investment management of PE capital can not only maintain the driving force for the development of invested enterprises but also protect investment interests effectively. According to experience in developed countries such as the US, most startup enterprises are initiated by new technology inventors who have strong competitive advantages in technology but typically lack business experience in market expansion, financial management, human resources management, and so on. By contrast, the managers of PE capital investment funds have abundant knowledge and experience in grasping market trends and exploiting investment opportunities as well as in enterprise operations and management. They can assist and support invested enterprises in terms of enterprise operations management and interpersonal relationships, thereby helping invested enterprises achieve their set goals. At present, the support provided by PE capital investment institutions in China to invested enterprises is limited to capital support, but support is seriously lacking for post-investment management urgently needed. Hence, in addition to providing capital support, PE capital investment institutions in China should focus on providing expert advice and guidance as well as professional services, such as management information and cooperative platform construction, to invested enterprises. This will advance the rapid growth and capital appreciation of invested enterprises and increase the income from PE capital investments. Furthermore, such a focus will be vital to the healthy development of China's PE capital industry.

(4) PE capital development requires smooth exit channels.

A sound exit mechanism is essential to the development of PE capital. PE capital focuses on equity appreciation, and exiting after profit-making is the main goal of PE capital. In the US, exiting through the primary market, such as an IPO, M&A, and resale, is still preferred, whereas existing through the secondary market has begun to show its superiority. In China, in addition to further improving the primary market for PE capital investment funds, the government should take effective measures to accelerate the construction and development of the secondary market for these funds, build an open and effective trading platform for PE capital in China, and efficiently increase the exit channels of PE capital investors by vigorously developing the professional intermediary agencies of PE capital investments. As is understood, the rapid development of the secondary market for PE capital is inseparable from the negotiation agency, consulting, and evaluation services provided by intermediary agencies such as investment services, consulting, and intellectual property evaluation. Moreover, countries such as the US have shown that the long-term construction and development of as well as volume and liquidity increases in the secondary market for PE capital entail constructing open and effective trading platforms for such capital. Hence, to considerably strengthen the competitiveness of China's PE capital market, professional intermediary agencies should be vigorously developed in the PE capital secondary market, and constructing and developing open and effective secondary market trading platforms for PE capital should be actively promoted. China should accelerate the construction of a nationwide PE capital trading platform that combines domestic conditions with lessons from foreign experiences during system construction and regulation. This important measure can advance the long-term construction and development of China's secondary market for PE capital. Further, expediting system construction can provide the legal basis for an exit through the secondary market. To effectively increase the willingness of China's PE capital investment funds to exit by transferring investment interests through the secondary market, China can adopt several changes. These changes include learning from the regulations and practices on publicity restrictions of the PE capital industry specified in JOBS of the US and its specific rules for implementation, changing the traditional restrictions on the publicity of PE capital issuances and transfers, and allowing institutional investors to advertise and conduct publicity via newspapers, networks, or TV if buyers are qualified investors. Such changes can increase the willingness of PE investors to exit through the secondary market and boost the healthy development of China's secondary market for PE capital.

1.4 Research Ideas And Methods

Given the research on the development of PE investment funds, this topic is divided into several aspects. First, research results from experts in domestic and foreign economic fields and academic circles are quoted, and the general conclusion of the topic research is summarized as a reference. Second, gold's development process, current situation, and prospects are analyzed by means of statistical data analysis as the basis of an in-depth analysis of the theme. Third, many problems in the development process are analyzed by using the case method of analysis, and similarities and differences between PE in China and developed capital markets in Europe and the US are compared to provide the basis for proposing solutions to promote the development of PE in China. Finally, corresponding solutions to existing disadvantages are proposed. Therefore, the research methods for this topic mainly include literature reference analysis, data statistics analysis, comparative analysis, and case analysis.

This topic mainly reveals the various shortcomings and obstacles of PE in China, analyzes the causes, combines the basic conditions of the domestic economy and financial markets, and develops countermeasures and suggestions to promote its development. A related overview of PE investment funds is first elaborated on by referencing and summarizing the relevant theoretical results of experts in domestic and foreign economic fields and academic circles. After elaborating on the relevant definitions, types, and functions of PE investment funds, the development process, current situation, and prospects for PE investment funds in China are analyzed by means of data statistics. After the theoretical analysis, problems in the development process of China's PE investment funds are determined by using CDH investments and Blue Ridge China as investment cases. Finally, corresponding solutions are proposed against drawbacks and obstacles.

1.5 Innovation And Shortcomings Of The Paper

1.5.1 Main Innovative Points

For the research on the development of PE investment funds, this topic mainly adopts different analysis methods, such as the literature reference analysis method, data statistics analysis method, comparative analysis method, and case analysis method. These methods allow for a relatively comprehensive introduction and analysis of the core content of the project. Different data are used to analyze the history, current situation, and prospects of PE in China, allowing for a relatively comprehensive analysis of the overall situation of China's PE investment funds. On this basis, two cases are used to expose the subject's core issues and reveal existing problems or restrictive factors of many aspects of China's PE investment funds. In addition, the comparative analysis method is used to analyze the development status of PE in China's and overseas markets. On the whole, numerous analytical methods have been applied in this study. Comprehensive core problems have been found, and corresponding solutions to these problems have been put forward as well as countermeasures and suggestions to improve the practical significance and value of the research.

1.5.2 Shortcomings

The overall notion of this topic of the development of China's PE investment fund is still "putting forward the core problem—determining the problem—and proposing a solution." Although various analytical methods are combined in the analyses, more objective existing problems can be found, and more comprehensive solutions are proposed. Given a lack of data to build data models, quantitative analysis is not available for many issues but is frequently required and reflects a limitation of this research. Further, this study is restricted because of its focus on theoretical research. Moreover, as limited by my lack of energy, the research is still insufficient on a practical level.

CHAPTER 2

LITERATURE REVIEW, EVALUATION, AND ENLIGHTENMENT

In the 1940s, PE funds originated in the US, where they were subsequently fully developed. PE funds gradually expanded to continental Europe, the UK, Asia, and other parts of the world and have become an important concept in financial research and practice. The maturity and brand awareness of American PE funds consistently lead the world in terms of market perfection and historical performance, followed by European PE funds, and rising trends are observed in other regions. Many foreign scholars have studied PE funds in the US and continental Europe from various perspectives, as well as their financing activities, such as principal-agent risk and exit mechanisms (Black & Gilson, 1998; Kaplan & Stromberg, 2009). These studies have guided the development of PE funds. By contrast, China’s PE funds in terms of market behavior are still in the independent exploration stage. Given insufficient practical experience, theoretical research has more of a learning and exploratory nature (Bruton & Ahlstrom, 2003). However, in recent years, the research has significantly yielded increasing results, and the research depth of the relevant results has steadily improved (Bruton et al., 2005).

2.1 Progress Of Research On PE Funds In Foreign Countries

The first step to researching a PE fund is to determine its core concept. Throughout the world, many different definitions exist for PE funds. In continental Europe, PE funds can be viewed directly as VC. VC generally refers to the equity investment of institutions, enterprises, or wealthy individuals in the early stage of development or the expansion of emerging enterprises (Cumming & Johan, 2007). The European Private Equity and Venture Capital Association (EVCA) (2001) defines VC as a professional equity investment fund that invests in the early (seed and startup) stages and the expansion stage of an enterprise. The Organization for Economic Cooperation and Development defines PE more broadly. All production or operation of technology-intensive innovative products or services and high-tech and knowledge-based industry investments are considered to be VC (Gompers & Lerner, 2004). The official literature of the British Venture Capital Association (BVCA) views VC as an alternative to PE funds, and the BVCA assists unlisted companies’ growth by providing long-term equity capital investments. The official statement of the American Venture Capital Association and two authoritative research institutions in the US, Venture Economics and Venture One, divides the positioning of PE funds into two aspects: broad and narrow definitions. The broad definition includes all risk investment funds, management buyouts (MBO), mezzanine investments, fund of funds (FOF), and secondary investment funds. Risk investment funds are not included in the narrow definition.

In the book “The Economics of the Private Equity Market,” Fenn, Prowse, and Liang (1995) systematically introduced the development history of American PE funds and divided it into four stages: early, formation, expansion, and maturity. By using the attributes of PE funds, two scholars divided these funds into two categories: non-entrepreneurial PE funds and entrepreneurial PE funds. They also analyzed the participants and each PE fund category, described the entire operation process of PE funds, and analyzed the reasons why PE funds were needed as intermediaries in the PE market. Their basic research framework on PE funds has a strong reference value and significance for the research in this field.

Since the turn of the century, research on PE funds began to standardize, and the contents gradually increased in profundity (Hall & Lerner, 2010). In “Venture Capital and Private Equity: A Course Review,” Josh Lemer (1997) reviewed issues such as fundraising and structure, the role of investors and enterprises, and their exit from the development of global PE funds from the 1980s to 1995. He also conducted a comparative analysis of why the development level of PE funds in the US differed from that in Europe. The author highlighted “exit efficiency” as one of the most important reasons. According to “Venture Capital and Private Equity: Review and Summary,” written by Mike Wright and Ken Robbie (1998), VC originated in the US, spread to the UK, and then developed in other European countries. Given the rapid application of the term “private equity,” the research and investment scope of VC has been greatly broadened. VC includes not only early-stage investments in enterprises but also late-stage investments and acquisitions. Even some public funds are starting to participate in private placements.

2.2 The Basic Research Progress Of PE Funds In China

Chinese translations of PE funds vary widely, and two generally accepted Chinese versions exist: 私人股权基金 and 私募股权基金. Throughout the history of foreign development, PE funds have been mainly collected from specific objects. Since “private” is the opposite of “public,” most scholars believe that 私募 is the more appropriate translation. Little debate exists on the translation of the word equity into 股权. However, PE funds invest in equity, similar to many mature other investment vehicles, such as common stock, convertible preferred stock, participating preferred stock, and redeemable preferred stock. In addition, instruments similar to warrants and options may be used when designing trading structures. However, any financial instrument will ultimately involve an equity stake in the companies in which it is invested. From this perspective, the translation of the word equity as 股权 is proper.

Although the basic understanding is consistent, in practical research, some differences still exist among scholars when defining PE funds given different positions and objectives. Sheng Lijun (2003) believed that PE funds make equity investments in unlisted enterprises and earn profits through exits. His definition of a PE fund also includes narrow and broad concepts. In the broad concept, the definition refers to the PE investment fund for non-listed enterprises in the seed stage, the startup stage, the development stage, the expansion stage, the maturity stage, and the pre-IPO stage. In the narrow concept, the definition refers to the equity investment fund of unlisted mature enterprises that have formed a certain scale and have generated stable cash flow. Zhou Wei (2007) observed that PE funds include VC, buyouts, mezzanine, real estate, distressed, and facilities. Zhou Wei's definition mixed two classification methods. First, PE can be divided into VC funds, acquisition funds, and mezzanine funds according to the investment stage. Second, PE funds can invest in any industry that generates high returns, such as agriculture, manufacturing, real estate, pharmaceuticals, education, and health. Therefore, this definition only approximately describes PE investment activities and does not fully describe the nature of PE funds.3 Wu Xiaoling, the former vice governor of the People's Bank of China, delivered a speech at the Annual Conference of China M&A and the First China International Private Equity Forum in June 2007. She defined various VC funds or industrial investment funds that mainly invest in unlisted enterprises as China-based PE funds, similar to the Bohai Industrial Investment Fund. According to Article II of Chapter I in "Measures for the Administration of Industry Investment Funds," the industrial investment fund refers to a type of equity investment in unlisted enterprises that provides management services, such as benefit-sharing and a risk-sharing collective investment system, and mainly engages in VC, corporate restructuring investments, infrastructure investments, and other industrial investments.4

Li Xinyang and Yang Wenhai (2008) have their unique views of the differences between industrial investment funds and PE funds that are characterized by three significant features: government-led investments, the regional differentiation of investments, and non-profits. Therefore, in the original sense, a vast difference exists between industrial investment funds and PE funds. These points of view show that PE funds have several features. First, these funds come from specific institutions and individuals. Second, equity investment is the subject. Third, the capital operation process is characterized by three stages: project screening, investment, and exit.

[3] Sun Xun: "Research on the Development of Private Equity Fund in Chinese Capital Market" [D], Harbin Institute of Technology, 2009

[4] State Development Planning Commission: Measures for the Administration of Industry Investment Funds, 2006

The understanding of different scholars at home and abroad shows that the essence of a PE fund is its PE investment in non-listed enterprises. The basic understanding is that investors in the market carefully screen before making investment decisions and then realize a value increase in equity through an exit after making an investment, which has led researchers in various fields to engage in significant exploration. The literature on PE funds is dazzling. Scholars at home and abroad have studied and expanded the denotation of PE funds from various perspectives, such as capital sources, screening mechanisms of enterprises and projects, design of transaction structures, risk control, exit mechanisms, and empirical research on investment performance and PE fund risk. From the research level, these studies mainly focused on three aspects: first, the factors that affect the development of the PE industry; second, the principal–agent risk control problem; and finally, the exit mechanism of the PE industry.

2.3 Research On The Influencing Factors Of PE Funds And Their Progress

The basic macro environment is the primary factor affecting the development of PE funds. Acs and Audretsch (1994) pointed out that enterprises' entrepreneurial activities were profoundly affected by changes in macroeconomic factors, such as gross domestic product (GDP) and loan interest rates. The demand for VC is directly proportional to the growth of GDP (Kaplan et al., 2002). In addition, enterprises can obtain more financing channels, and investors can enjoy a better investment environment, all of which are closely related to GDP growth. Further, improvement in these factors promotes an increase in the startup capital supply. From this perspective, GDP growth has a strong promotional effect on the development of the PE industry. In addition, the lending rate is a sensitive reflection of the breadth and depth of the debt market and the inherent degree of risk.

At present, no consensus exists on the empirical research results of the main influencing factors. Gompers and Lerner (1998) studied the financing process of PE funds in the US and pointed out that various important factors affecting the development of the PE industry include the GDP growth rate, the stock market return rate, capital gains taxes, pension fund size, R&D expenditures, and company performance and reputation. Among these factors, the GDP growth rate has the most significant impact on the VC industry, whereas the impact of IPOs on PE is not obvious. In addition, a country's economic situation will affect the development of the PE market.

Jeng and Wells (2000) studied panel data from 21 countries for 10 years as samples and systematically analyzed the factors affecting PE industry development, such as IPOs, labor market liquidity, financial reporting standards, private pension funds, GDP growth rate, market capitalization, and government policies. The degree of market capitalization reflects the comprehensive breadth, depth, and liquidity of the equity capital market. An improvement in market capitalization reflects the enhancement of market liquidity and the improvement in the comprehensive investment environment, whereas an improvement in equity market capitalization is a lateral reflection of the increase in the PE capital supply. From this perspective, the development of the PE industry will be affected by capital market liquidity, which will reduce the financing channels provided by enterprises. Jeng and Wells contradicted the conclusion of Gompers and Lerner (1998) and noted that the IPO exit mode is the main driving force in promoting VC activities, and the impact of government policies on PE is mainly reflected in regulation and investment policies. The impact that GDP growth rate, market capitalization, and financial reporting standards have is less significant on the PE industry.

