

Venture capital investment in China: market and regulatory overview¹

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A Q&A guide to venture capital law in China.

The Q&A gives a high level overview of the venture capital market; tax incentives; fund structures; fund formation and regulation; investor protection; founder and employee incentivisation and exits.

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This Q&A is part of the PLC multi-jurisdictional guide to venture capital. For a full list of jurisdictional Q&As visit www.practicallaw.com/venturecapital-mjg.

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Market overview

1. What are the main characteristics of the venture capital market in your jurisdiction?

Venture capital and private equity

Venture capital is distinguished from private equity mainly by investment stage, investment areas, investment scale, and risk and return:

- **Investment stage.** Private equity funds usually invest in mature companies with stable cash flow and growth rate. In contrast, venture capital funds typically invest in early- to mid-stage, high-risk and high-growth companies.
- **Investment areas.** Venture capital funds usually invest in high technology and high growth industries, whereas private equity funds invest across a broader array of more mature industries.
- **Investment scale.** Private equity investors usually invest larger amounts of money in the target company, to acquire control over the company. Venture capital investors typically only acquire a minority stake by investing smaller amounts of money.
- **Risk and return.** Venture capital investors assume higher risk by investing in less mature companies, and usually require a higher rate of return. The risk assumed by a venture capital investor when investing in a single company is normally much higher than for a private equity investor. In addition, the volatility of returns across a venture capital investment portfolio is much higher than for a private equity investor.

Private equity and venture capital funds are principally regulated by the National Development and Reform Commission (NDRC). Venture capital funds are governed by established national regulations promulgated by the NDRC, whereas private equity funds are governed by relatively new local (provincial/municipal) regulations with limited unified synchronisation at the national level. This often leads to inconsistent practices with respect to the formation, recording, operation,

investment and taxation of private equity funds in different areas across China. Private equity funds are subject to generally higher standards (for example, with respect to total size and the minimum investment by a single investor).

Sources of funding

Founders of start-up companies typically receive their initial funding from friends and family. Some companies receive funding from angel investors before venture capital comes in. Government guidance funds in China are also available for early stage companies in certain industries and locations. For example, high-tech companies in Beijing Zhongguancun Science Park can apply for several types of preferential policies, such as financial subsidies, tax preference and special funds. Early-stage companies often cannot provide sufficient collateral to receive loans from traditional bank channels. In response to the huge demand of early to mid-stage companies for financing, small loan companies, trust companies and other lending institutions have designed innovative loan programmes focused on providing loans to small- and medium-sized enterprises.

Types of company

The most active sectors for venture capital investments are consumer, biotechnology, healthcare, information technology, media, telecommunication, e-commerce and clean energy industries.

Market trends

Some venture capital funds directly invest in a Chinese company and then seek to exit the company through an IPO or trade sale in China. However, due to the increasing difficulty in getting listed on A-share market in China, significantly reduced valuation on IPOs and foreign exchange restrictions, venture capital funds increasingly invest in an offshore company that indirectly holds shares of a Chinese company. This is so that the offshore company can seek an overseas listing. In addition, shares held by venture capital funds are easier to transfer to a third party outside of China in the case of a trade sale.

Venture capital investment activities have slowed down significantly since the second half of 2011, due to the unfavourable global economic outlook and the poor performance of Chinese concept stocks on international capital markets. However, they have gradually improved since the beginning of 2013, following the improved performance of Chinese concept stocks on international capital markets from the fourth quarter of 2012.

The Bohai Region (centered around Beijing and Tianjin), the Yangtze River Delta Region (centered around Shanghai, Jiangsu Province and Zhejiang Province) and the Pearl River Delta Region (centered around Canton Province) are the leading venture capital investment destinations.

However, venture capital investment has expanded geographically into new areas in Central and Western China, where the competition for deal flow is less fierce and more favourable governmental preferential policies are available.

2. Are there any recent or proposed regulatory changes affecting the venture capital industry?

Under the VIE structure (see [Question 7](#)), Chinese resident shareholders of an offshore company must both:

- Register with the local State Administration of Foreign Exchange (SAFE) before establishing or controlling the offshore special purpose vehicles (SPVs) (Circular 75 registration).
- Conduct change registration after the completion of the offshore financing, under the Circular of the State Administration of Foreign Exchange on Relevant Issues concerning Foreign Exchange Administration of Financing and Inbound Investment through Offshore Special Purpose Companies by PRC Residents (Circular 75) and implementing and/or supplemental rules issued by the SAFE.

