The Corporate Governance Crises in Venture Capital Investment of China:

Case Studies and Legislative Response

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Abstract

Venture capital funds have been playing an increasingly important role in corporate governance of Chinese companies. Owing to the dominating status of the state-owned enterprises in Chinese economy, however, a contractual and market-based company law system has not been fully adopted by the Chinese legislators or regulators, which has substantively threatened the efficiency of venture capital investment in China. This article attempts to 1) reveal the nature of the corporate governance crises in the venture capital industry of China by carrying out detailed case studies of the most typical corporate governance events in the venture capital investments of China; and to 2) explore a feasible approach to striking a balance of interests of heterogeneous shareholders in Chinese corporate governance via critically reviewing the emerging class share system in the Chinese commercial law system. Although the on-going legal reform of the Chinese company law is beneficial for mitigating the conflict between the venture capital shareholders and controlling shareholders in Chinese companies, it may be impractical to transplant a comprehensive legal system of dual-class shares in the Chinese company law in a short future, since the state-owned economy may still impede the advancement of a liberalistic reform.

Key words: Chinese law; venture capital; corporate governance; case study; class share.

Introduction

With the boom of high-tech and internet industries in China in recent two decades, the role of venture capital (VC) funds in corporate governance is being more and more important. The high premium of the public stock markets has attracted quite a large number of VC investors to get their return by listing the portfolio companies. Once the private company is listed, however, entrepreneurial shareholders' control

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over the company will be significantly diluted. Because the culture in family enterprises is based on the acquaintance relationship rooted in traditional Chinese social ethics, the interpersonal relationship in Chinese private companies is commonly established on the personal authority of entrepreneurs, rather than the spirit of contract. Based on the above factors, a series of internal conflicts between VC investors and controllers of Chinese VC-held companies have drawn greater attention. In addition, due to the political restrictions, foreign investors are not permitted to invest in some special industries. As a response, foreign VC investors widely adopt the variable interest entities (VIE) which consists of a bundle of contractual arrangements to achieve overseas listing, however, the complexity of the VIE structure also weakens the stability of corporate governance of the VC-held companies.

This article begins with a brief overview of the institutional background of the private companies in China. The following part carries out a series of case studies of the corporate governance crises in Chinese VC industry, by which the legal nature of above problems of corporate governance is explored. The third part of this article critically reviews the on-going reform of class share system in Chinese company law, by which a series of advices on the reform of dual-class shares in Chinese VC industry are given briefly. In the conclusion of this article, it is suggested that the on-going legal and regulatory reform of preferred shares in China may mitigate the conflict between the VC shareholders and the controllers of VC-held companies, in consideration of the dominating position of SOEs in Chinese economy, a comprehensive legal transplantation of class shares in Chinese law may still be a long-term task for the legislators.

The Institutional Background of the Non-state-owned Companies in China

Highly Concentrated Ownership Structure

It is not surprising that the SOEs always substantially influence the development path of Chinese corporate governance. The basic and original function of the Chinese corporate law was to establish a legal framework for restructuring the SOEs of China[1] and the official rules for corporate governance were not promulgated until the Law of Companies was enacted in 1993. During the past two decades, the Chinese

[1] Donald C. Clarke, 'Corporate Governance in China: An Overview' (2003) 14 China Economic Review 494.

company law was revised two times in 2005 and 2013 respectively and both of the amendments made efforts to improve the protection of minority shareholders in Chinese companies. However, the underlying principle of corporate governance in Chinese law is still based on a highly concentrated ownership structure.

Though the ownership structure of Chinese non-state-owned companies are relatively more diversified than the SOEs, quite a large number of the founding shareholders still hold more than one third of the shareholdings in listed non-state companies.[2] It is also quite common that the entrepreneurial shareholders of Chinese private companies at the same time are in the positions of the president of the board of directors, CEO and controlling shareholder of the company.[3] The controlling shareholders can easily determine the election of directors, by which minority shareholders such as VC investors may be excluded from the decision-making of the firm.

Confucian Ethics and the Commercial Practice in Chinese Enterprises

Confucianism that has developed throughout Chinese history for more than two thousand years has played an important role in shaping the morality and ideology in Chinese society. In ancient China, social life was organized on the basis of agricultural society, where the development of the economy was self-organized by families, instead of the class of merchants. In traditional Chinese families, income and labour were mainly subject to the male adults' abilities to farm. The family rules also emphasized the other family members' obedience to the family leader.[4] Moreover, subject to the technology and transportation, most Chinese people in rural areas did not migrate out of their hometown throughout their lifetime, and the people in the village or the nearby areas were acquainted with one another. As a consequence, the social norms in such a familiar society rested more upon customs that were accepted by the whole population in the community, rather than the law created by the authority.[5]

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[2] Xiaonan Lu and Weidong Zhang, The Study of the Development of Non-state-owned Corporations in Chinese Stock Exchanges (The Research Centre of Shanghai Stock Exchange, 2004) 47.

[3] Qilin Su, *Family Control, PE Investment and Corporate Governance of Private Listed Firm* (Economic Science Press, 2013) 63.

[4] Tung Tsu Chu, *Law and Society in Traditional China* (Zhonghua Book Company, 1981) 5–6.

[5] Hsiao Táung Fei, *From the Soil, the Foundations of Chinese Society* (Hsiang t'u Chung-kuo tr, University of California Press 1992) 42.

Accordingly, Confucian ethics were the philosophic reflection of the agricultural economy in ancient China, which can be shown by a series of values of Confucianism. Firstly, the most significant virtue in Confucianism is filial piety that absolutely requires offspring to respect and obey their parents. Secondly, the brotherhood requires the younger brother to respect his elder brothers; thirdly, *Li* (礼), as the core concept in Confucian philosophy, emphatically emphasises the hierarchy between different groups of people, such as subjects and ruler, old and young, husband and wife and so forth.[6] That is to say, from a Confucian perspective, the idealistic social order is established on the basis of strict hierarchical system, rather than the equality of individuals. In a practical sense, the nature of the Confucian social rules is obedience to the senior and prestigious members in a community or organization. A certain behaviour or idea was commonly justified on the basis of the authority of a specific virtuous individual in a community[7], rather than spirit of contracts.