Another concern is that many scholars have engaged in deep discussions on the impact of policies and laws on the development of the PE industry. Megginson (2004) proposed that the development of the PE industry depended on a country's basic system, such as the political system, innovation environment, and cultural system, among which the legal system had a more significant impact on PE. Cumming and MacIntosh (2002) argued that fund managers preferred to invest in high-tech small- and medium-sized enterprises in countries with relatively complete legal systems and tended to choose the IPO mode as an exit to obtain higher returns. Cumming et al. (2004) further studied the impact of the legal system on the governance structure. In a market with a relatively complete legal system, financing funds can be obtained quickly, thereby shortening the screening period. Lerner and Schoar (2005) believed that fund managers were more inclined to control invested enterprises in an imperfect legal system.5 This belief indicates that setting the law has a far-reaching impact on the equity allocation of fund managers and investee enterprises in trading contracts.

Kaplan and Schoar (2003) engaged in an in-depth study of contracts between investors and invested enterprises and found that, given a change in the legal system, board seats, the rights over cash flows, other control rights, and liquidity would change. The author found that the structure of financing contracts in different countries indicates different effects under different institutional environments. Djankov et al. (2003) noted that a good legal mechanism and legal system benefits economic growth and protects intellectual property rights. The lack of a legal system often leads to the government's rampant private theft or forced seizure of patents in a legal form. LaPorta (1999) believed that protecting investors' interests by law would affect the breadth and depth of enterprises' external financing. If investors' interests can be effectively protected in a country, the cost of financing will decrease, thereby encouraging

[5] Yang Feng: "Study on Legal Regulation of Private Equity Fund in China" [D], University of International Business and Economics, 2008

entrepreneurs and fund managers to create more external financing channels. By comparing the number of listed companies, the size of the stock market, the scale of creditor rights, and the number of enterprises exiting in the IPO mode in 49 countries, the author found that countries in which investors' interests are highly protected usually have relatively complete financial markets and reasonable scale and operations. La Porta (1999) selected research samples from 27 rich countries of enterprises with different properties invested in and found that the higher the protection degree of investors' interests in a country, the larger the Tobin Q. Moreover, the correlation between ownership and valuation is stronger in countries that provide weaker protections for investors' interests than in wealthy countries.

At the micro-enterprise level, internal and external factors are found to simultaneously affect the development of the PE industry. Internal factors refer to the characteristics of a startup, usually including innovation capacity, R&D expenditures, historical performance, and reputation in the industry. External factors are mainly the economic and legal factors of a country, such as the legal system and financial environment, the nature of the social economy, and the cultural tradition of the country. Among them, the perfection of laws will directly affect the development of the PE industry.

2.4 Evaluation And Reference Of Relevant Literature At Home And Abroad

Some national policymakers refer to foreign scholars' research on the PE industry when developing policies, which is one of the main contributions of these scholars. At the same time, the Chinese government seeks to improve the external environment to promote the development of the PE industry, but the corresponding policies cannot effectively improve the market environment (Megginson, 2004). The main problem that the government should address is how to effectively implement new market-friendly policies (Jeng & Wells, 2000). During implementation, the causes of moral hazard are unpredictable. Some government officials may engage in corruption for personal interests, including their economic interests and personal political futures, because of their power. However, this situation clearly involves the issue of the government as an agent.

From a practical perspective, China's PE funds will inevitably encounter many difficulties during the growth process, such as narrow sources of funds, imperfect exit channels, no systematic and stable legal and policy environment, and low fund management and service. At the same time, PE funds also face the dilemma of "too many looters for limited wealth" and a large number of foreign PE funds to carve up the Chinese market. We must immediately start planning and making efforts, take advantage of the restructuring of our industry, and seize the opportunity to occupy the market, capital, and foreign PE funds to enhance China's capital market competition and cooperation.

This paper draws on the theoretical research and market practice experience of developed countries to put forward a survival and development strategy for local Chinese PE funds. From the inherent point of view, the premise of a PE fund to improve operational levels and system efficiencies is privatization. In addition, branding is the only way for these funds to survive and succeed in market selection. Having inter-industry cooperation and communication to safeguard the interests of the PE fund industry and accelerate the growth and internationalization of local PE funds is also necessary. Moreover, from the perspective of external limiting factors, accelerating the pace of legal construction, supplementing missing laws and regulations, clarifying the government's attitude toward the PE fund industry, and providing enough tax incentives are necessary to quickly develop a systematic PE capital market. In this manner, the equity of enterprises of different sizes and stages of development can be fairly stuck on a trading platform. At the same time, we should improve PE funds' exit mechanisms and open an appropriate proportion of social security funds and insurance company funds to PE funds to increase the vitality of the PE capital market and promote the survival of the fittest local PE funds. All of these problems reflect what the PE funds of China need to learn from international funds and strive to solve on their future growth path.

CHAPTER 3

DEVELOPMENT OF PE FUNDS IN CHINA

Following the ups and downs of China's VC funds, this paper divides VC fund stages as follows: initial, slow development, irrationally rapid development, adjustment, and rational guided by the government.

3.1 Initial Stage (1985–1993)

VC funds are closely related to the reform of the science and technology system in China. Before 1978, China inherited the scientific and technological development system of the former Soviet Union. This system implemented the independent structure of enterprise scientific research, scientific research institutions, university scientific research, and national defense scientific research and promoted the development of scientific and technological projects with the plans to drive the transfer of science and technology. In the late 1970s, given the change in the international situation and national development strategy, the limitations of this system became increasingly apparent. First, the structure is a relatively closed vertical system; science technology and economy represent the "two skin" phenomenon. Second, no concept of intellectual property rights and no compensation mechanism for the transfer of scientific and technological achievements exist, which was detrimental to technology diffusion. Third, in scientific research institutions, state-level administrative means were used too frequently for direct management, given the existing "big-pot" phenomenon, and were not conducive to mobilizing the initiative and enthusiasm of scientific research institutions. To solve these problems, from 1985 to 1992, China executed the first stage of scientific and technological system reform marked by the release of the "Decision of the CPC (Communist Party of China) Central Committee on Scientific and Technological System Reform" in March 1985. The Decision called for China's major scientific and technological forces to face the main battlefield of the national economy and serve economic construction. The guiding ideology of the reform was "science and technology serving the economic construction, and economic construction depending on science and technology." The most important policy trend at that time was the so-called "blocking and opening." "Blocking" refers to reforming the funding system, that is, the gradual reduction of the financial allocation of scientific research institutions. "Opening" refers to opening up the technology market, adjusting the organizational structure, reforming the management system of scientific researchers, and establishing high-tech development and experimental areas.

Given this background, China VC funds began to emerge. Their main feature was that the government initiated and explored direct engagement with VC through equity investments. In 1984, the Science and Technology

Development Center of the State Scientific and Technological Commission organized the study of “new technological revolution and countermeasures of China” and put forward the suggestion of establishing a VC mechanism to promote the development of high and new technology. In March 1985, the “Decision Concerning the Deepening of the Reform of the Science and Technology Management System” issued by the Central Committee of the CPC observed that “venture capital can be set up to support the rapid change and high-risk, high-tech development work,” and China’s VC efforts officially kicked off. In September of the same year, supported by the State Scientific and Technological Commission (now the Ministry of Science and Technology) and the People’s Bank of China, the State Council formally approved the establishment of China’s first VC institution: China New Technology Venture Capital Corporation. This VC firm, which supports high-tech startups, is 40% owned by the State Scientific and Technological Commission and 23% owned by the Ministry of Finance. The following year, the State Scientific and Technological Commission put forward strategic guidelines for developing VC in China in the “Science and Technology White Paper” for the first time. Since then, China has established China KZ High Technology Co., Ltd., Guangzhou Technology Venture Company, Jiangsu High-tech Venture Capital Company, and other similar companies.

At the same time, VC institutions have been established that rely on high-tech development zones. In May 1988, the Beijing New Technology Industry Development Zone, China’s first national high-tech development zone, was approved for establishment. Subsequently, local governments at all levels established pilot zones for the development of high-tech industries and set up VC funds in these zones. In 1987, with the backing of various high-tech development zones and the goal of promoting the commercialization, industrialization, and internationalization of high-tech achievements, the “incubators” of high-tech enterprises—entrepreneurship centers, such as Wuhan Entrepreneurship Center and Shanghai Entrepreneurship Center—were successively organized in various places and laid the foundation for the development of VC. According to 2001 survey data from the Beijing Venture Capital Association, 11 VC companies had been formed in China by the end of 1993.

3.2 Slow Development Stage (1993–1996)

With Deng Xiaoping’s South Inspection Speech in 1992, China’s economy began to enter a new stage as a socialist market economy. In this stage, the reform direction of the science and technology system was adjusted to include “climbing the peak of science and technology” on the basis of “orientation” and “reliance.” Thus, the policy direction began to change to “stabilizing and opening.”

“Stabilizing” refers to stabilizing and supporting basic research, conducting research on high-tech and major scientific and technological issues, and enhancing the strength of science and technology. “Opening” indicates opening various research institutions that directly serve economic construction, opening the commercialization of scientific and technological achievements and industrial activities, and making them operate in a market-oriented manner and contribute to social and economic development.

Given this background, VC funds entered the second stage of development. In 1991, the State Council once again proposed the development of VC companies in the “Interim Provisions on Several Policies of the National High and New Technology Industry Development Zones”: “relevant departments may establish venture capital funds in high and new technology development zones, and use them for the development of high and new technology industries with greater risks. VC companies may be established in high-tech development zones where conditions permit.” Subsequently, in 1992, Shenyang took the lead in establishing a scientific and technological risk development investment fund that provided funds for the development of high-tech enterprises through loan guarantees, discount interest, equity dividends, and other paid investment methods.

In 1993, China Economic and Technological Investment Guarantee Corporation, the first national financial institution in China established by the State Economic and Trade Commission and the Ministry of Finance, with the target of promoting scientific and technological progress by means of an RMB economic guarantee as its main business, began providing guarantees for the industrial and regional trials of new and high technology achievements, was concurrently engaged in investment and financing businesses in new technology industries and technological progress of enterprises, and offered reviews and consultations for these projects. This move has had the positive effect of encouraging more social forces to participate in the VC field.

In 1994, the total number of VC companies increased to 26. These companies were mainly set up by the local government via financial funds in high-tech development zones. However, in 1995, the boom of forming “venture capital institutions” funded directly by local governments cooled. In 1995 and 1996, only one and five VC companies, respectively, were established nationwide. During this period, one of the main reasons why VC institutions did not grow rapidly was that the central government oversaw an overheated economy, which led to a downturn in the capital markets. After Deng Xiaoping’s South Inspection Speech, the stock market and real estate prices exploded, economic development overheated, and the winds of speculation prevailed. Therefore, in the second half of 1994, the central government began to control the overheating of the economy and suspended irregular transactions, such as those for national debt futures and foreign exchange futures, and closed Wuhan, Tianjin, and Beijing STAQ non-standard securities trading centers that used bonds and funds as the main transaction objects. These moves resulted in the capital markets experiencing a longer downturn period.

During this period, despite the slow development of the VC fund industry, some improvements were made in the external VC environment that were reflected in the relevant policies and regulations formulated by the central and local governments for developing VC. For example, the “Decision on the Reform of Science and Technology System during the ‘Ninth Five-Year Plan’ Period” and the “Law of the People’s Republic of China on Promoting the Transformation of Scientific and Technological Achievements” issued by the State Council were related to promoting the development of VC and establishing funds or venture funds to transform scientific and technological achievements. Examples include the “Provisional Regulations of Beijing New Technology Industry Development Zone” promulgated by the Beijing government on the establishment of Sino-foreign joint venture investment companies as well as relevant bank decisions regarding the establishment of loan risk funds. The promulgation of these policies and regulations provided favorable policy guarantees for further developing VC.

Another highlight during this stage was the entry of international VC into China’s VC market.
In 1992, IDG established the first wholly foreign-owned VC fund in China, PYV-CHINA, with more than US $100 million in investments. The company is active in China’s high-tech investment market and has invested and committed to invest a total of US $80 million.

In 1994, Walden International (WIIG), a famous international VC investment group, founded Walden (China) Venture Capital Investment Management Co., Ltd., namely, the Walden China Fund. The fund successively invested in a series of well-known enterprises in China, such as Stone Richsight, Kelon, D-link, and Little Swan. Other overseas VC funds (companies) entering China included ChinaVest (USA), Shanghai Shihua International Financial Consulting Co., Ltd., and Softbank (Japan). They not only provide funds for China’s high-tech enterprises but, more importantly, also bring professional assessment and management experience for VCs, promoting the Chinese VC industry to integrate with the world.

3.3 Irrationally Rapid Development Stage (1997–2002)

Since 1998, the main policy of China’s science and technology system reform has shifted to strengthening the construction of a national innovation system and accelerating the industrialization of scientific and technological achievements. Policy supply focuses on promoting the transformation of scientific research institutions and improving the innovative capacity of enterprises and industries to promote the transformation of scientific and technological achievements, strengthen the construction of the national innovation system, and guide the enthusiasm of scientific and technological personnel in scientific research with expected benefits. In March 1998, at the First Session of the Ninth National Committee of the Chinese People's Political Consultative Conference, the Central Committee of China National Democratic Construction Association submitted the "Proposal on Developing China's Venture Capital Industry as Soon as Possible." This proposal ("the No. 1 Proposal") was listed as the top proposal of this conference, which was a conference that had been taken seriously by China's major institutions.

China's VC has entered a stage of rapid development after the "No. 1 Proposal" served as its initial policy. First, China International Capital Corporation Limited announced that it would set up a seed fund to provide VC to domestic high-tech companies. Second, Beijing officially launched the "high-tech industry development guarantee fund" with an initial investment of 50 million yuan that would be invested by the municipal government. The fund plans to grow to 200 million yuan in the future. Third, Beijing Venture Capital Co., Ltd., named after a VC firm, was subsequently established. On May 31, 1998, the Shanghai municipality promulgated the "Provisions of Shanghai Municipality on Promoting the Transformation of New and High Technology Achievements," a document that was revised on June 9, 1999. The provisions therein provided several preferential policies for transforming high-tech achievements, such as financing guarantees and loan discounts. The Shanghai municipal government also allocated a VC fund of 600 million yuan for venture investments and prioritized approving projects that would transform high-tech achievements. Other local governments were also developing laws and policies to support the local VC industry.

In June 1999, the State Council allocated 1 billion yuan to a startup fund to establish an innovation fund for small- and medium-sized enterprises. In August, the CPC Central Committee and the State Council issued the "Decision on Strengthening Technological Innovation, Developing High-Tech and Realizing Industrialization," which stressed the need to cultivate the capital market, gradually establish a VC mechanism, and develop VC companies and VC funds. VC started to enter a phase of concept introduction, large-scale capital launches, and in-depth exploration. In 1986, there was only one VC company in China. In 1992, when VC was launched for the second time, there were slightly more than 20 VC companies operating in China, raising 4.82 billion yuan in capital for that year. Three years later, in 1995, only 27 VC institutions operated in China with a total capital under management of merely 5.13 billion yuan. Perhaps some institutions had foresight, for the number of VC firms and their total capital under management had grown rapidly since 1997. In 1997, a large number of VC companies began to emerge across the country, reaching 51 that year, with capital under management of 10.1 billion yuan. This figure increased to 366 in 2002, an increase of 334 over that in 1996, and total managed capital reached 68.85 billion yuan, an increase of 500 million yuan over that of 1996, with funds raised of 6.9 billion yuan. Between 1997 and 2001, the institutional growth rate averaged 52.95% and growth in total managed capital averaged 55.15%.