On 19 November 2012, SAFE issued the Circular on Further Improving and Adjusting the Direct Investment Foreign Exchange Administration Policies (Circular 59) and relevant supporting documents (including the Operational Guideline of Circular 59). The Operational Guideline of Circular 59 shortens the time limit for Circular 75 Registration and simplifies the procedures of fund repatriation. Circular 75 Registration must be conducted mainly in accordance with the Operational Guideline of Circular 59.

Tax incentive schemes

3. What tax incentive or other schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

General tax treatment

Offshore venture capital funds (offshore funds) are typically established in tax haven jurisdictions and invest in offshore structures. Therefore, offshore funds can in principle invest and exit tax free, subject only to the tax rules of its jurisdiction of domicile.

In contrast, onshore venture capital funds (onshore funds) are established within China and are subject to Chinese tax laws and regulations. The tax treatment of RMB funds depends on the legal vehicle used by the fund:

- Onshore fund organised as a limited liability company:
 - fund: 25% enterprise income tax (EIT) on capital gains of their investment exits. Dividend distributions from the investee companies are exempt from EIT;
 - enterprise investors: Chinese enterprise investors are generally exempt from EIT on dividend distributions made by the fund. Foreign enterprise investors are subject to a 10% withholding EIT on dividend distributions, unless an applicable tax treaty provides for a more favourable withholding arrangement;
 - individual investors: 20% individual income tax (IIT) on dividends distributed by the fund.
- Partnerships:
 - fund: no EIT at fund level;
 - enterprise investors: 25% EIT for Chinese investors on attributable income. The tax treatment for offshore enterprise investors is unclear, but a 10% withholding EIT is likely to be imposed;
 - individual investors: IIT is generally charged at a progressive rate ranging from 5% to 35%. Certain local tax rules permit a flat IIT rate of 20% to be imposed on the income of individual limited partners. In some localities, individual general partners may also benefit from 20% IIT. In addition, in certain localities, IIT may be imposed on a deemed profit basis, and the effective IIT rate could potentially be lowered to single digit.

Venture capital investment in non-listed high-tech companies

A venture capital fund organised in the form of a company may benefit from an incentive for investment in non-listed small- and medium-sized high-tech enterprises. The venture capital investment company can deduct 70% of the amount of its investment in qualified high-tech enterprises from its taxable income, if it has held its investment in the investee companies for at least two years. All of the following conditions must be satisfied to qualify:

- The venture capital enterprise must be registered as a "venture capital investment limited liability company" or "venture capital investment joint stock corporation".
- The venture capital enterprise must be recorded with the relevant local counterpart of the National Development and Reform Commission (NDRC).
- The investee companies must be recognised as high-tech enterprises and be small- to medium-sized (that is, have 500 or fewer employees, annual sales revenue of no more than RMB100 million, and total assets of no more than RMB 100 million).

Funding sources

4. From what sources do venture capital funds typically receive funding?

Offshore funds

Offshore funds (see [Question 7](#)) are typically invested into by cash-rich institutional investors, such as pension plans, universities, insurance companies, foundations, endowments and high-net worth individuals. If the offshore fund is structured as a limited partnership:

- The capital is contributed by the investors as limited partners.
- Typically, the general partner provides only a small proportion (about 1% to 5%) of the capital raised.

If the offshore fund is structured as a corporation, the capital is contributed by the investors as shareholders.

Onshore funds

Offshore funds (see [Question 7](#)) are typically invested into by domestic institutional investors, such as private funds focusing on investing in other funds (that is, funds of funds), investing companies, social security funds, insurance funds and high-net worth individuals. Onshore funds can be structured as limited partnerships or companies, and investors contribute their capital as limited partners or shareholders. The general partner of an onshore fund typically contributes 1-2% of the total capital raised by the fund.