Influenced by the Confucian culture and tradition, the merchants who behaved in accordance with Confucius's moral teaching were labelled as *Ru Shang* (Confucian merchants or virtuous merchants) and were widely praised in ancient Chinese society. Firstly, a notable and respectable businessman should never desert benevolence when he was dealing with others.[8] Secondly, a good businessman should frequently examine himself and voluntarily correct any inappropriate or immoral behaviour.[9] Moreover, Confucian ethics requires that any profit should only be obtained in a right way and any profit made from unscrupulous behaviour or against morality should be criticized.[10] Compared with the western legal culture, the values and ethics in the Chinese commercial world are fairly different. In Confucian ethics, individual virtue and good personality are regarded as the core of norm system, that is to say, both the harmony among people and social order are based on people's independent self-discipline, instead of an objective rule system of social or occupational norms, such as legislations and regulations. In sum, the

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[6] Patrick Kim Cheng Low and Sik Liong Ang, 'Confucian Ethics, Governance and Corporate Social Responsibility' (2013) 8 International Journal of Business and Management 30; Chu (n4) 272.
[7] See Teemu Ruskola, *Legal Orientalism: China, the United States and Modern Law* (Harvard University Press 2013) 67-72.
[8] Alex CK Chan and Angus Young, 'Chinese Corporate Governance Regime from a Historical-Cultural Perspective: Rethinking Confucian System of Governance'(2012) SSRN Electronic Journal <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2156300 > accessed 24 March 2017.
[9] Ibid.
[10] Ibid.

commercial culture of Chinese society is rooted in 'rule of man', instead of 'rule of law' or contractual spirit, which has profoundly shaped the corporate governance practice of Chinese enterprises.

Domestic Public Capital Market As An Inaccessible Financing Tunnel for Small and Medium Enterprises (SMEs) in China

The public stock market of China was not established until December 1990. Although the stock market has expanded the source of financing for Chinese enterprises, the public stock market in China is still dominated by the SOEs but not those non-state-owned companies who are in need of finance. Against this macro-economic background, the regulatory system of listed companies on the Chinese stock market is also established on a state-controlled instead of market-controlled basis.[11] In fact, prior to 1996, the quota of listed companies in a certain year was pre-planned by the central and local governments. In other words, only those enterprises recommended by the government to China Securities Regulatory Committee (CSRC) might be successfully listed, the entrepreneurs had no freedom to apply to list on the stock market independently.[12] Ever since the promulgation of the Law of Securities of the P.R.C in 1998, the CSRC has enjoyed the exclusive power to substantively assess the profitability of each applicant and to determine which firm should be approved.[13] As an inevitable result, compared to those SOEs who are supported by state-owned capital, those non-state-owned companies do not have competitive advantages in listing application.

Furthermore, the listing requirements of Chinese companies are too strict and costly for most non-state-owned firms. According to the Measures for the Administration of Initial Public Offering and Listing of Stocks (2016 Revision)[14] issued by the CSRC, the qualified issuer 'must have been profitable in the most recent three years with annual net profits of more than RMB 30 million'[15] and 'must have made the net cash flow more than RMB 50 million accumulated within the most recent three years or has made

[11] A comprehensive analysis of the relationship of the state and the Chinese stock markets is available in Iain G. MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies' (2002) Journal of Corporate Law Studies 289.

[12] 'The Concepts and Distinctions of the IPO Approval System and IPO Registration System' (Finance China, February 2014) <http://finance.china.com.cn/stock/special/zcz/20140212/2178702.shtml > accessed 13 August 2016.

[13] For details see s 10 and 11 of the Law of Securities (1998).

[14] Hereinafter referred to as 'the Listing Rule (2016 Revision)'.

[15] Calculated with the currency exchange rate in May 2017, this value is equal to £3.4m.

the revenue no less than RMB 300 million accumulated within most recent three years' and the issuer also 'must have a total share capital of no less than RMB 30 million before the IPO'.[16] By the end of 2012, the non-state-owned enterprises have accounted for more than 98% of the total number of enterprises in China.[17] However, the above high-level financial requirements are too burdensome for most Chinese SMEs which actually block their way to the public stock market in China.

In sum, such a series of strict and high-level listing rules can hardly provide sufficient financial sources for the majority of Chinese companies. By contrast, the more efficient approval procedures and low-level listing requirement in overseas stock markets have been quite attractive to Chinese private enterprises.[18] Although overseas listing can provide a wider range of finance for Chinese private companies in relatively more efficient listing procedures, in the long run, the particular capital control policies enacted by the Chinese regulators may lead to serious crises in corporate governance of Chinese companies which are listed overseas. This point will be illustrated shortly in detail.

The Conflicts of Interest between the Heterogeneous Shareholders: A Case Study

In terms of the corporate governance in China, the personality and self-cultivation of the key entrepreneurs usually play a significant role in shaping the corporate culture and establishing trust between the management and shareholders of the company. A fair number of successful Chinese entrepreneurs believe that their outstanding morality or personal charm is the irreplaceable strength in achieving successful business. As mentioned above, the good virtue of an entrepreneur will be conducive to establishing a good reputation in the market. The traditional commercial culture in China also emphasizes the core status of entrepreneur's personality and reputation in promoting the performance of the enterprise. In the modern commercial world, however, the deep-rooted governance mechanism based on 'rule of man' and Confucian culture may motivate Chinese entrepreneurs to over-confidently impose their personal opinion on the resolutions of the board of directors or general meeting of shareholders. Particularly, when a private

[16] The Measures for the Administration of Initial Public Offering and Listing of Stocks (2016 Revision), s 33.
[17] Jun Ma, 'The SMEs accounted for More Than 98% of All Enterprises in China' (Sina Finance, April 2012) < http://finance.sina.com.cn/hy/20120426/100211929864.shtml> accessed 12 August 2016.
[18] Yingmao Tang, 'Why Chinese Private Companies Choose Overseas Stock Markets: a regulatory analysis of Chinese Red-chip Listing' (2010) 28 Tribune of Political Science and Law 161.

company goes public, the shareholding of the entrepreneur will be diluted considerably, which can stimulate the controllers to act against corporate governance principles for enhancing their control over the company. In most cases the entrepreneurs are the controlling shareholders, therefore in the circumstances where the institutional investors such as VC funds are introduced as the minority shareholders in the company, any arbitrary conduct of the controllers may be against the interests of the VC investors and other minority shareholders. This point can be well illustrated by analysing the corporate governance event of NVC Lighting Limited (NVC), a VC-held Chinese listed company.