This wave of rapid development and the impact of the "No. 1 Proposal" are two important factors that promoted the development of VC institutions. The first is the wealth effect of the rapid development of Silicon Valley and the Internet industry. A large number of high-tech and Internet companies in the US, backed by VC funds, went public on NASDAQ and achieved great success, resulting in a boom in Internet investments. Through this influence, the number of Chinese companies investing in the Internet also increased, and the companies planned to launch the Growth Enterprises Market (GEM) to support the development of scientific and technological innovation with the capital markets. Second, since the Asian financial turmoil in 1997, China's economy fell into a deflationary situation, and state-owned enterprises suffered a large number of losses. To stimulate economic growth, the government began to attach importance to the role of consumer demand growth brought about by the wealth effect of the capital market. Thus, the government started the "5.19" market in 1999, which began the two-year bull market driven by the government and capital. Stimulated by the wealth effect from the sharp rise in domestic and foreign stock markets and guided by the wealth story of VC investments, the number and amount of VC investments in these two years also experienced strong growth momentum.

However, the VC institutions that grew up in this stage were short-sighted. They wanted to promote the high-tech concept and use it to make money by listing. Therefore, these institutions were not VC in the real sense, which implied considerable systemic risk. This risk was closely related to the government's motivation to initiate this round of the stock market. Since the government had positioned the stock market only as a tool to relieve the plight of state-owned enterprises, the rise of this market was also irrational. Therefore, the rapid development during this stage can be understood as the irrationally rapid development stage of Chinese VC funds.

3.4 Adjustment Stage (2002–2004)

In the second half of 2001, when the Internet bubble burst in the US, the NASDAQ stock index fell by more than 50%, and some listed companies that failed to make profits or could not generate cash flow continuously went bankrupt and into liquidation. Hong Kong's and Japan's GEM also nearly died after being affected by this situation.

Further, under the reflection and debate of mainstream economists, the main board of China's stock market declined rapidly from more than 2,100 points in 2001 to the lowest point of 1,000 points after the stock market bubble burst. These events made Chinese leaders slow the development of GEM, and the original plan to change Shenzhen GEM was repeatedly delayed. The Chinese government realized that the capital market should be regulated prior to an expansion of its scale or regulation of its development. Therefore, solving the problem wherein state-owned shares and legal person shares cannot circulate has become the main focus of this stage. When the capital market was regulated, it experienced a long-term downturn and temporarily lost its financing function. This situation left many VC firms that were founded during the early stages and intended to make a fortune by investing in a concept and then going public on ChiNext in a dilemma. At the time, most small- and medium-sized entrepreneurial enterprises were not profitable and could not continue to operate. Since the capital market could not provide continuous financing channels for these entrepreneurs, a large number of VC institutions failed from unrecoverable investments, and VC investments experienced a painful adjustment period. In 2003 and 2004, the number of VC institutions fell from 366 in 2002 to 304 in 2004. The amount of capital managed by VC institutions also declined from 6.885 million yuan in 2002 to 6.175 million yuan in 2004. The enthusiasm for VC investments reached a low point.

3.5 Rational Stage Guided By The Government (2005 to Today)

In 2005, China's securities regulatory authorities finally put forward a reform of the shareholding structure. China's capital market entered the full circulation stage and opened a new round that was the prologue to the bull market. In January 2006, the CPC Central Committee and the State Council held a national conference on science and technology, putting forward the strategic goal of improving the capability of independent innovation and building an innovation-oriented country.

Subsequently, the "Outline of the National Medium and Long Term Science and Technology Development Program" (2006–2020) and related supporting measures were released. This outline submitted clear policy requirements for the development of independent innovation VC and capital markets. The Chinese government fully recognized that small- and medium-sized innovative enterprises are now the carriers of technological innovation. In the US, more than 70% of patents are created by small businesses that are, on average, more than twice as innovative as those of large companies. In China, small businesses provide approximately 66% of the country's invention patents, 74% of technological innovations, and 82% of new product development and have become an important force and source of technological innovation. However, owing to the serious uncertainty and information asymmetry of small-and medium-sized innovative enterprises, the risk of making a direct investment in such enterprises is very high. Moreover, commercial banks are also reluctant to lend to such firms. Therefore, solving these enterprises' problem of insufficient development capital is the key to improving the capability of independent innovation and creating an innovation-oriented country. The key to guiding social capital investments in innovative small- and medium-sized enterprises lies in whether such enterprises can provide a good profit forecast under controllable risks. Therefore, for these investments, the government should find methods to reduce their transaction costs, solve their exit mechanisms, and provide risk compensation. Under the leadership and overall coordination of the State Council, the People's Bank of China, the China Securities Regulatory Commission, the China Banking Regulatory Commission, the National Development and Reform Commission, the Ministry of Finance, the Ministry of Science and Technology, and other departments have continuously introduced specific policies and measures for developing China's VC and capital markets.

For example, the "Interim Measures for the Management of Venture Capital Enterprises" and the "Pilot for the Quotation Transfer of Unlisted Companies' Shares in Zhongguancun Science and Technology Park of Securities Company Agency Share Transfer System" were issued. In 2007, state-level authorities promulgated a series of policies to encourage VC investments, among which the most important are the "Measures for the Management of Guiding Funds for Venture Capital Investment of Small and Medium-Sized Scientific and Technological Enterprises," the "Law of Corporation Income Tax," the "Administrative Measures for the Determination of High and New Technology Enterprises," and the "Partnership Enterprise Law." VC in China has entered the rapid development stage under the government's guidance.

Under the guidance of the government's efforts and driven by the bull capital market, VC investments in China gradually resumed their growth from 2005 onward, and the number of VC institutions increased from 319 in 2005 to 383 in 2007. Capital under management increased from 6.316 million yuan in 2005 to 105.15 billion yuan in 2007—a new high. The "Report of China's Venture Capital Development 2015" showed that the VC industry has developed rapidly in China in recent years, and both the number of institutions and the total capital have grown considerably. By the end of 2014, the number of various types of VC institutions in China reached 1,551, an increase of 10.2% compared to that in 2013, including 1,167 VC enterprises (funds) and 216 new funds raised that year. Regarding the investment scale, the total managed capital of VCs in China reached 523.24 billion yuan in 2014, reflecting an increase of 31.7%. Total managed capital accounted for 0.82% of total GDP. Funds' average capital under management was 448 million yuan, a significant increase from 2013. These increases show that China's VC investments performed well in the areas of fundraising, investment, and exit, and China's VC industry has entered a period of rational development.

At present, nearly 50 or 25% of approximately 200 small- and medium-sized listed companies have an entrepreneurial VC background. Among them, almost 60 VC funds have invested in approximately 50 SME board companies and held shares worth up to 52.1 billion yuan (at the end of 2007). In this sense, for the number of VC funds and managed capital to increase significantly is rational. However, another reason for this growth is excessive optimism and the possibility of "following the trend" because, since 2006, the securities regulatory authorities expressed their willingness to actively promote the impact of GEM, which led to the large-scale involvement of some institutions and funds in the VC business.

Main Form of China's Private Equity Investment

	Limited partnership	**Corporate**	**Trust**
Enterprise income tax	Exempted	Payable	Temporarily exempted
Mode of contribution	Capital contribution commitments, highly flexible	Paid-in capital, inflexible	Trust established through a single raise, inflexible
Income distribution	Able to be allocated by project, highly flexible	Distribution is available only when the company has a favorable balance, inflexible	Able to be allocated by project, highly flexible
Property registration system	Definite	Definite	Lack of system

Figure 3.1 Main Form Of China's Private Equity Investment

3.6 Current Numerical Characteristics Of The PE Market

Table 3.1 provides a comprehensive overview of the size of the private equity market, along with the public equity market, and bank loans market in China from 2017 to 2021. Specifically, this table includes key indicators on the number of PE fund managers, the total number of PE funds, the size of the PE market in Renminbi (RMB) trillions, the value of public equity A shares in RMB trillions, and the volume of bank loans in RMB trillions for each respective year. The data illustrates a consistent growth trend in the number of fund managers, PE funds, and the overall size of the PE market during this period.

Table 3.1 *The Size Of The Private Equity Market, Along With The Public Equity Market, And Bank Loans Market*

Year	2017	2018	2019	2020	2021
No. of PE fund managers	22446	24,448	24471	24561	24610
No. of PE fund	66418	74642	81739	96818	124098
PE market size (RMB trn)	11.1	12.78	13.74	16.96	20.27
Public equity A share (RMB trn)	56.58	43.37	59.29	79.7	91.2
Bank loans (RMB trn)	119.03	134.69	151.57	171.6	191.54

In general, the number of PE fund managers increased steadily over the five-year period, starting at 22,446 in 2017 and culminating at 24,610 in 2021. This reveals a sustained and growing interest in the PE sector, which could be indicative of a thriving PE landscape, as well as heightened demand for private equity investment expertise. The increasing number of PE funds in China displayed 66,418 PE funds in 2017 and rose to 124,098 in 2021. This persistent growth points towards greater diversification of investment vehicles and capital allocation within the PE industry. It signifies that more institutional and individual investors seek opportunities in the PE sector, thereby driving the creation of new funds. The most significant metric reflecting the growth of the Chinese PE industry is the size of the PE market. Starting at 11.1 trillion RMB in 2017, the market expanded notably to 20.27 trillion RMB in 2021. This substantial increase in the market size signifies an escalating attractiveness of the Chinese PE market for both domestic and international investors. This consistent growth can be attributed to several factors, including China's continued economic development and regulatory reforms. While this growth is promising, it is essential for stakeholders to maintain a balanced perspective and consider associated risks as the Chinese PE market is still evolving.

The data presented in Table 3.1 underscores the robust and sustained growth of the Chinese private equity industry from 2017 to 2021. This growth reflects a flourishing landscape characterized by a greater number of fund managers, an expanding array of PE funds, and a significantly enlarged market size. Additionally, it highlights fluctuations in the values of public equity A shares and bank loans, which are two other significant financial indicators. Notably, public equity A shares and bank loans have consistently larger amounts than PE equity over the specified years. In summary, the presence of larger amounts in public equity A shares and bank loans compared to private equity in the table reflects the diversity and complexity of China's financial markets, where various investment options co-exist to meet the varying needs and risk appetites of investors and borrowers.

Table 3.2 shows the numerical features of private equity markets in China across 31 provinces in 2021. More specifically, it focuses on three key parameters that offer a glimpse into the context of PE investment within these areas: the number of PE fund managers, the number of PE funds, and the total fund size measured in billions of RMB across 31 provinces.

Notably, the data underscores significant regional disparities in the PE industry's presence across the country. Two major economic centers, Shanghai and Beijing, stand out prominently. Shanghai boasts an impressive 4,410 PE fund managers and an extensive 41,488 PE funds. Meanwhile, Beijing is home to 3,970 fund managers and 22,908 PE funds. These numbers reveal the substantial concentration of PE professionals in these metropolitan regions, reflecting their pivotal roles in the Chinese PE market.

Moreover, fund size displays considerable variation across regions. For example, Liaoning reports a relatively smaller fund size of 9.35 billion RMB, suggesting a potentially less active PE market. Conversely, other regions such as Zhejiang, Guangdong, and Jiangsu, each having over 1,000 PE fund managers, indicate a robust and growing presence in the PE market. These disparities are intrinsically tied to the economic development of each region. Economically vibrant areas tend to attract more PE activities due to the abundance of investment opportunities and funding sources.

Overall, this table offers valuable insights into the regional dynamics of the Chinese PE industry. It highlights the significance of specific provinces and implies potential areas for further development in the PE market, which is important for researchers and policymakers in the future.

Table 3.2 *Private Equity Markets In China By Provinces*

Province	No. of managers	No. of funds	Fund size (RMB bn)
Shanghai	4410	41488	5110.94
Beijing	3970	22908	4510.62
Zhejiang	1921	11614	1059.54
Guangdong	1777	11673	1223.3.5
Jiangsu	1276	5293	1063.05

Table 3.2 *continued*

Province	No. of managers	No. of funds	Fund size (RMB bn)
Hainan	589	3226	227.36
Sichuan	429	1521	251.93
Shandong	426	1481	177.09
Hubei	411	1195	242.66
Tianjin	398	2143	718.86
Hunan	283	1160	132.02
Jiangxi	270	1104	151.77
Shaanxi	267	1024	123.92
Fujian	245	1852	172.59
Anhui	235	1034	310.77
Chongqing	181	629	181.92
Henan	169	466	92.93
Xizang	168	1419	330.67
Hebei	102	223	83.88
Xinjiang	96	351	127.33
Guangxi	88	339	115.68
Guizhou	73	266	168.92
Yunnan	72	175	110.47
Liaoning	68	150	9.35
Shanxi	60	175	145
Jilin	58	131	32.85
Inner Mongolia	52	156	34.15
Heilingjiang	51	97	12.42
Ningxia	42	114	22.17
Gansu	38	63	18.17
Qinghai	12	40	11.62

3.7 International Comparative Study

Figure 3.2 provides the results of an international comparative study, which investigates the relative size of private equity markets, which is measured as the aggregate capital raised and the no. of funds, in China vs., the US, UK, and Japan, based on the data from Preqin database.

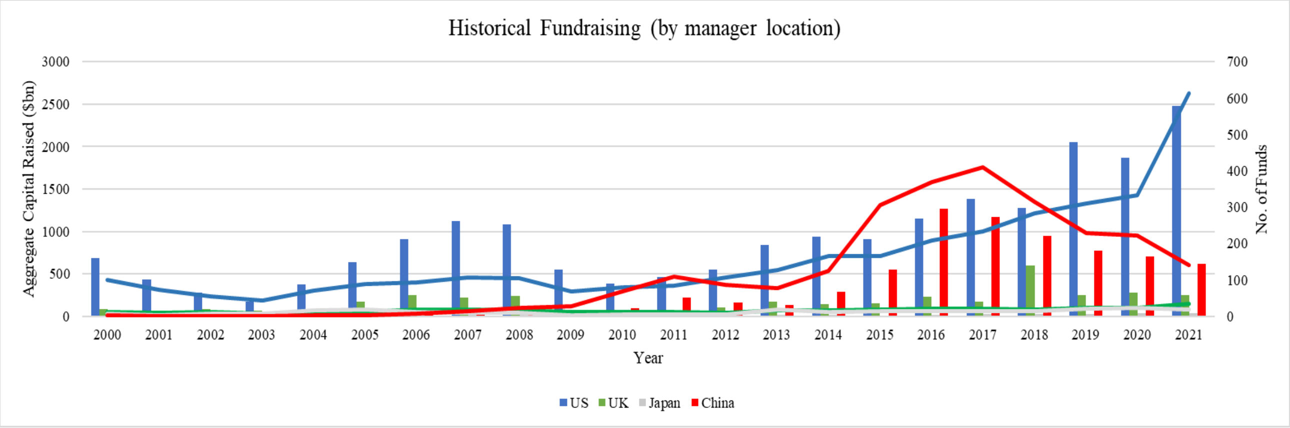

Figure 3.2 Historical PE Fundraising of US, UK, Japan, and China

Figure 3.2 indicates several notable trends regarding the size of the PE market across four countries. Firstly, when comparing China's private equity fundraising to that of the United States, it becomes evident that China initially lagged behind the United States during the early 2000s. However, a significant turning point occurred around 2010 when China's number of funds surpassed that of the US. This number of funds in China is consistently larger than that of the United States before 2019, resulting in China establishing a notably larger historical PE market. Moreover, in the comparison between China and the United Kingdom, a similar pattern emerged. In the initial years of the analysis, China's private equity fundraising was considerably smaller than that of the United Kingdom. China's fundraising began to accelerate in recent years, it overtook the United Kingdom. In the case of Japan, it is also evident that China's private equity fundraising was consistently higher in the most recent decade.