Fund structuring

5. Can the structure of the venture capital fund affect how investments are made?

The currency of a venture capital fund can have a direct and significant impact on how investments are made in China. Offshore funds and onshore funds with a foreign element may be limited by foreign capital investment policies. For example, they may be subject to:

- The Catalogue of Industries for Guiding Foreign Investment issued and updated from time to time by the Ministry of Commerce (MOFCOM) (the latest version was issued in 2011).
- Registration with the SAFE and currency converting control and supervision.

- Compliance with the Merger and Acquisition of Domestic Enterprises by Foreign Investors Order (MOFCOM Order [2009] No.6).

Due to these limits on foreign capital, a VIE structure (see [Question 7](#)) is usually used when investments are made by offshore funds.

Pure RMB funds generally do not need special government approval for various deals, and generally offer simpler structures and tax pass-through treatment.

For more details of the structure of the venture capital funds, see [Question 7](#).

6. Do venture capital funds typically invest with other funds?

Venture capital investments can be made either individually or by a syndicate of venture capital funds, in either RMB or US\$. It is common for venture capital and private equity investments to involve co-investors or syndicate investors.

7. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

Generally, venture capital funds are organised as offshore funds or onshore funds. Offshore funds are typically set up in tax favourable jurisdictions such as the Cayman Islands, British Virgin Islands and Bermuda. They invest in Chinese companies through the VIE structure (see *below*). Offshore funds are set up in accordance with the laws of their respective offshore jurisdictions. Most offshore funds are structured as standard limited partnerships or corporations, and are governed by the terms of their limited partnership agreements or articles of association.

Onshore funds

China recently promulgated new policies and rules to promote a healthy and steady development of private funds. Onshore funds can be structured as either:

- Foreign invested funds (FIFs).
- RMB funds.

According to the Notice of the General Affairs Department of the SAFE on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign-funded Enterprises (Circular 142), a foreign-invested enterprise cannot convert its foreign currency capital to further make any equity investments in the PRC. However, the following types of FIFs can engage in equity investment regardless of these restrictions:

- Foreign-invested venture capital enterprises (FIVCIE) under the Administrative Provisions for Foreign-Invested Venture Capital Enterprises. These can be structured as a corporation or an enterprise without legal person status.

- Foreign-invested investment companies (FICs) under the Provisions on the Establishment of Investment Companies by Foreign Investors. These can only be formed as corporation.
- Foreign-invested partnerships that have been granted pilot QFLP status (QFLP funds) under the qualified foreign limited partner pilot programme (QFLP programme). These usually take the legal form of a limited partnership.

Foreign venture capitalists can also raise and manage RMB funds. All of the investors (other than the GP) in an RMB fund are PRC domestic institutions/individuals. An RMB fund can take one of the following forms:

- A domestic equity investment enterprise (DEIE) incorporated under local rules and regulations. Generally, the DEIE must have registered capital of at least RMB100 million and individual limited partner contribution of at least RMB10 million (these amounts vary depending on the location).
- A domestic venture capital investment enterprise (DVCIE). Generally, the DVCIE must have registered capital of at least RMB30 million and individual contribution of at least RMB1 million (*Interim Administrative Measures for Venture Capital Enterprises (DVCIE Measures)*).
- A domestic investment enterprise (DIE) established according to the requirements of the State Administration of Industry and Commerce (SAIC) and its local counterparts. Generally, the DIE must have registered capital of at least RMB10 million.

All the above mentioned enterprises can be established in the form of a corporation or a partnership. In practice, a limited partnership (LLP) is considered most favourable, for tax reasons and flexibility in distribution and management.

VIE structure

Due to the restrictions on direct investment by foreign investors and Chinese entities' need to access the international capital market, most foreign venture capital is invested in an offshore holding company established by founders of the investee company. This facilitates lawful transactions and gives venture capital investors the same type of investment rights and protections as they would acquire in other jurisdictions. The offshore company (directly or indirectly) establishes a wholly foreign owned enterprise in China that controls and receives economic benefits from the investee company through contractual arrangements typically comprising a:

- Service agreement.
- Option agreement(s).

- Share pledge agreement(s).
- Power of attorney.

These are jointly or separately executed by and among the wholly foreign owned enterprise, the PRC domestic operating company and all shareholders of the operating company (VIE structure). The VIE structure typically applies to a domestic company which either:

- Operates in an industry restricted or prohibited for foreign investment.
- Is an affiliate of an offshore acquirer. The acquisition is subject to the prior approval of MOFCOM (*Rules on M&A of a Domestic Enterprise by Foreign Investors (M&A Rules)*).