NVC was incorporated in 1998. After more than ten years' development, the company has been ranked among the leading companies in China's lighting industry. Before introducing institutional investors, Changjiang Wu, the founder of NVC, held 70% shares of the company and actually controlled the company. During 2006 to 2008, Goldman Sachs and SAIF Partner Fund (a Hong Kong-based venture capital fund) invested in NVC as financial investors. By 2008, SAIF Partner Fund and Goldman Sachs respectively held 30.73% and 9.39% of the shares of the company and Wu's shareholding was diluted to 29.33%.[19] In 2010 NVC was listed on the Hong Kong Stock Exchange and public shareholders continually diluted Wu's shares. Moreover, in order to ehance the company's competitiveness in the household lighting market, NVC introduced Schneider Electric Company Limited,[20] a global-leading energy management service provider in July 2011 who held 9.04% of the shares in NVC.[21] Consequently, Wu's shareholding was diluted further to 17.15%.[22] By contrast, the SAIF Partner Fund, Goldman Sachs and Schneider, who can be regarded as the concerted party, in total held around 33% of the shares and the rest were held by public shareholders.

Although Wu did his best to increase his shareholding in the ownership structure of NVC,[23] the representatives of NVC on the board of directors of the company only held two seats. By contrast, the concerted party possessed four seats (i.e., two for the SAIF Partner Funds, one for Goldman Sachs and one

[19] The Prospectus of NVC Lighting Holding Limited, 68.
[20] Hereinafter referred to as 'Schneider'.
[21] Longfei Su, *The Battle of Control Power in Chinese Private Companies* (Peking University Press, 2012) 46.
[22] Ibid, 47.
[23] According to related reports in the public media, Changjiang Wu bought long the public shares of NVC in 2011 and became the first majority shareholder with over 19% of shares in NVC. Ibid, 49–50; 'A Storming Attack against Director Changjiang Wu: the Emergent 48 Hours for NVC Lighting' (Finance China, May 2012) <http://finance.china.com.cn/industry/20120625/824076.shtml> accessed 28 March 2017.

for Schneider).[24] Since the VC fund and other institutional shareholders had invested in NVC, it is obvious that the controlling power had been dramatically diluted in the process of both private financing and public listing. Wu, the president of board of directors was actually at the risk of being removed by the VC fund and other shareholders.

In response to such a disadvantageous status, Wu, the CEO and board president had a strong motivation to act against the board of directors to enhance his influence in the company. In the autumn of 2011, he proposed to relocate the headquarters of the company from Huizhou to Chongqing (his hometown). Although the board of directors disagreed about doing so, as a compromise, they agreed to register a subsidiary, NVC (Chongqing) Industrial Company, in Chongqing which would only function as a sale premises rather than the headquarters of NVC. In order to control the company directly, however, Wu personally authorised the subsidiary with other main functions, including marketing, purchasing and logistics departments without the approval of the board.[25] Moreover, Wu arbitrarily signed an agreement with the Chongqing government, by which the use of land for building the Chongqing NVC Plaza was authorised to another company personally held by Wu. In May 2012, the board of directors of NVC forced Wu to resign from the position of the CEO and president of the board of NVC, as his misconducts went seriously against the basic corporate governance principle.[26]

From the perspective of corporate governance theory, the CEO of the corporation should respect the resolutions of the board of directors. In other words, the CEO has no right to arbitrarily make any decision without the permission of the board of directors. Emotionally, however, based on the traditional Chinese culture, employees of a company may regard the entrepreneur as the ‘spiritual leader’ of the company. The personality and ability of the entrepreneur are sometimes held in higher regard than the managerial institution in corporate governance.[27] In July 2012, the staff of all the subsidiaries of NVC across the country started to strike. In the meantime the suppliers and sellers ceased any co-operation with the board

[24] Su (n 21) 50; Chenguang Ma, ‘The War of Control Power of NVC Lighting and the Development of Chinese Private Companies’ (Co-Effort Law Firm LLP, 2012).
[25] Su (n 21) 50; ‘NVC Lighting: The Chongqing ―Headquarters‖ as Illegal Headquarters for Regulatory Arbitrage’ (China Economy, August 2014) <http://finance.ce.cn/rolling/201408/28/t20140828_3444022.shtml> accessed 28 March 2017.
[26] Su (n 21) 50.
[27] Teemu Ruskola, ‘What Is a Corporation? Liberal, Confucian, and Socialist Theories of Enterprise Organization (and State, Family, and Personhood)’ (2014) 37 Seattle University Law Review 637.

of directors of NVC, and asserted that they would not co-operate with NVC unless the board has agreed to invite Wu back to the boardroom of the company, citing as reasons that among the members of the management only Wu was the expert in the lighting industry, and his personal ability and reputation were an irreplaceable resource for NVC.[28] Against the pressure of commercial reputation, the board of directors finally agreed to allow Wu back to the company in late August 2012.[29]

The case of NVC shows that although eventually the entrepreneur regained the controlling power over the company, the cost of such a long process of negotiation and compromise between the institutional investors and entrepreneur would be very high.[30] The nature of the problem in this case is that in the circumstances where the entrepreneur of the company is also the director and CEO of the company, once the entrepreneur shareholder's ownership is diluted by the public shareholders and institutional investors such as VC funds, the entrepreneur will be able to intervene in corporate management by exercising his or her managerial power and utilizing his social resources. This considerably increases the transaction costs and seriously erodes the fundamental principles of corporate governance.

Industrial Restrictions on Foreign Investment and Overseas Listing of Chinese Companies

The Industrial Policy Restriction on Foreign Investors

As early as 1995, the Ministry of Commerce of China (MOFCOM) enacted the Catalogue for the Guidance of Foreign Investment Industries,[31] which aims to restrict foreign investors' investment activities in mainland China. Basically, the industries for foreign investors to invest in China are classified into three categories, namely (i) encouraged industries; (ii) restricted industries and (iii) prohibited industries.

[28] 'Changjiang Wu's Counterattack: The Staff, Suppliers and Sellers vs the Board of Directors of the NVC' (Jiaju Sina, 13 July 2012) < http://jiaju.sina.com.cn/news/2012-07-13/091530158529.shtml> accessed 29 March 2017; 'The Sellers against the Investors: the Disordered Board of Directors of NVC' (Jiaju Sina, 13 July 2012) < http://jiaju.sina.com.cn/news/2012-07-13/144114158615.shtml> accessed 29 March 2017.

[29] Su (n 21) 62.

[30] Compared with 2011, the revenue of 2012 fell 7% (3.55 billion RMB); the gross profit of 2012 also dramatically went down by 22% (RMB 0.76 billion). See *The Annual Report of NVC Lighting Holding Limited* (2012), 5 <http://www.hkexnews.hk/listedco/listconews/SEHK/2013/0426/LTN20130426446.pdf> accessed 29 March 2017.

[31] Hereinafter referred to as the 'Catalogue'.