Overall, these trends underscore the remarkable growth trajectory of China's private equity market concerning historical fundraising. China, which initially had a relatively modest PE market in the early 2000s, has since transformed into one of the fast-growing private equity markets globally. This transformation has been driven by various factors, including robust economic development, an increasingly attractive investment environment, and growing interest from both domestic and international investors.

3.8 Actual PE Fund In China: A Case Of “Xin Hong Yuan Chuang” Fund

The "Xin Hong Yuan Chuang" fund (XHYC) is jointly initiated by "Japan Soft Bank Investment" and "Singapore Temasek Holdings (Private) Limited," with a total investment scale of USD 100 million, with Temasek and SBI each holding a 50% stake, focuses on private equity investments in the Chinese market. Since its establishment, the XHYC has invested in a series of Chinese enterprises, including Sichuan Meifeng Chemical, Zoomlion Heavy Industry, Kingsoft Corporation, Yingli Green Energy, and Tianjun Media. These investments span various industries such as chemicals, electronics, energy, news media, and food, resulting in substantial returns and significant success.

Sichuan Meifeng Chemical Co., Ltd. was listed on the Shenzhen Stock Exchange in 1997. In July 2002, Sichuan Meifeng underwent restructuring by a Sinopec Group's wholly-owned subsidiary then the subsidiary became the company's largest shareholder with a share of 18.33%. The second-largest shareholder is Sichuan Meifeng Group Co., Ltd., with a share of 17.79%. Both major shareholders hold state-owned shares. As a chemical enterprise, Sichuan Meifeng primarily engages in the production and sale of nitrogen-based chemical fertilizer products such as urea and compound fertilizer, as well as plastic packaging bags.

In August 2005, Sichuan Meifeng Chemical Co., Ltd. announced a "Notice on Shareholders' Equity Transfer," indicating that the company's second-largest shareholder, Sichuan Meifeng Group and XHYC signed a "Share Transfer Agreement" on August 18, 2005. Meifeng Group planned to transfer 24,566,570 shares out of its total of 43,707,420 shares to the XHYC fund at a price of CNY 4.8011 per share. If the transfer is succeeded, Sichuan Meifeng would hold 19,141,150 shares, making it the fourth-largest shareholder of the company (7.79% of the total share capital), while XHYC would hold 24,566,570 shares, becoming the third-largest shareholder of the company (10% of the total share capital). XHYC initiated a series of strategic and tactic adjustments and reforms after the acquisition.

On the corporate strategy aspect, Sichuan Meifeng is spurred by foreign capital injection and significant strategic opportunities in the nitrogen fertilizer industry's restructuring. Sixteen days after the Ministry of Commerce formally approved the equity transfer agreement between "Sichuan Meifeng" and XHYC on June 29, 2006, "Sichuan Meifeng" acquired a share of 45% in Gansu Liu Hua Group Co., Ltd. for CNY 251,155,000, which is the first step in implementing its restructuring and acquisition development strategy. Subsequently, "Sichuan Meifeng" carried out a shareholding reform in 2007. Moreover, "Sichuan Meifeng" invested CNY 2,614,704,000 in Guizhou Chemical Fertilizer Factory Co., Ltd. through capital increase and share expansion, raising its holding shares to 55.78%, making it the controlling shareholder. Additionally, "Sichuan Meifeng" acquired a share of 51% in Lanzhou Yuandong Chemical Fertilizer Co., Ltd., further expanding its scale.

"Sichuan Meifeng" achieved significant breakthroughs in technical innovations such as energy conservation and emissions reduction. For example, the operating cycle of production equipment achieved the highest historical level. Meifeng also jointly developed or independently researched technical applications such as non-powered ammonia recovery technology and the optimized operation methods for ammonia synthesis units with other institutions, resulting in both production efficiency and economic benefits.

Overall, the PE fund "Xin Hong Yuan Chuang" played a pivotal role in the development of Sichuan Meifeng after the acquisition. Firstly, the XHYC injects substantial capital into companies, this capital infusion allowed Sichuan Meifeng to pursue more strategic initiatives, which are crucial for growth and expansion. Moreover, with the support of the XHYC, Sichuan Meifeng experienced restructuring and expansion. This involved acquiring other companies and entering new markets. For example, the acquisition of shares in Gansu Liu Hua Group and the investment in Guizhou Chemical Fertilizer Factory were significant steps. These strategic moves allowed Sichuan Meifeng to diversify operations and increase scale. Finally, private equity investors often bring expertise and insights to acquired firms. In the case of Sichuan Meifeng, XHYC facilitated technical innovations, such as energy conservation and emissions reduction initiatives, which made the company more environmental-friendly and increasingly operationally efficient.

CHAPTER 4

CURRENT MANAGEMENT MODE OF PE FUNDS IN CHINA

The Chinese Private Equity (PE) market is severely affected by regulations. As mentioned in the prior section, this market has experienced significant growth and transformation in recent years, making it essential to understand the role of government institutions and regulations in the PE market. Similar to the Chinese government's role at the provincial level, the central government plays a crucial role in shaping the PE market. Government policies, regulations, and approvals are central to the functioning of the PE market. The regulatory environment in the Chinese PE market is complex, with rules and regulations evolving over time. It is vital to examine the autonomy of the PE market in different regions. Regional variations in regulatory practices, such as those in Beijing, Shanghai, and other provinces, can significantly impact the operations and performance of PE funds.

China's PE market provides a unique case, given its rapid growth and the government's involvement in the sector. It is important to highlight that China's political context influences government and regulatory dynamics in the PE market. The examination of government and regulation in the Chinese PE market reveals valuable insights for industry practitioners, policymakers, and researchers. Understanding the impact of government institutions, regulatory changes, and regional variations is crucial for navigating this market.

4.1 Government Regulation Mode Of PE Funds In China

In recent years, PE investment funds have enjoyed rapid development in China, with generally high returns and rapid growth masking many potential problems. As the industry develops further, the level of returns of the entire industry will return to a more reasonable level, and many funds will suffer massive losses because of improper operations. Moreover, illegal fundraising activities are being carried out by using legally registered PE funds. Given special institutional reasons in China, the right to supervise the PE industry is not yet clear. The National Development and Reform Commission, the China Securities Regulatory Commission, the China Banking Regulatory Commission, and even the Ministry of Industry and Information Technology all have the power to regulate the PE industry.

Since 2006 and until 2013, PE fund regulation was transferred back and forth between the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC). In 2013, the State Commission Office of Public Sectors Reform issued a document clarifying the regulatory powers and responsibilities of the two sides. In October 2005, the General Office of the State Council forwarded the “Interim Measures for the

Management of Venture Capital Enterprises," jointly issued by the NDRC and 10 other ministries and commissions, stipulating that the supervision power of VC funds belonged to the NDRC, and the Finance Office of the Ministry of Finance is responsible for the supervision. In 2009, the Finance and Economic Committee of the National People's Congress initiated a revision to the "Law on Securities Investment Fund" in an attempt to bring private securities funds and PE funds under the supervision scope of the law. The NDRC opposed the law, which was finalized in late 2012 but did not cover PE funds. After the "Law on Securities Investment Fund" was drafted, the CSRC required PE fund management companies that had a public offering or securities asset management scale of more than 100 million yuan to join the Asset Management Association of China. The CSRC also invited other fund management companies without a relevant business to join the Association.

In June 2013, the State Commission Office of Public Sectors Reform issued the "Notice on the Division of Responsibilities for the Management of Private Equity Funds," which clarified that the CSRC was responsible for the supervision and management of PE funds and implemented appropriate supervision to protect investors' rights and interests. The NDRC is responsible for organizing and formulating policies and measures to promote the development of PE funds and standards and norms for government contributions to PE funds with other relevant departments.

4.2 Organizational Structure Management Of PE Fund In China

In the early days of the structural design of China's PE funds, many funds adopted a corporate form, such as the famous Shenzhen Capital Group Co., Ltd. The main reason was that prior to 2007, the "Partnership Enterprise Law" had not been enacted and was not in effect. No limited partnerships except for general partnerships existed in China. Therefore, many early RMB funds took the corporate form. In China, in practice, the government formulated many preferential policies for corporate funds. For example, the NDRC led the formulation of the "Interim Measures for the Management of Venture Capital Enterprises," and the supporting tax preferential policies of the State Taxation Administration can exempt companies in corporate form from certain taxes on VC funds.

The current mainstream organizational structure in China is a limited partnership, which differs from foreign PE funds in terms of details regarding the background of foreign and domestic capital. For domestic PE funds with a foreign background, the general partner has to pay double taxes if it distributes management dividends to the fund manager and then remits them overseas. No transparent corporate form exists in China. The general partner needs to pay business income and corporate income taxes. In order to avoid tax, In practice, in China, the general partner distributes management dividends directly to the ultimate recipients, which are usually fund executives. Purely domestic PE funds operate more savagely, often with managers acting directly as general partners. Investors and regulators welcome such a situation because it binds the general partner's investment risk. However, a potential risk exists in that the liquidation for any reason of the fund manager would cause other funds in which he or she invests to suffer.

The trust structure is also a common form in China. Compared to a limited partnership, which has a maximum of 50 investors, a trust pool has a maximum of 200 investors. Limited companies can have more than 200 investors; however, in practice, the approval of the CSRC or another relevant regulatory agency is required if more than 200 investors exist; otherwise, fundraising is illegal. The upper limit of 200 investors can considerably reduce fundraising difficulties. Moreover, the trust can prioritize its benefits and inferior rights to earnings, which can also reduce the difficulty of raising funds to a certain extent. Thus, trusts are more popular in China.

In practice, fiduciary investment companies face policy barriers when applying for listings in China. The CSRC requires listed companies to disclose the actual controller, but trust regulations require the confidentiality of beneficiary information. Since this contradiction directly leads to the failure of listed enterprises with trust investments, trust funds are often applied to real estate funds without the listing as an exit channel.

In addition, because most fund managers do not have trust licenses, in practice, licensed trust companies often act as trustees, and fund managers participate in the investment decisions of the fund as co-trustees or investment advisors.

4.3 Raising The Management Mode Of PE Funds In China

In terms of fundraising objects, according to the latest survey data of ChinaVenture, listed companies, government guide funds, private enterprises, and FOFs are the most favored by general partnerships (GPs) in the Chinese market. Moreover, more than half of the investment institutions tend to raise funds from these entities. Many fund companies are designed to focus on the industrial integration of listed companies, making investment institutions willing to cooperate with listed companies, private enterprises, and FOFs. Fund owners, such as the National Council for Social Security Fund, and insurance funds have always been the objects with which fund managers are willing to cooperate. However, given the disadvantages of fundraising objects, such as a high threshold for capital input and slow investment speed, such objects seem to be out of time in a rapidly changing commercial society. Excluding some investment giants, most funds have adopted the principle of "going for it but not depending on it."

Domestic securities companies are also important fundraising objects of PE funds, which are popular given their "sponsor and direct investment" mode. The direct investment subsidiaries of the securities companies hold shares of the companies to be listed and their parent companies are responsible for the recommendation of going public.

Table 4.1 *Top 15 Direct Investment Subsidiaries Of Securities Companies In China*

S/N	Securities company	Direct investment subsidiaries	Registered capital (100,000,000 yuan)
1	CITIC Securities	Goldstone Investment Co., Ltd.	46
2	Haitong Securities	Haitong Capital Co., Ltd.	30
3	Everbright Securities	Everbright Capital Investment Co., Ltd.	20
4	GF Securities	GF Xinde Investment	13
5	Guosen Securities	Guosen H&S	10
6	Galaxy Securities	Galaxy Innovation Capital	10
7	Ping An Securities	Ping An Caizhi Investment Management	6
8	Qilu securities	LUZHENG CHUANGYE INVESTMENT LIMITED	6
9	Huatai Securities	Huatai Zijin Investment	5
10	Guoyuan Securities	Guoyuan Equity investment	5
11	Merchants Securities	Merchants Capital Investment	5
12	Shenyin & Wanguo Securities	Shenyin & Wanguo Investment	5
13	Guotai Jun'an Securities	Guotai Jun'an Innovation Investment	5
14	Changjiang Securities	Changjiang Growth Capital	5
15	China Jianyin Investment Securities	China Investment LuckyStone Management	5

Source: Internet

In terms of fundraising channels, most fund managers have years of prior experience in the financial industry or with industrial entities and can raise the required funds successfully by using their resources and relationship networks. Therefore, fundraising channels tend to raise funds on their own.

4.4 Operation And Management Mode Of PE Fnds In China

Throughout 2014, the PE investment market witnessed the completion of 943 investment cases, of which 847 disclosed their investment amount, totaling US $53.757 billion. The number of investment cases had a year-on-year growth of 42.9%, and the disclosed investment amount increased by 119.6% on a year-on-year basis. Both figures reached a record high. The main reasons for the booming investment market in 2014 were a new round of mixed ownership reform of state-owned enterprises, the booming M&A market at home and abroad, the active capital operations of listed companies, and the boom in emerging investment fields, such as the biomedical sector and mobile Internet.

From the perspective of project acquisition channels, the Chinese market mainly focuses on direct investment departments of securities companies, commercial banks, and independent financial advisors. A securities company can access numerous quality projects, and the Chinese market has adopted pre-IPO as the mainstream strategy; for this strategy, a company will hire a securities company as a tutor or sponsor before its listing. Moreover, because commercial banks in China are in a monopoly position, their customer databases become an important resource for fund managers seeking projects. Such intermediaries are chosen depending on fund size. For large funds, major investment banks are chosen for their cooperation, and for small- and medium-sized funds, small professional investment banks may be the choice.

From an investment strategy point of view, China’s current mainstream model maintains growth capital. In 2016, 751 investment cases occurred in China, of which 662 disclosed their investment amount, totaling US $34.557 billion. PIPE has replaced real estate investments and became the second-largest investment type this year. There are 115 PIPE investment cases that have invested a total of US $9.905 billion. VC/PE institutions represented by Jiangsu Winfast Holding, Heaven-Sent, and Wens Investment actively participated in the secondary market and strongly stimulated the scale of PIPE investments. Although the number of real estate investment cases fell significantly relative to 2015, total investments grew, which is related to the fact that real estate investments in the current year are primarily dominated by large private real estate institutions.

In terms of investment fields, the Internet remains the largest hotspot for investments, with a total of 145 investment cases. Of these, 129 disclosed their investment amounts, which totaled US $4.084 billion. The Internet is followed by the real estate industry, which saw the completion of 106 investment cases, 99 of which disclosed their investment amounts. The investment amount totaled US $9.497 billion, ranking first of all investment areas.

The industries with the next largest number of investment cases are biotechnology/health, machinery manufacturing, telecommunications and value-added services, IT, and entertainment media; other industries shared less than 50 investment cases. An analysis based on investment amount showed that substantial investment cases frequently occurred in real estate, energy and minerals, chain and retail, and finance, leading to relatively high investment totals.