The VIE structure enables offshore funds to both:

- Invest in restricted or prohibited industries.
- Circumvent the approval of MOFCOM under the M&A Rules, providing Chinese entities with access to international capital markets.

The following must be taken into account if the VIE structure is used:

- Circular 75 registration (*see Question 2*).
- Failure to comply with Circular 75 results in the offshore company being prohibited from remitting money to the PRC subsidiaries and distributing profits out of China.
- Risk of the VIE structure being challenged as a mechanism to circumvent PRC foreign investment restrictions.
- The announcement in July 2012 of a US Securities and Exchange Commission (SEC) investigation into New Oriental Education & Technology has reignited discussion over the VIE structure. The SEC and other agencies could potentially raise issues regarding accounting treatment, enforceability of the VIE structure under Chinese Law and possible inadequate disclosure.

Investment objectives

8. What are the most common investment objectives of venture capital funds?

Funds typically seek a high return for their high-risk investment activities, regardless of the type of currency. The average life of an offshore fund investing in China is about ten years, with an extension of one to three years. An offshore fund generally focuses on investing its capital during the first six years after its establishment, and on exiting its investments during the last four to six

years of its lifecycle. In contrast, an RMB fund may have a fund life as short as three years (ten year RMB funds are not common).

Fund regulation and licensing

9. Do a venture capital fund's promoter, manager and principals require licences?

In general, an offshore fund and its promoter, manager and principals are subject to the local rules in the jurisdiction of its organisation.

There are no specific national laws or regulations relating to the promoter, manager and principals of onshore funds. In practice, independent management enterprises are often established to provide investment consulting and management services for the fund (fund-ME). If the funds are structured as QFLP funds or DEIEs, the fund-ME must be established as an equity investment management enterprise with "managing equity enterprises" within its business scope (EIE-ME).

The registered capital requirements are:

- At least US\$2 million for a fund-ME for a QFLP fund.
- At least RMB10 million to RMB30 million for a fund-ME for a DEIE.

If the funds are structured as DVCIEs, the fund-MEs can be established as:

- Venture capital management enterprises (DVCIE-MEs), usually with registered capital of at least RMB1 million.
- Ordinary advisory or consulting enterprises providing management/consultation services, usually with registered capital of at least RMB30,000.

There are no special approval procedures for the establishment of fund-MEs, except for fund-MEs for QFLP funds, which require the approval of the local Financial Services Office as part of the pilot fund establishment process.

10. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Offshore funds

Offshore funds are mostly regulated by the law of the jurisdiction where the fund is domiciled or formed.

Onshore funds

A DEIE, DVCIE or DIE can be established by registration with the SAIC or its local counterparts. QFLP funds are subject to pre-approval of local Financial Services Offices. However, the establishment of QFLP funds, DEIEs and DVCIEs is further subject to filing procedures with the NDRC or other relevant local authorities. Subject to certain preconditions, DEIEs and DVCIEs may benefit from preferential benefits at local level, and DVCIEs formed as corporations may benefit from a tax deduction and exemption (see [Question 3](#)).

11. How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

For both offshore and onshore venture capital funds, a limited partnership is the most common form of organisation. The relationship between investor and fund is governed by the limited partnership agreement. A limited partner of an onshore fund established as a limited partnership cannot participate in the management of the partnership affairs (*Partnership Law*). Therefore, limited partners as investors usually seek protections through their information and reporting requirements, and right to remove and replace the general partner.

Interests in investee companies

12. What form of interest do venture capital funds take in an investee company?

The interest taken may take the form of equity, option rights, convertible loans, short-term bridge financing or any combination of these.

Valuing and investigating investee companies

13. How do venture capital funds value an investee company?

Venture capital funds use various methods to value investee companies, including evaluating the:

- Status of a company in the relevant Chinese market.
- Intellectual property of a company.
- Price-to-earnings ratio (P/E ratio), which is often benchmarked against a similarly situated publicly traded company.

In addition, funds look at a company's potential value, growth potential and management team. The competition among different venture capital funds may also affect the valuation of the investee companies.