Although this regulation has been revised six times[32] during 1996-2016 and the regulatory authority has tended to make the Chinese financial market more open to foreign investors, presently foreign investors are still prohibited from investing in cultural and media areas including information technologies (IT) industries.[33] In other words, international venture capital investors are not permitted to hold shares in Chinese IT companies. As a consequence, Chinese IT companies have no choice but to use alternative organizational structures for overseas listing, which mitigates the risk of MOFCOM turning down their application.[34]

The Capital Restriction on Overseas Listing of VC-held Companies

Ever since the first Chinese private company was successfully listed on NASDAQ in US in 1999,[35] more and more Chinese entrepreneurs recognized that overseas listing is a more efficient way of raising funds in comparison with the strict administrative approval requirements of listing on the Chinese stock markets. Coincidentally, with the great prosperity of the internet economy in the global market in the late 1990s, an increasing number of Chinese entrepreneurs engaged in the IT industry. Particularly, encouraged by the successful overseas listings of the three most influential Chinese web portal operators, namely Sina, SOHU and Net Ease in 2000, the emerging Chinese IT industry believed that introducing international VC funds and then listing on overseas stock exchanges would be a very efficient and conducive way of expanding financing and establishing their international commercial reputation.

In practice, the most popular way to list VC-held companies overseas before 2006 was the so-called 'red-chip listing'.[36] In this model of overseas listing, the domestic actual controller and international VC funds jointly register a shell company in offshore financial centres such as the British Virgin Islands (BVI) or Cayman Islands. The offshore company then registers another shell company in Hong Kong[37] and the

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[32] Since the promulgation of the Catalogue, it has been revised in 1997, 2002, 2004, 2007, 2011 and 2015.
[33] The Catalogue (2015 Revision), s 11 of the Sub-catalogue of Prohibited Industries for Foreign Investment..
[34] Wu Wang, 'The Legal Analysis of VIE Structure' (Global Law Bulletin, August 2013).
[35] Qiao Xing Universal Resources, Inc. (NASDAQ：XING) was the first Chinese private company listed on foreign stock exchange market.
[36] The basic structure is illustrated as Figure 1.
[37] The function of the Hong Kong shell company is the tax shelter. According to s 10(2) of the Arrangement between Mainland China and Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income (2006)

Hong Kong shell company will wholly acquire the domestic company. Finally, the BVI or Cayman offshore company will be listed on a overseas stock exchanges.[38] In such a way, some of the most famous Chinese enterprises were successfully listed on foreign stock exchanges during the period 2000-2006 by huge financial supporting from international VC funds and investment banks.[39]

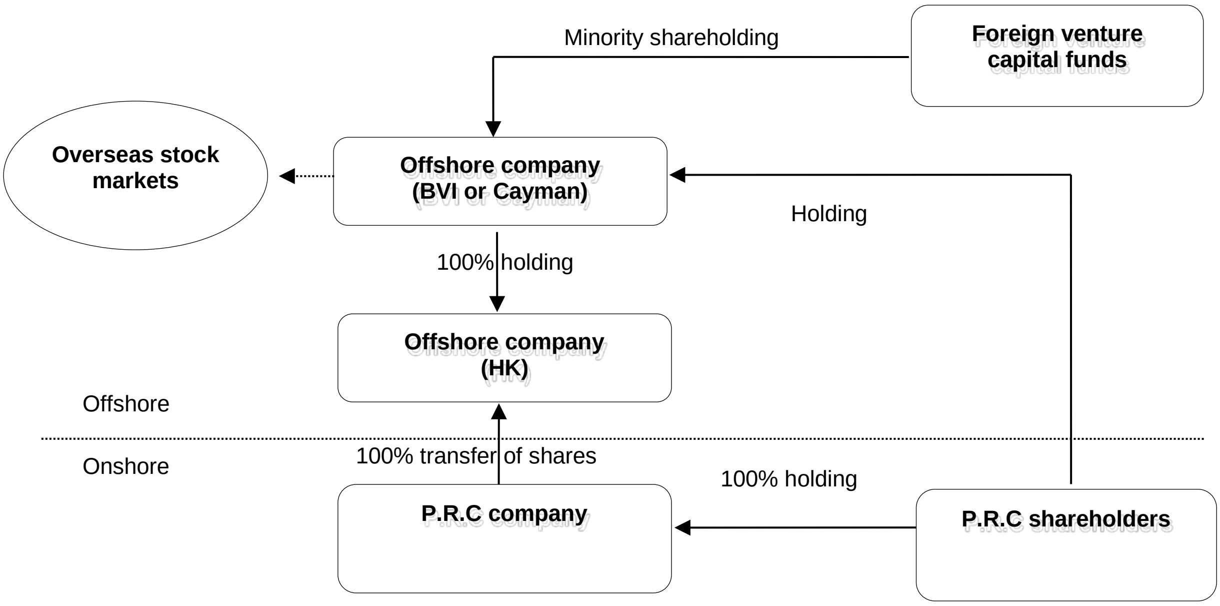

Figure 1: The red-chip structure

The Chinese financial regulator, however, was concerned that the uncontrolled overseas listing of Chinese private companies may cause serious capital flight and Chinese public investors also criticised that the CSRC's policy failed to attract excellent Chinese companies to list on domestic stock market.[40] Against this background, a very strict listing rule, namely the Provisions on the Merger or Acquisition of Domestic Enterprises by Foreign Investors was enacted by the MOFCOM in September 2006,[41] which substantively blocks the path for the overseas listing of Chinese companies. Specifically, pursuance to s 42 of the M&A Rules (2006), any domestic corporations or natural persons are not allowed to register any offshore special

(hereinafter referred to as the 'Arrangement (2006)'), where a Hong Kong-registered company holds no less than 25% of a domestic company registered in Mainland China, the rate of tax on dividends can be reduced to 5%. By contrast, pursuant to s 3(3) and 4(2) of the Law of Enterprise Income Tax of Republic of China (2007 Revision), for non-resident enterprises that make a profit inside China, the non-resident enterprise shall pay tax at the rate of 20%.

38 Beijing Docvit Law Firm, *Foreign Private Equity in China* (CITIC Press, 2011) 193.

39 For example, Sina, the earliest Chinese website company backed by Walden International ($6.5 million) was listed on the NASDAQ in 2000; MengNiu, the second-largest dairy producer in China backed by Morgan Stanley and Actis (US$61 million) and listed on the HKSE in 2004; Baidu, the largest Internet search service company in China backed by Draper Fisher Juvetson (US$12 million) and listed on the NASDAQ in 2005; New Oriental Education Group, the largest education training company in China backed by Tiger Universal Fund (US$30 million) and listed on the NYSE in 2006. See details in Shoushuang Li, Longfei Su and Rui Zhu, *Red-chip Listing Game* (China University of Political Science and Law Press, 2012) 17; Su (n 21)144–149.