4.5 Exit Management Mode Of PE Funds In China

At present, the main exit modes in the domestic and foreign markets are overall sales, second-hand transactions, redemptions, IPOs, and liquidations. Before the opening of China's National Equities Exchange and Quotations (NEEQ) trading market, IPOs were the main exit channel, primarily because the investment strategies of PE funds in China were mainly VC and growth capital and most invested in growth businesses. Before the launch of the GEM in 2009, IPOs accounted for approximately 50% of all PE exit cases. After the launch, this proportion increased to more than 80%.

In pre-IPO practices in China, the buy-back clause is generally agreed to in advance. If an enterprise fails to exit successfully within a certain period in the future, investors have the right to require the enterprise or controlling shareholder to redeem their initial investments at a premium. However, amid the uncertain IPO market under China's audit system, many enterprises triggered the buy-back clause after IPO auditing tightened in recent years. In addition, in the case of any major disagreement among external investors and the management team over a company's operation, an MBO may also occur.

After the opening and expansion of the NEEQ market, it became the mainstream exit mode in China. The main reason is that, compared to the auditing system of the main board market, the NEEQ has a lower listing threshold and most small funds confront more intense exit pressure than large PE funds. Therefore, the NEEQ becomes a good choice. In 2015, the NEEQ exit accounted for 51% of the exit methods of China's PE funds. Owing to the tightening of IPO auditing, only 14% of cases exited through an IPO. A total of 450 equity transfers accounted for 12%, and the buy-back and the MBO accounted for 3%. The development of China's NEEQ market gave PE funds a channel for a quick exit.

From the distribution of IPO exits of PE funds from the market in 2014, it is not difficult to see that a total of 56 IPO exit cases were listed on the Hong Kong Main Board, 36 exit cases on the Shanghai Stock Exchange, and 25 and 13 exit cases on the Shenzhen GEM and the SME board, respectively. Given the policy tightening in China, fewer companies chose to list overseas. A total of 22 cases were listed on the NASDAQ and 13 cases were listed on the New York Stock Exchange (NYSE).

CHAPTER 5
COMPARATIVE ANALYSIS OF MANAGEMENT MODES OF CHINESE AND FOREIGN PE FUNDS

5.1 Comparison Of The Government Regulation Modes Of Chinese And Foreign PE Funds

As the PE fund industry in the UK and the US boasts many years of success, their regulatory mode is worth learning from and referencing. The regulations for PE funds in the UK and the US are characterized by their goal of protecting investors and giving full play to the role of the market and industry self-regulation given the premise of proper supervision and rational guidance for industrial development. During the entire regulatory process, the UK and US governments paid more attention to creating a good external environment for PE funds to fully play to their characteristics. Japan's PE funds are a typical negative example because they are primarily subsidiaries of consortia and are therefore supervised too strictly, which hinders the healthy development of the industry considerably.

Table 5.1 *Comparison Of Regulation Modes Of Chinese And Foreign Private Equity Funds*

Country	United States	United Kingdom	Japan	China
Regulatory mode	Easy regulation, with the goal of protecting investors and implementing industry self-discipline; the "absence of legal prohibition means permission"; the government is positioned to guide the development of the industry and create an external environment conducive to driving industry development	Easy regulation, providing only guidance through macroeconomic policies and emphasizing industry self-discipline; the government is positioned to actively play the role of resource allocation, providing services such as subsidies and loan guarantees for enterprises	Strict regulation because the funds are mainly from the government and banking institutions; the government has been heavily involved in industry development and provided services such as loan guarantees	The regulatory mode has not yet been fully formed, with the regulatory body, goal, and content not specified explicitly; "absence of legal specification means prohibition"; the government does not position itself clearly, failing to play an effective guiding role in the early stage of industry development

Under the supervision mode of PE investments in China, supervision is decentralized, with the ambiguity of power and division of labor making it barely possible to have the entire industry supervised efficiently. The laws that have been enacted at present only restrict and control PE funds within their scope of supervision and fail to have a macro grasp on the industry as a whole. Consequently, the feedback on the obstacles and problems encountered during the industrial development has difficulty reaching regulators in a timely manner; the lack of clear responsibilities will lead to the embarrassing situation of “everyone in charge of supervision, while no one can manage it.” This situation may have little impact in the early stages of the PE investment industry, but given its rapid development, the outbreak of a series of problems in the future will force supervision to be reformed and upgraded.

5.2 Comparison Of The Organizational Structures Of Chinese And Foreign PE Funds

Originally, PE funds in the US reflected the corporate form. Later, as some of the architectural design experiences of hedge funds were adopted, the limited partnership became the current mainstream organizational structure. At present, this structure has been adopted in 80% of PE funds. PE funds in the UK are mainly limited partnerships and trusts, although the government-run British Technology Group has a corporate form. Trusts are a major feature of the UK. After the promulgation of the *Venture Capital Trust Act* in 1995, the VC trust began to be used widely. PE funds in Japan are mostly subsidiaries of large consortia. To facilitate management, these funds primarily have a corporate structure.

Table 5.2 *Comparison Of Organizational Structures Of Chinese And Foreign Private Equity Funds*

Country	United States	United Kingdom	Japan	China
Organizational structure	· Initially corporate and gradually developed into a limited partnership	· Mainly limited partnership and trust, although the official companies are mainly of the corporate form	· Mainly corporate	· Mainly limited partnership, followed by trust and partly corporate given the history

In the Chinese market prior to 2007, when the *Partnership Enterprise Law* had not yet been enacted, there were no limited partnerships in China, only GPs. Therefore, many early RMB funds had a corporate form. For the practice in China, the government formulated a number of preferential policies for corporate funds and exempted certain taxation of corporate VC funds. Following the legalization of limited partnerships, an increasing number of PE funds have adopted the organizational structure of limited partnerships. At the same time, trusts have also become a mainstream choice. Compared to a limited partnership, which has a limited number of investors, a trust has a maximum of 200 investors, thereby greatly reducing the difficulty of fundraising.

5.3 Comparison Of The Fundraising Management Modes Of Chinese And Foreign PE Funds

In Europe and the US, the main sources of fundraising for PE funds are mainly large institutions represented by pensions, banks, and insurance companies. Such large investors can provide a large amount of low-cost, long-term funds, which is suited to the features of PE investments. Most PE funds in Japan are subsidiaries that have been established by large consortia because their funds are mainly from their parent companies. Long-term development experience proves that institutional investors can better match the operational characteristics of PE funds because PE funds require a large amount of capital to invest. Further, their long investment period requires capital requirements to be stable and low-cost.

Table 5.3 *Comparison Of Fundraising Management Modes Of Chinese And Foreign Private Equity Funds*

Country	United States	United Kingdom	Japan	China
Fundraising management	Mainly large institutional investors such as pensions, endowment funds, banks, and insurance companies	Mainly pensions, insurance companies, banks, and high-net-worth (HNW) individuals	Mainly consortia such as banks, securities companies, and insurance companies	Listed companies, government guiding funds, private enterprises, funds of funds

In the Chinese market, listed companies, government guiding funds, private enterprises, and FOFs are favored by GPs, and more than half of investment institutions tend to raise funds from such entities. Given policy restrictions, low-cost and stable funds such as pensions, insurance funds, and bank funds now still fail to enter the PE investment market, in spite of such capital representing precisely the funds that are most suitable for nurturing the development of the PE investment industry.

5.4 Comparison of the Operational Management Modes of Chinese and Foreign PE Funds

The study of the operational management of international PE funds indicates that they feature flexible investment strategies, standardized operational processes, and complete post-investment management. PE funds in the US invest in emerging industries in large proportions, significantly larger than in other countries. Among them, investment is mainly concentrated in high-tech industries: computers, biomedicine, communications, and so on account for approximately 90% of total investments. In the US, PE funds have the effect of investment agglomeration. Investment objects focus on California and Massachusetts, where a large number of startups and institutions of higher education operate. Compared to the US, the UK’s PE funds invest primarily in high-tech industries, and Japan’s PE funds invest mainly in mature companies, mostly in line with the strategic development needs of their parent companies.

Table 5.4 *Comparison Of Operational Management Modes of Chinese And Foreign Private Equity Funds*

Country	United States	United Kingdom	Japan	China
Operational management	Mainly investing in emerging industries such as computers, biomedicine, and communications; investment strategies are relatively rich and mainly from VC and M&A funds	Mainly investing in high-tech industries; investment strategies are rich; VC investments focus on growth and seed investments, whereas government agencies focus on maturity investments	Mainly investing in traditional industries; investment strategy is mainly M&A funds	Mainly traditional industries; investment strategies of China's PE funds are mainly Pre-IPO and growth capital

The mature foreign business environment provides more diversified strategy choices for PE funds. In addition to venture investment capital and growth capital, the developed economic environment of foreign businesses also provides abundant M&A resources. The mature business environment makes international fund managers more professional and allows them to implement more standardized and reasonable control over the investment process. The rapid growth of China's PE investment industry has led to a lack of standardized management for operations. Many PE funds have even skipped over due diligence when seizing an opportunity. During an economic upswing, such issues remain hidden but will gradually emerge when China's macroeconomic growth slows.

Post-investment management can be said to be a worldwide problem. In Europe and the US, large PE investment companies will set up special post-investment management departments to help improve the operations of the invested companies, whereas investment managers have multiple jobs for smaller PE funds. The same is true in China. PE investments have high professional requirements for fund managers. The quality of fund managers in China varies, leading to insufficient post-investment management in many PE funds.

5.5 Comparison Of Exit Management Modes Between Chinese And Foreign PE Funds

A diversity of exit channels is an important prerequisite for a virtuous circle in the PE industry. The EVCA and the BVCA have been working to advance the secondary PE market. At present, second-hand transactions of corporate shares among funds have become an important exit channel for PE in Europe and the US. The NASDAQ trading market in the US is a model of success and provides an efficient exit channel for many international PE funds. Moreover, its mature trading system also increases equity liquidity, which attracts numerous investors conducting equity transactions, thereby providing a platform for PE funds to exit at high prices. To shorten the gap with developed countries and build a harmonious society under the rule of law quickly, learning from the successful experience of developed countries such as Europe and the US is essential to avoid similar mistakes as well as to gradually develop and improve China's VC exit mechanism.

(1) Choose the best VC exit method. The two VC exit methods, public listing, and M&A, play a crucial role in the VC industry in the US. A public listing is the best choice for a VC exit. However, public listings face numerous problems, such as high transaction costs, a long period required for the exit, and strong dependence on the capital market. In recent years, although authoritative credit rating agencies and mature second-board markets exist in developed countries, the proportion of many successfully invested high-tech enterprises exiting through public listings has declined year by year. It is rather intriguing to note that, throughout the US, the proportion of M&A exits of all VC exits is increasing. By contrast, in the VC field, the government played a role that cannot be underestimated. The government can encourage and support but cannot interfere too much. For example, the Chinese government can adopt various incentives to support the development of the VC industry, introduce a series of measures to protect the industry to a certain extent and create a stable and healthy development environment to fundamentally reduce the risks of VC. The developed American government has long recognized that VC plays an important role in promoting economic development and has played a protective role. In actuality, the American government rarely participates directly in the management and operations of VC. Admirably, the American government can make full use of its characteristics of high risk and high returns, on the one hand, to induce investors to make venture investments and, on the other hand, adjust and improve the talent management and management capabilities internally and the living environment externally to effectively avoid many of the confronted risk factors.

(2) Establish diversified VC exit channels. VC institutions do not invest in an enterprise to obtain short-term economic benefits for the enterprise; the main purpose is to choose the most appropriate time to enter the enterprise and to exit at the most appropriate time when the business operates well to obtain long-term capital appreciation. Three main exit methods exist for VC funds: IPO, M&A, and liquidation. A comparison of these three methods makes it easy to conclude that the third exit method is passive and that the other two are of corresponding positive significance. The current situation of VC appreciation, particularly the fact that enterprises can be approved for IPOs, is the best example of the venture success of business operators, and the high premium obtained after a public listing can result in significant returns to enterprises. Strengthening the development of the legal system is necessary. The US and other developed countries are doing better in this aspect. These countries attach considerable importance to

developing legal systems for VC and, from a national level, have strengthened the management and supervision of VC investments in high-tech enterprises through legislation, thereby creating a good legal environment for the healthy development of high-tech enterprises. The *Small Business Investment Act*, which was enacted by the American government in 1958, has provided the main legal basis for the development of VC.

Table 5.5 *Comparison Of Exit Management Modes Between Chinese And Foreign Private Equity Funds*

Country	United States	United Kingdom	Japan	China
Exit management	Mainly exit through NASDAQ	Mainly exit through the third market	Mainly exit through M&A, although the GEM is established	The NEEQ market is currently the main exit channel

China's NEEQ is set up to provide an effective exit channel for many PE funds. In contrast to the past, waiting to go public on the main board is no longer necessary when too many candidates are available for only a few openings. Furthermore, because the NEEQ threshold is low, it is an exit for some emerging industries that cannot enter the GEM. However, the NEEQ faces the problem of insufficient trading activity, which also leaves a hidden danger that may subsequently give rise to the exit of PE through the NEEQ.

CHAPTER 6
PROBLEMS AND CAUSES OF THE ORGANIZATIONAL STRUCTURE MANAGEMENT OF PE FUNDS

6.1 Problems And Causes Of The Organizational Structure Management Of PE Funds In China

6.1.1 Manifestation Of Problems With Organizational Structure Management

(1) Problems with corporate form PE funds

First, when investing in a PE fund, individual investors bear a double tax liability. Second, given the lack of flexibility in corporate form PE funds, the rights and obligations of investors shall be specified in accordance with the *Company Law*. Third, because the rules and regulations are relatively stringent, the procedures for capital increase and decrease are complicated, and good investment opportunities are very likely to be missed. Fourth, for an enterprise's listing, a limited partner cannot act as an independent shareholder of an enterprise to be listed.

(2) Problems of limited partnership PE funds

First, before the implementation of the newly revised *Partnership Enterprise Law*, the organizational form of partnership PE developed slowly, and after its implementation, investors did not know enough about it. Second, as regulated by Chinese laws, partnership enterprises are not allowed to raise funds or be publicly listed; however, in foreign countries, partnership enterprises can be publicly listed. Third, a partnership enterprise does not have a legal personality, and only in the name of a partner can it invest, indicating a relatively large principal-agent risk.

(3) Problems of trust PE funds

First, similar to partnerships, trusts do not have independent qualifications, and a trust manager must make the investments, implying that a principal-agent problem exists. Second, because a trust does not possess an independent legal personality, it hinders a trust-holding to-be-listed company from going public. Third, no clear legal provisions exist on tax policies. Fourth, because an investment company is not allowed to be founded in the form of a trust, it cannot enjoy tax incentives for unlisted small- and medium-sized high-tech enterprises. Fifth, the funds of a trust must be in place at one time, which cannot meet the flexible investment needs of investors who seek to invest in installments or withdraw funds at any time. Sixth, a trust cannot reasonably and effectively arrange incentive and restraint mechanisms, increasing the principal–agent risk.

6.1.2 Cause Analysis

The main reason for the confusion in organizational structures is that the current relevant laws in China are not sound. As mentioned previously, before 2007, when the *Partnership Enterprise Law* had not yet been enacted, no limited partnerships existed in China. Only GPs existed; therefore, many early RMB funds were of the corporate form.