14. What investigations do venture capital funds carry out on potential investee companies?

Venture capital funds carry out a thorough due diligence investigation into each company in which they invest. Due diligence usually includes reviewing the company's:

- Corporate organisation and history.
- Licences and permits that must be obtained.
- Management and employee relations.
- Assets and intellectual property.
- Financial and accounting matters.
- Material contracts.
- Other legal and tax matters.

In particular:

- legal professionals issue a due diligence report regarding the corporate history, capital structure, compliance, material contracts, assets, labour and potential legal disputes.
- Financial professionals issue an audit report summarising the financial condition and accounting policies.

In addition to talking with the management of the company, the venture capital fund will also consult with the business partners, clients, employees and banks of the company, if necessary.

Legal documentation

15. What are the principal legal documents used in a venture capital transaction?

A standard venture investment by a foreign fund in China includes the following documentation:

- Shareholders' agreement.
- Share purchase agreement.
- Share restriction agreement (optional).
- Indemnification agreement (optional).
- Documents for establishing the VIE structure (optional) (VIE documents).
- Memorandum and articles of association of the investee company.

In addition, the investor may also require:

- Resolutions approving the transactions and the waiver of existing shareholders' participation in the current round of financing.
- A management rights letter.
- A compliance certificate certifying:
 - that the closing conditions required in the share purchase agreement have been satisfied;
 - the absence of adverse effect;
 - the truthfulness of the warranties and representations included in the share purchase agreement.
- Copies of the company's standard employment contract and confidentiality, non-compete and intellectual property assignment agreements, to ensure the company's intellectual property and other rights are adequately protected.
- Updated registers of members and directors.
- Share certificate issued in the name of the investor.

Venture capital funds almost always require the issuance of both:

- A formal legal opinion by local Chinese counsel concerning the legal existence and qualification of the Chinese subsidiaries and the validity of the VIE documents.
- An opinion from offshore counsel on the good standing of the offshore company that is the financing entity and the legality of the securities being issued.

Protection of the fund as investor

Contractual protections

16. What form of contractual protection does an investor receive on its investment in a company?

Investors in a company using an offshore structure usually have contractual protections in the form of extensive representations and warranties by the offshore company, the founders of the offshore company, and each of its subsidiaries.

A typical shareholders' agreement contains:

- Information rights that require a company to provide financial information to the investor.

- Inspection rights that allow the investor to inspect the company's books and records.

As preferred shareholders, investors usually also have (see [Question 21](#)):

- Rights of first refusal.
- Rights of first offer.
- Rights of co-sale (or tag-along).
- Pre-emption rights.
- Dividend preference.
- Liquidation preference.
- Anti-dilution rights.
- Conversion rights.
- Registration rights.
- Redemption rights.
- Drag-along rights.
- Protective voting rights.

An investor also usually requires the company to buy directors' and officers' (D&O) insurance for the director appointed by the investor, and to execute a separate indemnification agreement with the investor and its director.

Forms of equity interest

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

A venture capital fund often purchases an equity interest in the form of preferred shares in the offshore company.

The concept of preferred shares in a limited liability company is not legally recognised in China. Preferential rights under corporate charter documents and/or transaction documents may not be enforceable under Chinese laws and regulations. This is because, under Chinese law, all equity interests must be issued in the same form and have the same rights.

Preferred shares

18. What rights does a fund have in its capacity as a holder of preferred shares?

Offshore funds, as holders of preferred shares, commonly enjoy preferential rights including dividend preferences, liquidation preferences, anti-dilution protection, redemption rights and protective voting rights (veto rights).

The following rights, preferences and privileges are common in most venture capital investments by foreign funds in China:

- Liquidation preference.
- Dividend preference.
- Anti-dilution protection.
- Pre-emptive rights.
- Veto rights.
- Drag-along rights.
- Registration rights.
- Information rights.
- Right of first offer.
- Right of first refusal.
- Conversion right.

Management control

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company?

The fund commonly has control over the investee company through:

- Provisions regarding the voting procedures in the memorandum and articles of association.
- Certain provisions in the shareholders' agreement.