40 Li, *et al*, (n 39) 20.

41 Hereinafter referred to as the 'M&A Rules (2006)'.

purpose company (SPC), unless it is approved by the MOFCOM. If a given application has been approved by the MOFCOM, then the applicant needs to be approved by the CSRC subsequently,[42] which may take a very long period of time. Moreover, where the offshore SPC acquires the domestic company's shares, it must also be authorised by the MOFCOM, otherwise any acquisition is invalid.[43] Although the law formally allows overseas listing of Chinese companies, in fact, ever since the promulgation of the M&A Rules (2006), the CSRC and MOFCOM have never approved any company to be listed overseas.[44] As a result, the existing capital control policy on Chinese companies has motivated both the international institutional investors and Chinese entrepreneurs to organise their transactions in an alternative legal structure which can reduce the risk of being disapproved by Chinese regulators.

The VIE Structure as an Alternative Legal Structure for Overseas Listing of VC-held Companies

The aforesaid restrictions on foreign investment in Chinese companies have shown that foreign investors are still restricted by the Chinese regulators strictly. In order to complete overseas listing and to circumvent the uncertain and time-consuming procedures of approving, the VIE structure is widely used by both international VC funds and Chinese companies. The nature of the VIE structure is an adjustment of the red-chip structure, as indicated in Figure 2. The differences between the 'red-chip structure' and the VIE are that firstly, in the VIE structure the foreign VC funds do not directly hold shares in the domestic company which is the operator of the business, instead, the foreign investors hold shares in a wholly foreign-owned enterprise (WFOE) registered in China; secondly, the shareholders' control over the domestic company will be achieved by entering into a bundle of contracts between the domestic company, the WFOE and domestic shareholders. That is to say, in the VIE structure the shareholding relationship between the foreign investors and domestic company is replaced by contractual arrangements, which smartly complies with the regulatory requirement of Chinese government.

[42] M&A Rules (2006), s 40.
[43] M&A Rules (2006), s 44.
[44] Li, *et al*, (n 39) 58; Beijing Docvit Law Firm, (n 38) 193; Xinhui Liu, 'Private Equity Investment and the Legal Issues of Listing Rules' in Lawyer College of Renmin University of China (eds), *Legal Practices of Venture Capital and Private Equity* (Law Press China, 2014) 97.

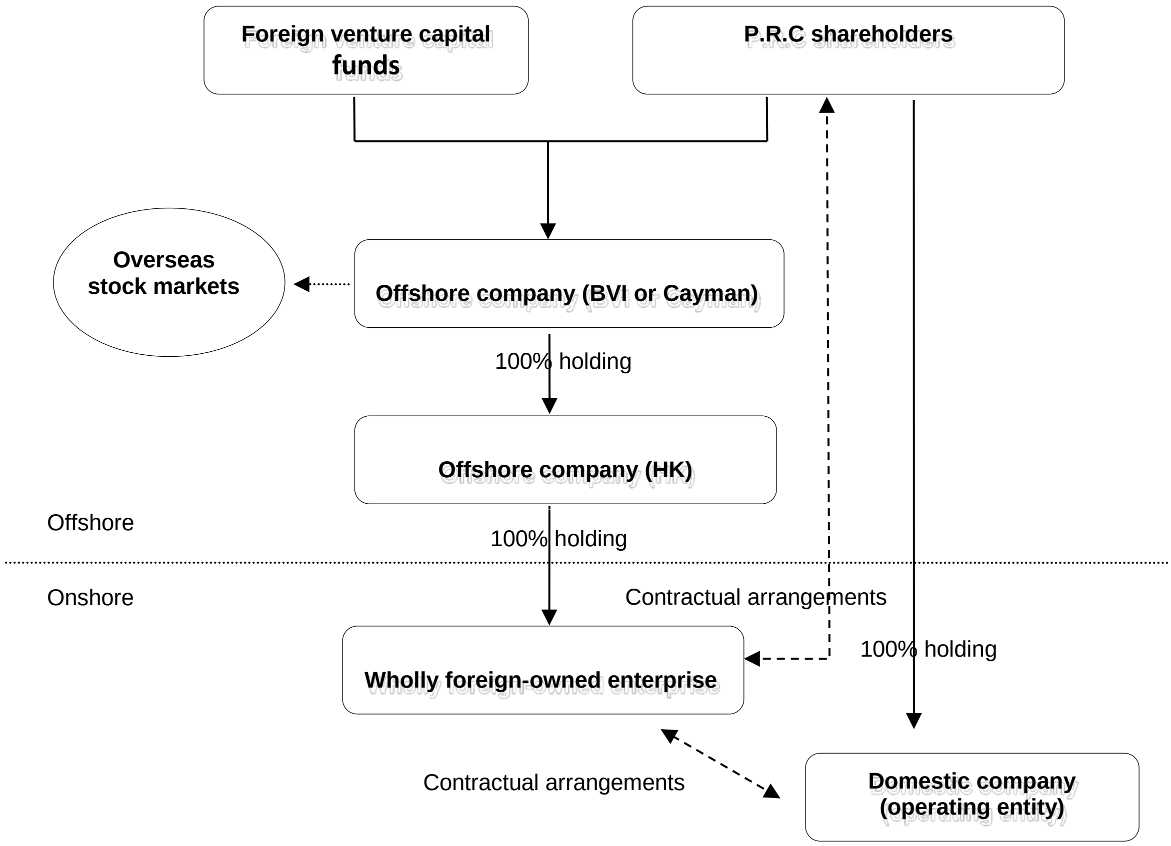

Figure 2: The VIE structure

As with the red-chip structure, prior to establishing a series of contractual arrangements between the parties, the P.R.C shareholders and foreign VC investors jointly incorporate two shell companies in BVI (or Cayman Islands) and Hong Kong respectively and then register a WFOE in mainland China as a main contractual party in a VIE structure.[45] The contractual arrangements in the VIE structure include the following provisions, by which international VC funds are able to invest indirectly in domestic companies: First, the loan agreement between the WFOE and P.R.C shareholders, according to which the capital of the WFOE contributed by the overseas VC funds and P.R.C shareholders will be loaned to the P.R.C shareholders and then the P.R.C shareholders contribute the loan to the domestic company for financing the business. Second, the WFOE and domestic company enter into a consulting and services agreement, through which the WFOE provides pre-agreed services such as industrial consulting or technical supporting for the domestic company. In return, the domestic company is obliged to transfer all the profit