After the promulgation of the *Partnership Enterprise Law*, problems exist in the conditions of establishment, taxation, supervision, and so on given imperfect laws. Moreover, government agencies do not understand PE funds, and differences exist in local regulations. Therefore, PE funds may bear certain legal risks when they are established, leading to many variants of limited partnerships in practice.

6.2 Problems In The Current Regulatory System

6.2.1 Manifestation Of Problems In The Current Regulatory System

(1) Absence of regulatory laws

To date, China has not introduced special legal provisions to supervise and regulate PE funds. Some relevant provisions are in the current *Company Law*, *Trust Law,* and *Partnership Enterprise Law*, but they fail to specify the legal status of a new financial vehicle—private placements. In addition, because existing regulatory laws are viewed as having different legal norms, taxing private placements of different organizational forms is subject to different standards, a situation that is not conducive to protecting the legitimate rights and interests of PE funds.

(2) Lack of regulatory bodies and unregulated supervision ideas reduce management efficiency

At present, special regulatory departments for PE funds in China are lacking, which implies a lack of regulatory bodies and systematic supervision. Current laws only have relatively clear provisions on the establishment and operation of PE funds in the form of VC and lack provisions for regulatory departments for other forms of PE funds. The current regulatory system lacks a unified system of regulatory departments, the regulatory functions of relevant departments are unclear, and departments fail to cooperate well.

(3) Unclear regulatory objectives are not conducive to financing and to protecting investors

China's current laws also impose strict restrictions on large institutional investors' entry into PE funds. At present, given limited financing channels, PE funds continue to have difficulty fundraising and finding qualified institutional investors. In terms of investor qualifications, the relevant provisions of China's laws mainly use the investment amount as a limiting condition; China's regulatory system also lacks an effective definition of qualified investors. With respect to the existing laws, only the *Measures for the Administration of Trust Companies' Trust Plans* contain provisions on qualified investors; however, no definitive definition of qualified investors exists for other organizational forms. PE funds with other organizational forms are not subject to these two laws.

(4) Inexplicit regulation content and unstandardized fund establishment and operation

The current laws have no explicit norms in terms of regulatory objects and content. Developed countries impose regulatory exemptions on PE funds, provided that relevant laws have already stipulated investor access, limitations on the number of people, private placement method, and other conditions to control for risks and protect small- and medium-sized investors—to ensure a stable financial market. In China, excluding PE funds of the trust form, other PEs have not established a qualified investor access system. Therefore, some funds often have illegal publications and hide risks when established, which may create sizable losses for investors. Therefore, an urgent task is to explicitly specify investors, fund managers, and fund operation norms and to include such content in regulations.

6.2.2 Analysis Of The Causes Of Problems

(1) Related to the development process of the industry

The industry is an emerging “imported product” for China. When entering China, PE funds were merely regarded as a case. Since then, they have developed quickly from pure US dollar funds to RMB funds, and the government has not had time to develop a systematic response. In recent years, regulators have introduced a number of policies and regulations to regulate PE funds, but these are limited to macro-level legal interpretations and a degree of impermanence. The relevant laws include the *Company Law* and the *Partnership Enterprise Law*. However, considering the issues discussed in this article, the two are not uniform and have many contradictions. Relevant regulations include the relatively macro *Interim Measures for the Administration of Venture Capital Investment Enterprises* issued by China’s 10 ministries and commissions and other notices issued by the NDRC on the provisions on fundraising behavior. These Measures and such notices are not quite consistent in terms of the minimum LP investment amount. In addition, the notices issued by the tax authorities on tax regulations and preferences are quite difficult to implement. Even many local tax authorities shirk each other for various reasons.

(2) Lack of clear legal definition and supervision resulting in absences at the institutional level

In particular, temporary regulations are not systematic and uniform, resulting in the poor operability of relevant policies. For example, the aforementioned fund filing problem is a very typical case. In December 2011, the NDRC issued the *Notice for Promoting the Development of Equity Investment Enterprise Specification* (referred to as the Notice), restarting the PE fund filing policy. The Notice stipulates that equity investment enterprises with a capital scale (including the amount of capital that an investor has contributed and has not contributed but has promised to contribute) of 500 million yuan or equivalent foreign currency shall be filed with the NDRC and that those with a capital scale less than 500 million yuan shall be filed with the administrative department determined by the provincial government. However, given a lack of relevant operational experience and professional guidance, the PE management departments of some local governments have caused fund filings to be slow, and administrative work such as the annual industrial and commercial inspection of the funds has been tentatively set up in some areas. If we state that the fund filing did not have a significant adverse effect on fund development, the postponement of the annual inspection of an enterprise will have a relatively large impact, particularly if the fund investment project is to be listed.

6.3 Problems And Causes Of The Fundraising Management Of PE Funds In China

6.3.1 Manifestation Of Fundraising Management Problems

From the perspective of financing management, international PE funds are more mature in operational systems and operations, and pensions' shares are important proportions throughout fundraising management. The successful experience of the UK and the US reveals an important conclusion: the entry of large and low-cost funds, such as pensions and insurance funds, into the PE investment market, brings tremendous development momentum to the development of the industry.

(1) Insufficient institutional investors

According to the provisions of China's relevant policies, the national social security funds, commercial banks and commercial insurance companies, enterprise annuities, securities traders, and trust companies are allowed to make PE investments. However, the actual investment scale and proportion of these institutions are minuscule, and these institutions cannot truly become China's institutional investors in PE investments. On October 29, 2015, Wang Zhongmin, vice-chairman of the National Council for Social Security Fund, delivered a speech at the "China Fund Industry Innovation and Development Forum and Beijing Fund Town Seminar." He stated that, as stipulated by the State, the proportion of social security funds that can be used for PE investments shall not exceed 20% of the total capital. The current total amount of national social security funds is approximately 1.5 trillion yuan, whereas PE investments have reached only 2% of this amount, or 30 billion yuan, far lower than the quota stipulated. Judging from the proportion of global PE fundraising sources, pension funds have accounted for 25%, ranking second in sources of funds. In 1978, the US also revised the "prudent man" clause of pension funds, expanding the sources for and improving the financing structure of PE funds.

Since then, pension funds have gradually become the main investors in the PE funds of the US. Research from the US indicates that, during the 20 years after 1978, the proportion of pensions in total financing increased from 15% to 60%, and these 20 years witnessed the first and second periods of prosperity for US PE funds.

(2) Small fundraising scale of PE funds

Although the fundraising scale of PE funds in China has been increasing in recent years, compared to foreign developed countries, this scale, for China's PE funds as a whole or per fund, is significantly lower than that of the US and developed countries in Europe. In 2014, China's PE funds raised 388.2 billion yuan, which accounted for approximately 0.61% of China's total GDP. In comparison, the proportion in the US and the UK was 5%. In 2015, China's PE funds raised an average of 358 million yuan, whereas the same average amount per fund in the US in 2014 was US $846 million, equivalent to approximately 5.1 billion yuan. These figures show that the fundraising scale of China's PE funds as a whole or per fund is significantly lower than that of developed countries. The main reason for this is that China's PE funds have only a few sources of funds. Compared to the US, direct government investments account for a large proportion, whereas relatively wealthy individuals and enterprises invest less. Social security funds face certain restrictions on PE investments, and securities and insurance companies also need to meet certain conditions. All these factors have resulted in the small scale of Chinese PE funds.

(3) Low participation by social security and pensions

In terms of the sources of funds, investors in the US's PE market mainly include pension funds, financial investment institutions, endowment funds, and HNW individuals. Among them, institutional investors are the mainstays, particularly public pensions, which accounted for 27.3% of the US's PE fund sources in 2007. In recent years, the proportion of the US's public funds in the PE market has further increased. For example, Oregon's National Fund Plan increases the proportion of PE funds from the original 16% to 20%, the California State's Teacher Retirement Fund intends to increase this proportion from 12% to 13%, and the Pompano Beach Police and Firefighter Retirement Fund will double the proportion of PE funds. Investors in China's PE market have always been dominated by financial institutions and private capital, and the participation by social security funds and pension funds is very limited. Although China's social security funds have been approved for entry into the PE investment field since June 2008, the investment ratio is clearly defined not to exceed 10% of the total assets (calculated by cost) of the National Social Security Fund.

6.3.2 Cause Analysis

The nature of PE investments determines that institutional investors are more suitable for participating in such investments because they have abundant funds and low-risk sensitivity, can guarantee a long investment period, and can resist fluctuations in the macro environment. These factors of PE funds ultimately create high returns. However, regarding China’s current situation, policy factors have led to a restriction on the entry of large institutional investors, such as social security funds, pension funds, insurance capital, and bank capital into the PE fund industry. Moreover, government-guided funds and industrial investment funds focus too much on a certain type of investment. All these issues result in the market failing to function well. At present, the more common practice is to cooperate with listed companies for strategic equity investments. However, regarding the entire industry, the financial ability of a single enterprise cannot provide sufficient investments after meeting daily operational needs. More crucially, a single enterprise cannot support long-term investment projects, which is why the early PE investment cases in China are all investment operations with participation from foreign-invested funds.

6.4 Problems And Causes Of The Operational Management Of PE Funds In China

6.4.1 Manifestation Of Operational Management Problems

(1) Uneven proportions in the PE investment industry, too concentrated in certain fields

According to the Zdatabase data, the main industries for PE investments in China include IT, the Internet, telecommunications, and some traditional ones. Among them, the IT industry was the hotspot for investments in 2015, with investment cases and investment amounts ranking at the top. The six major industries—Internet, IT, biotechnology/healthcare, telecommunications and value-added services, machinery manufacturing, and finance—account for more than 50% of both the total investment cases and investment amount.[6] This is primarily because they are either monopolistic or in new industries, featuring quick investment returns and short life cycles as well as considerable room for appreciation, which is convenient for investment recovery.

(2) Small investment scale and simple investment strategy

The scale of PE investments in China is relatively small when viewed from either the overall investment scale or the average investment amount of a single fund. In the US, individual project investments often attract up to tens of billions of dollars. However, this situation is rare in China primarily because individual investors are the main object of fundraising in China, and institutional investors invest only a small percentage of funds; that is, given an insufficient fundraising scale, the investment scale is also small. Moreover, China’s PE investments are mainly concentrated on VC and growth capital, which account for approximately 85%, followed by real estate investments, PIPE, etc., and by M&A funds at only 0.5%. However, M&A investments in Europe and the US during 2005–2007

[6] PE investment hit a new high; emergent IPO closure and booming NEEQ — VC/PE industry data interpretation of the 3Q of 2015 [J]. China's strategic emerging industry, 2015, 22: 60-64.

accounted for almost 80%, whereas VC accounted for less than 0.2%, mainly because PE funds in China have not been perfected and remain in the primary development stage, whereas the newly emerged high-tech industry is still in the startup and development stages. European countries and the US have developed high-tech industries that are more mature; therefore, as VC is already saturated, achieving large-scale operations through M&A is necessary to strengthen industrial competitiveness.

(3) Concentrated investment area

China's PE investments are still concentrated in Beijing, Shanghai, Shenzhen, Guangdong, Jiangsu, and Zhejiang, which are primarily coastal cities in the east. This geographic concentration has appeared because the economic development level in these areas is relatively high, and the government has provided considerable assistance through policy guidance for PE funds. Many local governments in these areas have introduced promising policies to encourage fast growth of PE funds. Thus, the investment areas of PE funds are more concentrated.

(4) Inadequate management level and professional quality of investment institutions

According to relevant data from www.ce.cn, as of the end of October 2015, China's Fund Industry Association had 21,821 registered private fund managers, including 9,632 private securities managers and 10,195 PE managers. The number of filed private funds reached 20,853, including 12,407 private securities funds and 6,382 PE funds. The scale of private fund management is 4.89 trillion yuan (approximately US $770 billion), where the total size of private securities funds is 1,903.8 billion yuan, and that of PE funds is 2,553.2 billion yuan. The US has 2,694 private fund managers, with a total management size of US $9.96 trillion (total net assets of US $6.71 trillion). The approximation is that the total size of private placement industrial management in the US is more than 10 times that of China. The US has 8,635 hedge funds with a total net asset size of US $3,399 billion and 8,407 PE funds with a total net asset size of US $1,744 billion. For a single hedge fund, the average net asset size is US $3.94, and the average size of a single PE fund is US $207 million. These data show that, although China has a far higher number of private fund managers than the US, its fund management scale is quite similar and the asset size is much smaller. Among the 21,821 fund managers in China, approximately 15,000 or 70% have a management scale of zero, mainly because local private fund managers have immature investment experience and low professional quality. They are eager for quick successes and instant benefits when investing in projects, making it impossible to judge whether a project is a qualified investment from a professional perspective. Some of these managers depend on consulting intermediaries to decide on the projects in which to invest and, even after investing, rarely participate in managing the invested companies and providing value-added services. Such irresponsible behavior substantially reduces investment efficiency and seriously affects investors' understanding of the PE fund industry. If investment managers' professional qualities are not improved, solving these problems becomes impossible.

6.4.2 Cause Analysis

The PE investment industry has stringent professional requirements for practitioners, including not only professional investment operation capabilities but also professional ethics, a rich investment experience, and an extensive network of contacts. Practitioners in China are not well-balanced, which directly leads to the fact that actual personnel qualities cannot effectively meet the industry's development needs. In this respect, China is far behind foreign countries. On the one hand, the country has no experienced fund managers, and on the other hand, its operating system of funds is relatively lacking.

For post-investment management, most PE funds in China adopt the pre-IPO strategy, which does not require, to some extent, investment managers to intervene excessively in target enterprises' operations. In addition, business owners in China generally have such strong control that even if investors wish to intervene, doing so in practice is difficult. The more important reason is that the numerous PE fund projects in China seriously distract investment managers with respect to their time and energy. In the international market, a fund management company invests in an average of fewer than four projects a year, whereas in China, this number is in the dozens. For example, Shenzhen Capital Group (SCGC) invested in nearly 50 companies in 2012 and 81 companies in 2011.

6.5 Problems And Causes Of The Exit Management Of PE Funds In China

6.5.1 Manifestation Of Exit Management Problems

Today, China's PE funds are mainly invested in unlisted enterprises, and the exit methods are relatively similar. In 2015, China's PE investment exit method was primarily to list on the NEEQ, and its proportion reached 51%, followed by IPO and M&A. By choosing to list as an exit strategy, investors often receive higher income; however, this exit method has a strong relationship with the perfection of China's capital market system. At present, China's multi-level capital market system still needs to be improved. Although launched on January 16, 2013, the NEEQ is not a new capital market system with standardized operations yet. For PE fund investments, the NEEQ market is undoubtedly the best method of exit. The main board market has high listing requirements, the SME board and the GEM markets have limited capacity, and the NEEQ market has just emerged. All these factors reflect the difficulty that China's PE funds have in exiting, thereby reducing the circulation efficiency of PE funds.