The protective provisions usually require either shareholder or board approval, with an affirmative vote of the investor or the director appointed by the investor, for company actions such as:

- Sale, issuance or redemption of any equity security.
- Declaration or remittance of any dividend or distribution.
- Any action which would change the rights, preferences, privileges or powers of the investor's preferred shares.
- Mergers and acquisitions (M&A).

- Dissolution or liquidation.
- Recapitalisations.
- Approval or amendment to budget, business plan and operating plan.
- Engagement of any material agreement.
- Appointment and removal of directors and key employees.
- Increasing top compensated employees' compensation.
- Amendment to memorandum and articles of association.
- Award or amendment of any employee share ownership plan.
- Amendment or termination of VIE documents.

Share transfer restrictions

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

The typical provisions in a company's shareholders' agreement include a:

- **Prohibition on share transfer.** This provides that ordinary shares held by the existing shareholders cannot be transferred to any third party without the investor's prior consent.
- **Right of first refusal and right of first offer.** These give the investor an option to purchase the offered ordinary shares on terms and conditions not less favourable than other potential buyers.
- **Right of co-sale.** Under this, the investor can participate in the sale of ordinary shares held by existing shareholders on the co-sale right of the investor.

It is common for an investor to require the founder(s) or other key management of a company to covenant not to transfer their shares (other than back to the company) for a specified period of time. To supplement this restriction, the investor usually requires the founder(s) or key management to enter into a share restriction agreement as a closing condition of the financing. The share restriction agreement provides a vesting schedule for the shares held by the founder(s) and key management. If any founder or key management personnel leave the company within the specified period of time, the company can repurchase a certain number of shares held by that founder or key person at an agreed price. Any transfer of unvested shares or vested shares must be made in compliance with the share restriction agreement and the shareholders' agreement.

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

Co-sale or tag-along rights can protect minority shareholders in a sale exit, as they allow the minority shareholder to:

- Participate in the sale of the shares held by the existing shareholder.
- Sell to the potential purchaser an equivalent percentage of its shares, at the same price and under the same terms and conditions.

The minority shareholder may also require a right to sell and transfer all of its shares if there is an offer for sale of all, or almost all, of the company's equity or assets.

A drag-along provision may also be included in the shareholders' agreement. This obliges the founders and other company shareholders to sell their securities together with the sale of the investor's shares, in the event of a transaction over a certain threshold. The founders and other shareholders are entitled to the same terms and conditions reached by the venture capital investor and the potential buyer.

Pre-emption rights

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Pre-emption rights are typically included in venture capital investment. A venture capital investor typically requires the right to purchase the number of shares necessary to maintain its percentage ownership in the company, where the investee company makes a future share offering. Sometimes, a venture capital investor also requires a warrant to purchase a certain amount of future shares at a discounted price per share.

Consents

23. What consents are required to approve the investment documentation?

A venture investment cannot be completed until all of the required consents and approvals from third parties and governmental bodies have been received. These are:

- MOFCOM's approval and AIC registration are required for an SPV to set up a wholly foreign invested enterprise in China.
- Circular 75 registration (see [Question 2](#)).
- Shareholders' approval and board approval for:
 - execution of the transaction documents;

- issuance of the preferred shares;
 - reservation of employee stock ownership plan (ESOP) shares;
 - appointment of the director appointed by the investor;
 - amendment of the memorandum and articles of association.
- Approval of the board and shareholders of the company's subsidiaries for execution of the transaction documents and the VIE documents.

Costs

24. Who covers the costs of the venture capital funds?

An investor usually requests that the investee company pays or reimburses the investor for all or at least a portion of both:

- Financial, accounting and attorney fees.
- Costs related tax liability incurred in the course of investment.

This reimbursement is sometimes subject to a cap and may exclude certain extraordinary expenses. However, if the transaction fails for reasons attributable to the investor, the investor may have to pay its own transaction expenses.

Founder and employee incentivisation

25. In what ways are founders and employees incentivised? What are the resulting tax considerations?

Incentives

Founders' and employee incentive plans generally include option plans, restricted share plans and sometimes valuation adjustment mechanisms (VAMs).

Option plans. For venture capital investment in an offshore company, the offshore company sets aside about 10% of all outstanding ordinary shares as option shares to be granted to employees. The investors require the option shares to be authorised and reserved before or on closing, to avoid diluting the investor's shares.