[45] The P.R.C shareholders usually contribute very little amount of capital, therefore the Chinese authority's restriction on capital flow can be successfully avoided.

to the WFOE as the 'service fee'. In this way, international investors are able to fully obtain the profit of the domestic company who is licensed to engage in the industries that are not accessible to foreign investors. Third, in terms of the corporate governance of the domestic company, the voting rights proxy agreement between the WFOE, domestic company and P.R.C shareholders commonly provides that any voting rights exercised by the P.R.C shareholders in the general meeting of shareholders in the WFOE should have the direct, full and same legal effect in the domestic company (the actual operator), by which the WFOE will be able to control the domestic company. For the convenience of listing, the P.R.C shareholders commonly agree to grant an option to the WFOE permitting the WFOE or a third party to purchase the shares of the domestic company at a pre-agreed price. Finally, by signing the equity pledge agreement, the P.R.C shareholders' equity interests in the domestic company will be pledged to the WFOE as a guaranty of the performance of the domestic company's obligations.[46]

The Problems of Corporate Governance in the VIE Structure

Case Studies of the Corporate Governance Crises in relation to the VIE Structure

Although the popularization of the VIE structure expands the financing channel of Chinese companies in overseas capital markets, owing to its inherent drawbacks, however, a series of corporate governance crisis has emerged in Chinese companies, some of which have led to serious aftermath. In the late 1990s, Walden International, an US-based venture capital firm invested in Sina which has been one of the leading Chinese internet operators, and then successfully listed on the NASDAQ in 2000. Owing to the restriction policy on the IT industry, the VIE structure was used in the listing application of Sina, by which two of the founders of Sina jointly held a domestic company (Sina Internet Service CO., Ltd) for the purpose of holding the internet content provider (ICP)[47] licence from the Chinese government. The profit of the

[46] The evidence and details of the above diagram and analysis of VIE structures can be found from the following resources: Jian Qiu, 'Private Equity Investment Transactions and Legal Services' in Lawyer College of Renmin University of China (eds), *Legal Practices of Venture Capital and Private Equity* (Law Press China, 2014) 175-176; Xianwu Zeng and Lihui Bai, 'Variable Interest Entity Structure in China' (King & Wood Mallesons Law Offices, February 9 2012) <http://www.chinalawinsight.com/2012/02/ articles/corporate/foreign-investment/variable-interest-entity-structure-in-china/ > accessed 7 April 2017; Su, (n 21) 28–29; David Roberts and Thomas Hall, 'VIE Structures in China: What You Need to Know' (O'Melveny & Myers LLP, October 2011) < http://iis-db.stanford.edu/evnts/6963/TICL_-_VIE_Structures_in_China.pdf > accessed 7 April 2017.

[47] The ICP refers to the commercial entities that provide Internet services to the public. In China any company is not permitted to enter the Internet services industry unless it is licensed by the authority.

domestic company was transferred to the offshore entities that were listed on the overseas stock exchange. However, owing to the inconsistencies in business strategies between Zhidong Wang, the key founder of Sina and other board members, Wang was removed by a resolution of the board. As a defence, Wang attempted to break the VIE contract between the domestic company and the WFOE, which might have given rise to the collapse of the VIE structure and almost have led to the failure of overseas listing.[48] Although the adverse consequences in Sina case were prevented via negotiations in the boardroom of Sina, the serious legal problems within the VIE structure had drawn more attention and concern.

Similarly, the Alipay corporate governance event is another high-profile case showing the potential conflicts between the founder of the investee company and VC investors under the VIE structure. The Alibaba Group, the most influential Chinese e-commerce company, has attracted investment from a series of world-renowned institutional investors since 1999. Given overseas listing in future, the VIE structure was built up between the Alibaba Group (Cayman) and Alibaba E-commerce (Zhejiang) Corporation. As the domestic company, Alibaba E-commerce (Zhejiang) Corporation that was controlled by Jack Ma who is the key founder of Alibaba,[49] was licensed to engage in third-party payment service; Alipay, the most lucrative subsidiaries of the Alibaba Group, was controlled by both foreign institutional investors and P.R.C shareholders via the VIE agreements.[50] To establish the commercial reputation in the online commerce market, Alibaba agreed to co-operate with Yahoo! in 2005. Pursuance to the agreement between the two companies, Yahoo! holds 40% of shares in the Alibaba Group.[51] As a consequence, the shares of Jack Ma and other individual Chinese shareholders were diluted to 31% and Yahoo! became the largest shareholder in the Alibaba Group.[52]

In order to keep control of business, Jack Ma and other Chinese individual shareholders held one half of the seats on the board at any time, while Yahoo! and other institutional investors possessed the other half. As a defence, however, Yahoo! required that Yahoo! must be entitled to appoint one more director from

[48] Su, (n 21) 142–157.
[49] Jack Ma held 80% and another key founder of Alibaba held 20% of the shares of Alibaba.
[50] Su, (n 21) 21.
[51] Ibid, 16-17.
[52] Ibid, 16.

October 2010, which means that the founder would lose control both of capital and governance.[53] Although the Alibaba Group acquired financing and reputational resources from Yahoo! to develop its own business in global market, the tense relationship between the founder and institutional investors has become a great threat to the stability of the Alibaba Group's corporate governance.[54]

Coincidently, the People's Bank of China (PBOC) issued the Administrative Measures for the Payment Services Provided by Non-financial Institutions (2010) in June 2010 which stipulates that any entity applying for a payment services licence should be an incorporated body legally formed in China.[55] In the name of regulatory compliance, Jack Ma unilaterally unwound the VIE agreement and transferred the shares of Alipay to the Alibaba E-commerce (Zhejiang) Corporation without being permitted by the board. In this way, although Jack Ma had enhanced control over the core business of the Alibaba Group,[56] the interests of foreign institutional shareholders have been seriously damaged.

The Nature of the Corporate Governance Crises in the Chinese VC Industry

As discussed at the outset of this article, the concentrated ownership is one of the most significant features of Chinese companies including the non-state-owned firms. It is also very common in Chinese companies that the controlling shareholders directly control the boardroom of the Chinese companies. The corporate control power of the founders may be considerably diluted, once the companies are listed on public stock markets. As a response to this issue, the controllers of the listed companies have strong motivation to enhance their control power of the firm by alternative or even illegal means, which may substantially threaten the interests of minority shareholders.