(1) Few exit channels

The exit mechanism is an important part of the PE market. Its smoothness and perfection directly determine PE investment enthusiasm and activity. The perfect multi-level capital market in the US provides a broad stage for PE funds to exit. Investment targets of different types and different business conditions have suitable exit platforms. Over the years, it is of critical importance that the proportion of M&A exit has always exceeded 50% for the US's PE funds. This finding is closely related to the developed OTC market in the US. The exit channels of China's PE funds are relatively much narrower. Although both the Shanghai and Shenzhen Stock Exchanges have formed a three-plate market system, the three plates are increasingly showing significant similarities and considerably high thresholds that most SMEs find difficult to meet. The over-the-counter NEEQ experienced a comprehensive expansion in 2014, but its number of listed companies and market activity still needs to improve. In addition, the transfer mechanism from the on-board to the off-board and from the GEM to the main board market has not yet formed, directly leading to the decline in the attractiveness of the NEEQ market. Furthermore, the M&A market, another important exit channel, has considerable room for improvement in breaking down local protection, improving the efficiency of M&A audits, perfecting the basic institutional environment of capital markets, and enriching M&A financing and means of payment. In general, compared to developed markets such as the US, the exit channels for PE investment in China are still relatively narrow.

(2) Relatively heavy dependence on the domestic IPO market

Since China's IPOs generally have a valuation advantage and a high price-to-earnings ratio (P/E ratio), PE funds in China tend to exit through IPOs. For example, in 2012, under various influencing factors such as China's IPO system reform, a significant decrease in the P/E ratio, and a relatively sluggish market, the average P/E ratio of 155 newly issued stocks was 30 times, a significant decrease from the 58 times in 2010 and 47 times in 2011. As the P/E ratio was significantly higher than the average IPO P/E ratio of foreign markets, PE investors in China were very keen on an IPO exit method. Moreover, given the impact of the Chinese capital concept stock fraud in 2012, only three companies were listed on the NYSE and the NASDAQ in 2012, fewer than overseas listings.

Although listing through an IPO ensures relatively large earnings for fund investors, only a few enterprises can go public through an IPO because of China's high IPO listing threshold and the complicated approval process. The number of PE investment institutions is increasing, and these institutions mostly tend to invest in mature enterprises that are to be listed. Therefore, competition is becoming increasingly fierce. The enthusiasm of China's PE funds for the IPO exit method reflects a lack of long-term investment awareness of PE investment institutions in China, resulting in a disordered development of the industry. Moreover, this enthusiasm also provides a hotbed for power rent-seeking, which is prone to corruption.

(3) Imperfect capital market

Investors often prioritize exit methods for PE investments. An expedited exit method can provide convenient conditions for the development of PE funds and ensure fund investors' investment activity and enthusiasm. At present, China's capital market is still not perfect, the capacity of the A-share market is relatively small, and the listing threshold is relatively high. Although the listing difficulty has declined in recent years, it is still difficult and the cycle is too long. Notwithstanding the pilot expansion of the share transfer system in the over-the-counter market in 2012, only enterprises established in the four national-level high-tech development zones, including Beijing Zhongguancun can be listed. Further, as another important exit method, the M&A market also has a complicated approval process and lacks activity. In addition, China's over-the-counter and property rights markets also keep a slow growth momentum and have narrow exit channels. They cannot better serve PE funds and are not conducive to the sustainable development of PE funds.

(4) Absence of specific laws and regulations

Many years of reforms from the limited *Partnership Enterprise Law* to the *Interim Measures for the Administration of Venture Capital Investment Enterprises* have created no legal or regulatory obstacles in the development of PE funds. However, to date, no administrative regulation, no special VC law, and no industrial investment fund law exist that specifically regulates PE behavior. The law that can be regarded as the first national-level law in China's VC industry is the *Interim Measures for the Administration of Venture Capital Investment Enterprises*, jointly issued by the 10 ministries and commissions of China.

No property rights transaction law exists, and the relevant provisions on this part are observed sporadically in the *Company Law*, the *Securities Law*, the *Law Against Unfair Competition*, and so on. Specific regulations are fragmented and are conflicted in many aspects. Meeting the needs of enterprises to exit from the property rights trading market is not only difficult but also, in some cases, faces obstacles.

China's laws and various rules and regulations have increased the difficulty of the PE investment exit. For example, both the *Company Law* and the *Enterprise Bankruptcy Law* stipulate the following: "Where an enterprise has caused serious losses due to poor operation and management and is unable to repay its debts due, it shall be declared bankrupt in accordance with the provisions of this Law." This regulation is too strict to delay the best exit time for PE investments after bankruptcy. The No. 142 document of the CSRC restricts listing in China of companies supported by partnerships, and PE institutions supported by partnerships are the most common organizational form in the world. The CSRC also has regulations for overseas listings of enterprises. Enterprises must complete the entire process of fund acceptance and return within one year after the approval of the establishment of a special purpose vehicle (SPV). This makes the time cost of overseas IPO listing enterprises two to three months longer.

China's tax law also lacks relevant legislation on exit earnings. After June 2007, the limited partnership operation mechanism officially appeared on the stage of China's PE. China's partnership-type enterprises are not taxpayers, but the lack of capital gains taxes and its current suspense of the collection of individual income taxes for income from securities transfers causes problems in identifying investment returns. The problem that general partners' returns are either capital gains or service income is not specifically answered by China's tax law, and no prior experience exists in practice.

6.5.2 Cause Analysis

A complete and mature capital market should be composed of the main board, the second board, the bond market, the over-the-counter market, and the property rights trading market. Such a rich structure can ensure that PE funds can flexibly choose exit channels for different projects. Only sustained profits are the source of power for their continuous development. The unsound development of China's capital market is a long-standing problem. The listing threshold in the market is so high that IPOs have always faced fierce competition, and the lack of a hierarchical capital market will reduce the investment enthusiasm for PE funds.

(1) VC institutions' defects

1) Investment institutions lack professional and high-quality talent teams. China's venture investments have relatively weak team-building efforts. Under the operational mode of China's economic environment, professional managers and technicians in China's VC industry mostly have independent functions. This fact has caused a lack of professional management personnel and entrepreneurs who specialize in professional management, financial knowledge, and technology development. In the absence of these high-quality professionals in China, VC institutions are prone to mistakes and deviations when formulating exit decisions and engaging in exit operations, thus affecting their smooth exit from VC firms.

2) The property rights model structure of investment institutions is problematic. As the vast majority of VC institutions in China are funded by the government, VC enterprises should inevitably operate in accordance with the mode of state-owned enterprises. In the current situation, the exit decisions made by VC firms are often not the most reasonable ones. To summarize, problems with the property rights model structure of VC institutions restrict the smooth exit of VC.

3) Uncertain property rights of venture companies. Many venture companies in China are born in research institutions colleges and universities. Such an initiation is bound to blur the property rights relationship between VC firms and original units. Defining the rights and obligations between them in the form of contracts on the basis of law is not easy. Therefore, constructing a trading entity that is qualified for a VC exit is difficult, thus restricting such an exit.

(2) Imperfect exit site

1) As the entry threshold for China's securities market is relatively high, small-scaled venture companies invested in VC have difficulty meeting the listing requirements. Further exploration and innovation should be undertaken before making China's current GEM into a GEM that is suitable for VC exits. Given its relatively recent establishment, China's securities market does not have a relevant regulatory system for VC, and the main market players need to be standardized.

2) Underdeveloped property rights trading market. An equity buy-back is simpler than the public listing operation process and low in cost, enabling the realization of a one-time divestment. For small-scale, high-risk, high-tech companies in the early stages, the buy-back is the only feasible and effective exit channel. However, because of the underdevelopment of China's property rights trading and capital markets, trading venues have relatively few restrictions. In general, the number of high-tech enterprises is large, and completing transactions on the main board and the second board market is impossible. China's property rights trading market has crossed through many hard roads primarily because the supervision system is not perfect, the supervision is not strong enough, and many serious violations have been discovered during implementation, leading to a considerable deviation from the real property rights trading market. The poorly managed property rights trading market will inevitably lead to the decentralization and wasting of resources, which is not conducive to the optimal allocation of resources, increases VC transaction costs, and reduces operational efficiency, all of which are very unfavorable to the development of the

property rights trading market. The unsound development of the property rights trading market has seriously affected the exit of venture companies in the form of mergers.

(3) Unsound exit environment

1) Unsound legal environment. At present, China’s current laws are lagging. During practice, many loopholes exist. The legal system for the VC exit is not perfect, and no relevant legislation exists for the VC exit mechanism, which restricts China’s VC exits considerably. The *Interim Measures for the Administration of Venture Capital Investment Enterprises* are mainly issued for VC institutions. Many VC exits have not been protected and regulated by laws and regulations. China needs to further improve its formulation of laws and regulations for VC.

2) A strong policy environment. The government is crucial to the process of China’s VC exits, and today’s social bureaucracy is very popular. VC exits are bound to meet with resistance from the government’s administrative departments. Because the government’s administrative supervision is inefficient, excessive intervention leads to black-box trading rule operations.

3) Lack of standardized intermediary service environment. The functional limitations and the authenticity, rationality, and scientificity of the evaluation value of China’s intermediary service organizations cannot meet the basic requirements of a VC exit. Their inaccurate evaluation and inadequate service during the exit process cause unnecessary losses for both parties to the exit.

4) The backward cultural environment leads to integrity. Many large and powerful companies in China make extensive investments in their research projects focus on such projects, and are reluctant to conduct M&A. Many managers of small- and medium-sized ventures are reluctant to accept enterprises’ M&A as an exit. Integrity in today’s society is very important. a lack of integrity will restrict exits, and a backward and conservative cultural environment will cause problems, such as untimely, unreal disclosures, when a company exits.

(4) Imperfect exit channels

1) Corporate bankruptcy liquidation is used less frequently in China.

Liquidation is the most effective exit method to reduce losses after the failure of a VC investment. The main problems with this method are as follows. First, China has a mandatory requirement for this method; in other words, only when the enterprise is insolvent can it be liquidated. Such a requirement will cause the enterprise to miss the best time for a divestment. Second, the inevitable result of an investment failure is significant losses for the enterprise.

Third, the current auction market in China is not very developed. All of these issues have made it difficult to realize corporate assets; therefore, the cost of liquidation will increase, limiting the use of liquidation.

2) Exiting through a public listing in China is still difficult for enterprises.

Investment institutions have difficulty exiting through a public listing on the Chinese mainboard market. The main restrictions are as follows. First, application procedures are complicated, market access requirements are strict, and the time required to complete a listing is longer. Second, if the venture business is successfully listed, the VC of a VC institution cannot be withdrawn immediately, and the process will take some time. Third, the restriction on an exit is substantially affected by the secondary market. Currently, China has a SME board market. However, the requirements of listing standards and conditions are as strict as those of the main board market, leading to an inability to truly provide opportunities for SMEs to trade. Thus, in the case of the imperfect development of China's capital market, realizing an exit through a public listing is still difficult for VC institutions.

3) Exiting through an overseas offering and listing is still difficult.

As China's capital market becomes increasingly open and mature, using overseas offerings and listings to achieve a capital exit has become a viable option. However, substantial difficulties remain. First, laws between countries have similarities and differences and may even conflict. Second, accounting standards vary from country to country, and readjusting and preparing reports according to the requirements of the listing location is necessary, increasing financial expenses. Third, a number of strict, cumbersome, and complicated examination and approval procedures must be completed, particularly for listings involving state-owned enterprise assets.

CHAPTER 7

SUGGESTIONS FOR IMPROVING PE FUNDS' MANAGEMENT MODE IN CHINA

7.1 Strengthening Industry Self-regulation On The Basis Of Improving Macro-regulation

7.1.1 Making Clear The Purpose Of Regulation

When developing a regulatory policy on PE investment, the government should first consider the purpose of regulation and not just for the sake of having a regulation. China should draw lessons from the US's thinking on regulations, that is, ensuring that investor protection is the primary goal of regulation. Owing to the serious information asymmetry in the PE investment industry, considerable investment risks may bring large losses to investors. Therefore, the qualifications of qualified investors should be clarified and publicity and the induction of investments should be strictly prohibited. In this regard, numerous cases have already occurred in China, and many funds have committed fraud in the name of PE.

7.1.2 Making Clear The Subject Of Regulation

The PE investment industry is a vibrant industry, but excessive regulation may stifle its inherent vitality. Japan's experience in regulation tells us that excessive government regulations can only plunge the industry into a vicious cycle of development. Excessive government regulations may significantly lower the operating efficiency of PE funds and raise comprehensive management costs; however, China has not yet established a sound industry self-regulation mode. The current self-regulation mode in China has many problems, such as strong administrative color and a particular emphasis on management. An appropriate industry self-regulation mode should be as follows: regulation management rules and industry standards are formulated through consultation within the industry and industry associations supervise and restrict PE funds according to these rules and standards.

7.1.3 Clarifying The Contents Of Regulations

The first requirement is making adjustments to the market access mechanism. At present, China implements a filing management system for PE funds, which essentially conforms to the current national conditions of China. In the short term, the filing system is an intermediate product of the transition from the approval system to the registration system. Nonetheless, the registration exemption system should be a future trend of PE fund regulations. To protect investors, after defining the concept of qualified investors, we should adopt effective regulations over fund investors and fundraising methods and sources during the fund establishment stage.

Information disclosure has always been a key point of PE regulation worldwide. During the development of the PE investment industry in the US, information disclosure standards have also gone through several adjustments. Owing to their particularity, PE funds generally prefer not to disclose the investment scale and strategy. Excessive information disclosure will make it difficult for PE funds to conduct business, but a lack of necessary information disclosure creates insufficient investor protection. PE funds should engage in information disclosure to their investors, rather than external disclosures, to protect them. During fund operations, information related to fundraising, investments, post-investment management, and exit performance should be disclosed to investors in a timely manner. In particular, large funds should perform mandatory disclosures to prevent systematic risks.

7.2 Optimizing The Organizational Form Of PE Funds In China

At present, PE fund investment in China is still in the continuous development stage, and many relevant laws and policies are imperfect. According to the *Investment Risk Yearbook 2014*, the organizational form of PE funds in China can be divided into, for example, corporations, limited partnerships, and VC firms affiliated with a financial institution.

7.2.1 Adopting The Limited Partnership Organizational Form

International experience shows that the limited partnership is a common organizational form for PE funds in most countries.

PE funds are organized as limited partnerships mainly because of the advantages of avoiding double taxation and properly addressing the principal-agent issue. In light of these advantages, this organizational form is recommended for China.

In particular, the *Partnership Enterprise Law* issued in 2007 has created a better legal and policy environment for the adoption of limited partnerships in China, detailed as follows.

First, some new provisions on limited partnerships have been added. Limited partners are required to assume limited liability to the extent of their capital contributions, which will assist in enhancing investors' enthusiasm and expanding the source of funds.

Second, an enterprise's legal persons can invest as limited partners. The law stipulates that an enterprise's legal persons can invest in PE in the form of a partnership. Hence, listed companies, state-owned enterprises, public institutions, and other social organizations can invest as limited partners in PE.

Third, the law stipulates that partnerships are not taxpayers; hence, only their partners are required to bear the tax obligation.

7.2.2 Perfecting The Policy And Legal Environment Of Limited Partnerships

As the *Partnership Enterprises Law* and the *Enterprise Income Law* do not have clear provisions on the taxation of institutional investors in limited partnerships, limited partnership enterprises cannot enjoy investment tax credits in practice. Therefore, in China, we can perfect PE funds that are in the organizational form of limited partnerships with respect to the following aspects.

(1) Setting different tax standards for different types of investors

Investors in limited partnerships can be divided into individual investors and institutional investors and into general partners and limited partners depending on the type of investors. Different investors and partners face different liabilities and benefits, thus differing in taxable items and tax rates.