Restricted share plans. SAFE requires Chinese residents to register any offshore shareholdings. Domestic individuals who participate in the share incentive plan of a company listed overseas can be registered under the Circular on Issues concerning the Administration of Foreign Exchange for

Domestic Individuals' Participation in Incentive Plans of Companies Listed Overseas (Circular 7) with SAFE and its local counterparts. However, domestic individuals who participate in the share incentive plan of a non-listed offshore company cannot be registered under Circular 7. If those individuals intend to exercise their options under the share incentive plan, they must register their offshore shareholdings with SAFE under Circular 75. This may result in onerous obligations on the company to complete this registration. Therefore, many offshore companies' incentive plans provide that their respective employees cannot exercise the options granted under these incentive plans until the consummation of the companies' public offering.

VAMs. VAMs are often used to incentivise founders. VAM's usually adjust a company's valuation on the occurrence or non-occurrence of certain events. A typical VAM provides that if the company reaches (or fails to reach) a specified level of financial target (for example, revenue, net profit or growth rate) within the agreed period following the investment, both:

- The valuation of the company will be increased (or decreased) accordingly.
- The shareholding percentage of the investor in the investee company will be adjusted to reflect the increased (or decreased) valuation of the company.

The possibility of gaining a greater equity interest in the company motivates the founders and management. However, if the company fails to reach the pre-determined financial target, the valuation of the company will be decreased and the investors will be entitled to receive more shares of the company.

In 2012, the Supreme Court of China held a VAM clause to be invalid. This made the enforceability of VAM clauses uncertain.

Tax

Income related to stocks or options granted to employees is treated as salary and wage income for the employees. In principle, the grant of options does not trigger individual income tax (IIT) liability for the participating employees. IIT liability arises on exercise of the option. On exercise, the taxable income is the difference between the fair market value of the shares purchased and the option exercise price. A progressive tax rate ranging from 3% to 45% applies. If the stock incentive plans are implemented by listed companies and subject to the satisfaction of certain other requirements (including the filing of the relevant documents to the applicable PRC tax authorities), preferential tax treatment may apply. This may reduce the marginal tax rate applicable to that income. Therefore, the participant's basis in the stocks acquired is the fair market value of the shares on the date of exercise.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

A share restriction agreement is often used to ensure that a founder or other key employee who holds any share of the company remains with the company (see [Question 20](#)).

Founders and key employees are usually required to execute an employment contract with a minimum term prescribed by the investor. In addition, founders and members of management teams are often required to enter into non-disclosure and non-competition agreements with the investee company. These agreements prohibit them from engaging in the related business for a certain period of time. Non-competition obligations within these agreements are enforceable, provided that they comply with Chinese labour contract law, under which employers must pay reasonable compensation on a monthly basis to an employee during the term of a non-competition period.

Exit strategies

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

A venture capital fund usually exits through an IPO or trade sale. If an IPO or trade sale does not take place after a certain period, the investor can usually require the company to redeem its shares at the agreed redemption price. The redemption right can be exercised on the satisfaction of certain conditions, such as:

- The time when the right is exercisable has passed.
- There has been a material adverse change on the business and financial status of the investee company, attributable to the company or the founders.

In addition, in the event of the company's liquidation, dissolution or winding up, the investor has a liquidation preference to receive the agreed liquidation amount.

However, unsuccessful companies are often sold at a low price and their assets may not be sufficient to pay each investor its full redemption or liquidation amount.

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

IPO

The most common exit strategies for venture capital funds investing in Chinese portfolio companies are IPOs and trade sales. The percentage of successful exits in the form of IPOs in China is much higher than in the United States or some other developed capital markets. Venture capital funds favour exiting through offshore IPOs on the Hong Kong main board, the New York Stock Exchange or the NASDAQ. However, venture capital funds are typically not able to sell their shares immediately after the company is listed. They must wait for expiry of their lock-up periods.

Trade sale

Trade sales are less relied on by venture capital funds to exit their investments in China. This is due to the dominating role played by IPOs in exit strategy and the much lower valuation usually received by venture capital funds for their investment in trade sales than in IPOs. However, due to the sharp decrease in the valuation of IPOs and the moratorium placed by the CSRCC on IPOs since 2012, trade sales are gaining more attention. In addition to sales to strategic buyers, financial buyers such as private equity and venture capital funds specialised in purchasing existing investments from other funds have emerged. In trade sales, venture capital investors often sell some or all of their shares in the investee company to another investor or an acquiring company. In contrast to exiting through an IPO, the most significant benefit of a trade sale exit is that it is a complete and immediate exit.