By reviewing the above case studies, we can also clearly see how the VIE structure may significantly increase risk in corporate governance of Chinese companies when the interest pattern of P.R.C shareholders and foreign investors is highly unbalanced. Although the VIE structure facilitates international institutional investors to get access to the industries which are prohibited by Chinese

[53] Ibid, 16–19.
[54] Ibid, 16–19.
[55] The Administrative Measures for the Payment Services Provided by Non-financial Institutions (2010), s 8.
[56] Wang, (n 34).

government from cross-border investment, owing to the contractual nature of the VIE structure, the stability of the WFOE's controlling power over the operating entity is much weaker than the direct shareholding relationship. In such circumstances, if the P.R.C shareholders breaks VIE agreements for their personal purposes or interests, the offshore companies may lose control over the domestic businesses. In other words, from the perspective of corporate governance, the P.R.C controlling shareholder will be able to unilaterally control the domestic company and to threaten the equity interests of the VC investors who do not direct hold any shares in the domestic company.

The Direction of the Company Law Reform in China

Prior to considering the detailed reform proposal for improving corporate governance in the Chinese VC industry, the primary issue needs to be answered is what the specific path-dependence is of Chinese corporate law reform and which model of corporate governance is feasible and effective in solving agency problems and enhancing protection for minority shareholders of Chinese companies. Similar to the initial conditions in the economy of Eastern European countries,[57] the Chinese company law was initially designed for the corporatization and commercialization of the Chinese SOEs as well. Thus, the inherent interest pattern in the Chinese politics and economy will still play a significant role in impeding the liberalistic reform in Chinese corporate law.

On the one hand, the rapid developing private economy in China has been calling for a new model of corporate governance with more contractual freedom and less administrative intervention. From a political perspective, ever since the Third Plenary Session of the 18th Central Committee of Communist Party of China convened in November 2013, the supreme Chinese authority has decided to substantially speed up the reforms of market economy and to encourage the non-public sectors in the Chinese economy.[58] Moreover, with the development of industrial restructuring in the Chinese economy, takeover activities

[57] For details of this aspect, refers to the following literature: Gregory Wolk, 'Corporate Governance Reform in Russia: the Effectiveness of the 1996 Russian Company Law' (1999) 8 Pacific Rim Law & Policy Association 119; Bernard Black, Reinier Kraakman and Anna Tarassova, 'Russian Privatization and Corporate Governance: What Went Wrong?' (2000) 52 Stanford Law Review 1731; Edward Glaeser, Simon Johnson and Andrei Shleifer, 'Coase versus the Coasians' (2001) 116 The Quarterly Journal of Economics 853.

[58] The Central Committee of the China Communist Party, The Decision on Major Issues Concerning Comprehensively Deepening Reforms of (2013).

will boom in a foreseeable future and then the private equity and venture capital funds or buyout investors will play a more important role in corporate governance of Chinese enterprises. As a response to such a trend in the Chinese economy, one should have the confidence that further comprehensive legal reform of company law and financial regulations which encourages shareholder protection and investor participation in corporate governance should be insistently favoured and supported by the Chinese legislators.[59]

On the other hand, owing to the statutorily dominating status of the party-state system, however, the unshakable status of the state-owned economy in China makes it quite difficult to wholly transplant a highly contractual and shareholder-protection-oriented system into the Chinese company law in a short term;[60] in other words, the path of corporate law reform in China will still be significantly influenced by the state-owned firms. Especially, the Chinese SOEs that dominate particular sectors such as energy and finance may have strong motivation to slow down the transformation of the Chinese company law from an insider model to a dispersed shareholder-centred model.

In terms of the corporate governance of VC-held companies in China, the primary task is to balance the pluralistic interest pattern in the company. Hence, the shareholder-centred company law that provides a series of advantages in minority shareholder protection should still be useful for reducing agency costs and for promoting economic efficiency in the corporate governance of Chinese VC-held firms.[61] Therefore, it is not inappropriate to suggest that a more contractual regime which is able to flexibly balance the interests of heterogeneous shareholders should be adopted in the Chinese corporate law.

Class Shares as Efficient Contracts for Balancing the Interests of Heterogeneous Shareholders

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59 A similar trend can also be found in the development of British takeover rules: owing to the lag of economy after WW II in the western world, both entrepreneurs and British citizens put pressure on the UK government. As a positive response, the self-regulatory body concerning the takeovers in UK, namely the Panel on Takeovers and Mergers, was established in 1968. Moreover, in order to accelerate industrial expansion, the Labour's government adopted a relatively modest and liberal antitrust policy since the second half of 1960s. For details, see Christopher M. Bruner, 'Power and Purpose in the 'Anglo-American' Corporation' (2010) 50 Virginia Journal of International Law 579, 625–632.

60 According to the Section of 'Basic Economic System' of The Decision on Major Issues Concerning Comprehensively Deepening Reforms (2013), it is clearly stated that 'China's economic system is one with public ownership serving as its main body but allowing for the development of all types of ownership', which means that although the price mechanism is emphasised by the present authority, the prioritised position of public-owned economy will not be waived. Also see an historical analysis from An Liu, 'The Political-Economic Dimension of Corporate Governance: An Analysis based on Chinese Company Law' (2014) 13 Securities Law Review 62.

61 Ciyun Zhu and Kai Lin, 'A Review of Chinese Corporate Governance based on the Global Convergence Theory' (2013) 5 Chinese Journal of Law 24, 27.

Owing to the deep-rooted tradition of the 'rule of man' in Chinese society, when outside investors such as VC funds enter into a firm with a highly concentrated shareholding structure, the conflicts between the capital and control would be easily triggered. More specifically, it can be seen from the corporate governance crises in the case of VIE structure that a stable and friendly collaboration between the entrepreneurs and institutional investors can hardly be reached under the existing company law and financial regulatory system in China. The class share system as a flexible capital structure that facilitates to balance the heterogeneous interests of institutional investors and founder-controllers in Chinese companies is strongly desired.