First, the earnings of individual general partners belong to incomes from production or business operations because they participate in the daily management of PE funds. Consequently, they should pay taxes according to the individual income tax law, that is, at the progressive tax rate of 5%—35% in excess of specific amounts. The earnings of individual limited partners belong to income from the transfer of property because they only transfer the right to use their assets rather than participating in the daily management of PE funds. Thus, they should pay individual income taxes at a 20% rate.

Second, institutional general partners should pay the enterprise income tax on their profits at a 25% rate because they participate in the daily management of PE funds. The income of institutional limited partners is neither the income from the transfer of property nor dividends or bonuses according to the tax laws in force because they cannot participate in fund management. In the context of a lack of an appropriate tax base, China should define tax items for this type of income as soon as possible to solve this problem.

(2) Improving the specific provisions on tax declarations

In terms of tax declarations, different tax policies are implemented in different regions in China. For example, the tax policies for natural persons in Beijing and Tianjin are different from those in Shanghai. In this context, China should formulate unified and detailed preferential tax policies as soon as possible to encourage the development of PE funds.

(3) Gradually removing obstacles in partnership enterprises to shareholders of companies to be listed

China should promulgate applicable laws to provide specific provisions for partnership enterprises as shareholders of companies to be listed. On the one hand, China can allow partnership enterprises to open accounts and relax the restrictions on the number of partners. On the other hand, China can enhance the promotion of partnership enterprises to enable investors to have a better understanding of partnership enterprises.

7.3 Expanding Funding Sources Of PE Funds

The PE markets in the US and developed European countries have rich sources of funds. In the US, PE funds mainly raise funds from institutional investors, with pension funds accounting for the largest proportion, followed by endowment funds, foundations, insurance companies, and banks. Families and individuals account for only a small proportion. At present, the main funding sources of PE funds in China are individual investors, a fact that has seriously inhibited their rapid development. Therefore, China should increase investments from institutional investors. In China, no endowment funds exist. The main institutional investors include social security funds, pension funds, insurance companies, and banks. Past experience shows that China's social security funds have invested in PE and ultimately achieved high returns. In 2006, China's insurance companies made PE investments in industry funds through pilot infrastructure projects. In 2008, the CBRC issued relevant guidelines to encourage trust companies to invest in PE funds. In recent years, commercial banks have also begun to directly and indirectly invest in PE funds.

7.3.1 Encouraging Pension Funds And Enterprise Annuities To Invest In PE Funds

International experience shows that investing in PE funds through pension funds and enterprise annuities not only raises pension fund returns but also promotes the rapid development of PE funds rather than increasing investment risks.

China's social security funds reached 1 trillion yuan in 2011 and 1.5 trillion yuan in 2015. Further, China's enterprise annuities are under rapid development and are expected to reach 15 trillion yuan by 2030. Therefore, on a large scale, pension funds and enterprise annuities can bring abundant funds to PE funds in China. Pension funds and enterprise annuities should be strongly encouraged to invest in PE funds.

At present, China's pension funds and enterprise annuities are subject to quantitative restrictions in relation to investment scale. For example, the *Interim Measures for the Administration of Investments by the National Social Security Fund* and the *Trial Measures for the Administration of Enterprise Annuities* promulgated by China restrict the investment proportion and investment tools of pension funds and enterprise annuities, respectively. The National Social Security Fund may invest in the industry funds approved by the NDRC and PE funds registered by the NDRC, provided that the investment proportion cannot exceed 10%. However, local social security funds and enterprise annuities in China are not allowed to invest in PE. In this context, China should gradually develop pilot projects for investments in PE by these social security funds and enterprise annuities.

7.3.2 Encouraging Financial Institutions To Invest In PE Funds

In recent years, China has promulgated several laws in succession to strongly encourage financial institutions to invest in PE funds, such as the *Guidelines for the Risk Management of Merger and Acquisition Loans Granted by Commercial Banks*, the *Guidelines for the Pilot Program of Direct Investment Business of Securities Companies*, and the *Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds*. To increase institutional investor participation in PE funds, we suggest the following improvements.

First, measures for the management of insurance companies in China must be improved, and the enthusiasm of insurance companies for investments in PE funds must be increased.

Second, China has begun to encourage trust and investment companies to invest in PE in a certain proportion. On this basis, China can gradually relax its policies on investments in PE by financial lease companies, guarantee companies, and business finance companies.

Third, commercial banks have become an important funding source of PE funds in developed countries in Europe and the US. China can learn from the experience of European countries, the US, and Japan, that is, establishing commercial bank subsidiaries to mainly engage in PE investments and management.

7.4 Standardizing Investment Operations In China

Rational systems and norms, similar to highways, are an important guarantee for the rapid development of the industry. Therefore, the future PE investment industry faces the proposition to develop a reasonable architecture design, establish sound fund operation processes, and utilize some framework agreements in the transaction structure to help invested enterprises develop well.

Rational system construction can be performed from the following aspects. First, investment strategies should be enriched. The implementation of diversified investment strategies not only requires the support of the macro environment but also raises higher requirements for professional fund managers. The investment fields should be completely expanded from some high-tech industries to cover traditional industries. Second, in the past, PE funds failed to address the principal-agent problem between funds and enterprise managers. This problem needs to be given more attention in the future. We can stimulate target entrepreneurs through equity incentives, thereby binding the interest goal more effectively. Third, enhancing the supervision over target enterprises through phased investments is suggested. Strengthening the operational audit of target enterprises at all stages and emphasizing financial and labor controls is a “small man first and gentleman second” way, which can help fund managers reduce investment risks effectively.

Providing value-added services may be a possible method for PE funds to carry out post-investment management. In the face of increasingly fierce industrial competition, only first-class PE investment services can stand out. The experience of KKR & Co. in the US shows that value-added services can be developed as a new business growth point for fund companies. Professional operations managers can be employed to provide good post-investment management services for invested companies and extend other fund operation links. In the initial fundraising stage, excellent value-added services are more likely to attract abundant funds; in the process of investment operations, post-investment management departments can intervene and provide professional evaluation reports.

7.5 Improving The Comprehensive Quality Of Management Teams Of China’s PE Funds

China’s PE investments have a serious blind following in terms of scale, strategy, industry, and investment areas. At present, a common problem of PE funds in China is the inability to choose high-quality investment projects reasonably, which usually results in low returns. The fundamental reason is that China’s PE funds always lack professional management teams, meaning that human and monetary capital cannot be combined well to ultimately achieve the value-added of PE funds. In foreign countries, however, many outstanding management teams of PE funds exist. They can choose the best of several projects and finally earn high returns. Hence, high-quality fund management teams are also very important for the rapid development of PE funds.

7.5.1 Paying Considerable Attention To The Cultivation Of PE Fund Management Talent

When solving the problems of PE funds in China, the principal-agent problem should be addressed first. To this end, we should stimulate the management ability of PE fund managers to allow them to devote more energy to fund operations, thereby reducing the risks of PE funds considerably. Consequently, PE fund managers are required to have rich professional knowledge, unique judgment, and outstanding personal ability. Hence, we can cultivate fund managers from the following aspects.

(1) Provide convenience for professionals of other financial institutions to enter the PE fund industry to enable them to serve as project operators or leaders, and improve the professional competence of PE fund managers.

(2) Gradually attract overseas PE fund management talent to China's PE fund industry; promote the formation of China's market competition environment, improve the governance structure of China's PE funds, which can help establish a standardized investment operation mechanism; and improve China's PE operating mechanism through continuous learning. When attracting overseas management talent, domestic PE fund management teams and managers can be encouraged to learn from overseas management professionals and study overseas advanced strategic management and investment experience, thereby increasing outstanding management talent in China's PE fund industry.

(3) Strengthen the construction of integrity in China's PE fund managers to enable them to play a certain role in restraining the entire PE investment industry.

7.5.2 Improving The Ability In Operation Of PE Fund Managers

In terms of PE investment operations, we can improve the ability of China's PE fund managers from two aspects.

(1) Carrying out pre-investment investigations

Project evaluation is a precondition for selecting a good investment project for PE funds. In general, project evaluation can be performed from two aspects: enterprises' internal conditions and external conditions. The investigation of internal conditions usually covers the personal abilities and qualities of enterprise managers and the overall organizational structure, scale, and management level of enterprises. An investigation of external conditions mainly covers industry-related laws, regulations, and economic policies as well as enterprises' position in the industry and industrial competitiveness. All these factors will have a certain impact on the future operating capacity and profitability of enterprises. After the evaluation, investors will decide whether or not to invest according to the evaluation results.

(2) Correct the investment philosophy

Investment managers should change their original investment philosophy and treat PE investments as long-term rather than short-term investments. In PE investments, seeking quick success and instant benefits and blindly following trends are undesirable. When investing in an enterprise, investors should fully evaluate it. According to the evaluation results, investors should correct the enterprise's organizational management mode and rebuild its business process and corporate culture to further raise its intrinsic value.

7.6 Improving The Exit Environment Of PE Funds In China

The rapid development of PE funds in the US is inseparable from the developed stock market and the rich capital market in the US. The fundamental purpose of PE investments is to gain profits. Hence, an appropriate exit is essential to PE investments. To create a good exit environment for PE investments, China can improve its domestic capital market in the following aspects.

7.6.1 Improving The Main Board And SME Board Markets

The main board of the Shanghai Stock Exchange and the SME board of the Shenzhen Stock Exchange are now the main securities trading markets in China. At present, these two markets are too similar in functional orientation, trading rules, and listing requirements to reflect the differences in China's capital market and meet the listing demands of different enterprises. The two markets are characterized by a high IPO P/E ratio, unstandardized pricing mechanism, low market capacity, high listing criteria, complicated approval procedures, and long listing cycle. In 2009, CSRC, through a reform of the new share issuance system, increased the market's size and capacity, gradually optimized the market structure and mechanism, and lowered the listing criteria. Despite the reform, many difficulties remain in the listing.

In the future, China should further deepen the reform of new share issuances, advance marketization, reduce administrative interference, and improve the basic construction and market restraint mechanism to allow issuers, investors, underwriters, and other market players to assume their respective responsibilities. In terms of new stock pricing, China should reduce government interventions and establish a market-oriented pricing mechanism under which the new stock price can reflect a company's real value, thereby realizing the optimal development of the primary and secondary markets. Through the reform, China can achieve quicker, healthier, and more market-oriented development of the main and SME boards, thus providing a good exit channel for PE funds.

7.6.2 Vigorously Developing GEM And NEEQ

GEM and NEEQ are the trading markets that provide financing for emerging and promising enterprises that cannot currently be listed on the main board and are important parts of the capital market. Compared to the main board market, GEM and NEEQ have unique advantages that compensate for the shortcomings of excessively high criteria for listing on the main board market and provide an effective exit for PE funds. However, China's GEM is not significantly different from the main board market in terms of listing standards, rules, and approval procedures; hence, it cannot reflect the characteristics of GEM well. Further, China's NEEQ, recently established at present, lacks clear provisions on many listing procedures and needs significant improvement, thus bringing certain problems to SMEs in listing.

Hence, China should draw lessons from the development experience of foreign mature capital markets and establish different listing standards for different enterprises to give full play to GEM's and NEEQ's role in serving high-tech, growing, and emerging industries. On the one hand, we should lower the listing standards for enterprises regarding scale, profitability, and so on, and formulate a number of standards to serve more SMEs with growth potential. On the other hand, we can properly adjust the going-concern period of enterprises, set different requirements for the going-concern period for different industries (overall, the going-concern period can be shortened), pay more attention to the growth and quality of enterprises, and reduce the audit standards to provide a good exit for PE funds.

7.6.3 Developing The OTC Market

OTC trading can also be used as an exit for PE funds to broaden their exit channel. A well-run OTC market can make the exit of PE funds more convenient, help investors gain returns, and stimulate investors' enthusiasm, thus promoting the development of SMEs in China. At present, the CSRC is optimizing the share transfer agency system of the Shenzhen Stock Exchange. However, this market is not yet an OTC market for qualified investors. In this context, China should clearly define and gradually open the OTC market as soon as possible, further standardize enterprise qualifications, trading rules, and the settlement methods of OTC trading on the basis of a full consideration of the development needs of such trading and constantly improve the regulatory system to allow the OTC market to provide a convenient exit for PE funds. Specific measures include the following: clearly define the types of transactions by establishing a unified trading rules system, develop a regulatory committee to supervise market behavior and require OTC trading enterprises to have clear property rights and an organizational structure of companies limited by shares.

7.6.4 Developing The Property Rights Transaction Market

The exit of PE funds is essentially a property rights transfer. To exit from invested enterprises, PE funds should have a clear property rights relationship. Therefore, China should continuously standardize and optimize the property rights market to promote its healthy development and thereby enable PE funds to exit the capital market successfully. According to the current situation, China's property rights market has been developing for nearly 10 years, is highly standardized, and has become a very important part of China's capital market.

At present, China's capital market is still imperfect. The vigorous development of the property rights trading market can provide a good exit for PE funds. Under the existing property rights trading system, however, acquired unlisted enterprises still face many constraints when trading in the property rights market. Therefore, China should improve the property rights trading market as soon as possible, give full play to the role of the market by lowering the conditions and standards of property rights trading, and develop property rights trading into an important exit channel.

CHAPTER 8

CONCLUSION AND OUTLOOK

8.1 Conclusion

In the context of global economic weakness, China will be the country with the most opportunities in the future, and PE funds will play an important role in providing opportunities. PE funds can effectively use the profit-pursuing property of capital and help enterprises grow rapidly and create value by virtue of their abundant funds and rich professional knowledge. Compared to the stock market, PE funds are more down-to-earth. They can guide funds to entity enterprises and truly nurture industry development.

The international experience of PE funds shows that the rapid economic development in the US cannot be separated from active PE funds. Most of the major 500 companies in the world are more or less backed by PE funds. Given a late start, China's PE funds still have a lot of room for improvement: chaotic organizational structure is a persistent problem of China's legal system, which restricts the healthy development of the industry; regulatory uncertainties lead to industry irregularities and leave investors unprotected; given policy restrictions, the financing channel cannot obtain long-term, low-cost capital support and lacks the motivation for growth; in terms of investment operations, a lack of professional fund managers and perfect industry self-regulation results in an imperfect operation system; and China's imperfect capital market restricts the exit channel.

China's PE investment industry faces many problems in all aspects. Nevertheless, hard-working and talented Chinese citizens still follow this path and have made considerable achievements. If the problems mentioned in the previous paragraph can be solved, China's PE investments will usher in a new round of explosive growth, becoming an important engine for economic growth. When performing macro-regulation in the PE investment industry, the government should make clear the purpose, subject, and content of the regulation. In terms of the management mode of China's PE funds, we need to expand the source of funds, standardize the investment process, improve post-investment management, and broaden the exit channels.

The conclusion is unclear. The main points in each chapter need to be summarized, such as the problems that exist and the specific countermeasures that are put forward.

8.2 Outlook

The author believes that the following aspects need further study and discussion.

(1) In the early stage, China's PE industry was dominated by foreign PE funds. With the continuous growth of domestic fund managers and PE funds, many companies such as Fosun have frequently participated in the international PE market. Hence, the internationalization of China's PE funds is a worthwhile direction for future research.

(2) The continuous expansion of NEEQ helps many PE funds release the pressure of an exit. However, we still face a NEEQ with insufficient liquidity. In the future, improving the trading system and advancing the M&A in NEEQ will be a new concept for activating the vitality of the industry.

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