29. How can this exit strategy be built into the investment?

Venture capital investors usually require undertakings from the investee company and other shareholders that they will endeavor to achieve an appropriate share listing or trade sale within a limited period of time. If the company fails to meet this time frame, the redemption right is triggered, allowing the investor to recoup its investment and rate of return.

A trade sale also usually triggers preferred shareholders' liquidation preference (and the participation right, if it exists).

Venture capital investors always request that standard registration rights be included in the investment documentation. This is so that the investors can demand that their shares be registered after the IPO.

If investors wish to exit through an IPO or a trade sale, a drag-along provision (see [Question 21](#)) can force the founders or other investors to approve a public offering or a trade sale.

Online resources

State Administration of Foreign Exchange (SAFE)

www.safe.gov.cn

Description. This is an official website for laws and regulations governing foreign exchange issues. Click on "English" at the top right hand corner for an English language version of the website, and then on the "Rules and Regulations" tab for English versions of relevant rules and regulations.

Ministry of Commerce (MOFCOM)

<http://english.mofcom.gov.cn/article/policyrelease/Businessregulations/>

Description. This is the official website for laws and regulations governing foreign investment.

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Areas of practice. Venture capital and private equity financings (VC/PE); formation and management of private equity investment funds (RMB funds); mergers & acquisitions (M&A); foreign direct investment (FDI); capital market transactions.

Non-professional qualifications. BA, Dalian University of Foreign Languages; LL.M., Law School of Remin University of China.

Recent transactions

- Represented Tencent Group and Chinese Academy of Sciences Holdings Co., Ltd. in establishing Beijing Sequoia Xinyuan Equity Investment Centre (Limited Partnership).

- Represented Qiming Venture Capital in establishing Beijing Qiming Chuangke VC Investment Centre (Limited Partnership) and Beijing Qiming Chuangyuan VC Investment Management Co., Ltd. in Beijing.
- Represented China Everbright Bank in its formation of an RMB fund.

Languages. Mandarin (native); English (fluent)

Professional associations/memberships. Member of the PRC Bar.

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Professional qualifications. Admitted in New York, US; Chartered Financial Analyst (CFA) and Chartered Alternative Investment Analyst (CAIA).

Areas of practice. Fund formation; asset management; private equity/venture capital; foreign direct investment; capital markets.

Non-professional qualifications. JD, Columbia Law School; BA in German and LLB, Peking University.

Recent transactions

- Advising leading global asset managers such as BlackRock and Invesco on various QFII matters ranging from offshore QFII fund formation to tax, foreign exchange and other regulatory counselling.
- Acting for a number of global hedge fund managers on applying to set up Qualified Domestic Limited Partner (QDLP) pilot funds in Shanghai in connection with raising capital in China for offshore hedge fund vehicles.

- Advising seven leading international private equity and venture capital firms such as Fidelity Asia, Qiming Ventures and SBI Holdings in setting up Qualified Foreign Limited Partner (QFLP) and RMB QFLP pilot funds in Shanghai.

Languages. Mandarin (native); English (fluent), German (fluent), Cantonese (fluent)

Professional associations/memberships

- Expert Review Committee of the QFLP and QDLP Pilot Programs administered by the Shanghai Financial Services Office.
- Expert Advisor to China Private Equity Association.
- Member, New York State Bar Association
- Member, International Bar Association, Investment Funds Subcommittee
- Member, New York Hedge Fund Roundtable
- Member, CFA Institute
- Member, CAIA Association

Publications

- What You Need to Know When Thinking about Forming a China Fund, forthcoming.
- What You Need to Know When Thinking about Forming a China Hedge Fund, forthcoming.
- Comparative Analysis of Local Rules Regarding Formation of Private Equity and Venture Capital Funds and Their Management Companies in China, Han Kun Asset Management Commentary, January 2011.
- How to Incentivize Your Private Fund Manager, Chinese Venture, May 2012.