The On-going Reform of Class Share System in China: 'State Control' As the Key Word

Ever since the promulgation of the Decision on Major Issues Concerning Comprehensively Deepening Reforms by the China Communist Party in November 2013, a new wave of marketization of the Chinese economy has been launched, in which the privatisation of China's SOEs is positioned as the primary goal.[62] In this aspect, the class share system as a particular legal regime in China is expected to play a significant role in facilitating mixed ownership reform of the Chinese SOEs. For example, it is suggested that the state-owned shares in the SOEs will be allowed to be converted into preferred shares without voting rights, by which the administrative bodies' monopolistic control power over SOEs will be significantly diluted. At the same time, the preferred economic rights attached to preferred shares can also maximize the value of state-owned and publicly owned shares in SOEs. In such a way, the leading status of the SOEs in the Chinese economy is remained.[63]

In a general sense, the use of dual-class shares in the Chinese SOEs should also be beneficial. Learning lessons from the failed management buyouts (MBOs) of the Chinese SOEs during 1990s-2003, the root reason for the failure was the over-concentrated ownership in the hands of the management layers,[64] the 'one vote per share' principle in the Chinese company law was unable to provide minority shareholders

[62] *Supra* n 58.
[63] Junhai Liu, 'Preferred Shares May Cure the Illness of SOEs and VIE Structure' (2012) 3 Directors and Boards 43.
[64] Guo Feng and Meng Yang, 'The Second Wave of SOEs Reform and the Application of Dual-Class Share Structure' (2014) 32 Science of Law 150.

with sufficient power to protect their interests. As a response to such problems, it is recommended that the state should hold special shares with super-votes and the private shareholders hold preferred or common shares in those SOEs having a close relationship with public welfare or state security.[65] In such proposed ownership structures, the pluralistic ownership structure in the SOEs may be more balanced, the economic interests of institutional investors can be guaranteed by the preferred shares and in the case of special industries, the super-voting share will keep state control for public interests or state security.

Against the present background of Chinese economy, the time is ripe to transplant the class share regime into Chinese commercial law system which may essentially improve the quality of corporate governance in companies held by VC funds. Almost at the same time as the new reform proposal of the Chinese economy was promulgated, the State Council of China approved the Guiding Opinions of the State Council on Carrying out the Pilot Program of Preferred Shares (2013),[66] in which the basic legal framework of preferred shares was preliminarily established. As a pilot project in the legal reform relating to the Chinese private equity and venture capital industry, the basic functions of preferred shares such as preference in distributing dividends and liquidation are provided in this regulation,[67] whereas some restrictions such as the prohibition of issuing participating preferred stocks[68] are also highlighted. Successively, a more detailed regulation of preferred shares was also issued by the CSRC in March 2014, namely The Measures for the Pilot Administration of Preferred Stock (March 2014),[69] according to which both listed and unlisted companies registered in China are permitted to issue preferred stocks. In terms of protecting the interests of preferred stockholders, the Measures for Preferred Stock (2014) entitles the preferred stockholders to the voting right in deciding a series of issues including '(i) the alteration of the provisions relating to preferred shares in the articles of association; (ii) a proposed capital reduction in the sum of more than 10% of the registered capital of the corporation; (iii) the mergers, separations, liquidations or alteration of form of the corporation; (iv) issuing preferred stocks and (v) other circumstances stated in the articles of association'.[70] Moreover, in the circumstances where the company refuses to disburse dividends

[65] Ibid.
[66] Hereinafter referred to as 'Guidance on Preferred Shares (2013)'.
[67] Ibid., s 2 and 3.
[68] At present, the holders of preferred shares are not allowed to participate in profit distribution with the holders of common shares after the dividends of preferred shares have been gained. See ibid., s 10(4).
[69] Hereinafter referred to as the 'Measures for Preferred Stock (2014)'.
[70] Ibid., s 10.

to preferred stockholders for three fiscal years cumulatively or two fiscal years consecutively, the preferred stockholders' voting rights in the general meeting of shareholders shall be recovered as the same as other holders of ordinary shares.[71]

The Pros and Cons of Class Shares in the Chinese Venture Capital Industry

The on-going pilot reform of preferred shares makes it possible to apply class shares in VC-held companies in Chinese market, by which the economic interests of institutional investors and the control power of the founder-controllers can be well balanced. Although the concept of contractual spirit has been increasingly highlighted in both the media and academia in China during recent years, the change of deep-rooted Chinese culture of the 'rule of man' within a short period may be impractical. Providing the minority shareholders with preferred shares and the founder-controlling shareholders with common stock respectively can, to a great extent, balance the interests of heterogeneous shareholders of the company.

As regards the corporate governance crises in relation to the VIE structure, the class share, especially the dual-class voting right regime, is also beneficial. Serving as a balance mechanism for heterogeneous shareholders in the companies held by foreign VC funds, the dual-class share may effectively mitigate the risk in the overseas-listed companies involving VIE structure such as AliPay and Sina.[72] Specifically, if the controllers can hold a special class of shares attached with super-votes through which the controllers can firmly control the enterprise and be shielded from hostile takeovers or dilution in successive financing, the corporate governance crises caused by the scramble of control in VIE structures can be mitigated. In practice, some related experimental applications of dual-class shares in Chinese companies have been launched in overseas listings.[73] By listing the companies on overseas stock exchanges, the Chinese

[71] Ibid., s 11.

[72] Actually, in the media and among IT barons, the dual-class share regime has been widely welcomed; for example, the Murdoch family owns around 12% of the shareholding in News Corporation, but controls about 40% voting rights by means of a special class of shares; similarly, Google and LinkedIn are also firmly controlled by the founder shareholders in the application of class shares with super votes. 'Dual-class Share Structures: The Cost of Control, the Trouble with Non-Voting Shares' *The Economist* (21 July 2011) < http://www.economist.com/node/18988938> accessed 15 November 2016.

[73] For example, JD.com (JD), Inc, another Chinese e-commerce tycoon that was listed on the NASDAQ in May 2014 successfully applied class share system in overseas listing. The founder of JD.com, Richard Qiangdong Liu, owns all Class B shares attached with 20 votes per share, by which the founder represents 83.7 % votes but only holds 20% equity interests in the shareholding structure of the company; in other words, the founder of the company as minority shareholder is able to firmly control the listed company by holding special classes of shares with super votes. See *The Prospectus of JD.com, Inc* (January 30, 2014)

entrepreneurs not only expanded the financing tunnels but also improved the quality of corporate governance by reasonably balancing among the shareholders with heterogeneous demands for interest in the companies, as the Company Law of China (2013 Revision) still has not provided any clear guidance on issuing dual-class shares.[74]

Moreover, preferred shares should be particularly encouraged by the Chinese regulators, because it may even address the problems radically in the VIE structure. For instance, the Chinese company that operates the business which is inaccessible to foreign investors should be permitted to issue preferred stocks to foreign shareholders and ordinary stocks to the P.R.C shareholders respectively, by which the foreign investors do not threat the state control of those politically sensitive industries and the Chinese enterprises can efficiently get money from global capital market at the same time. By doing so, the VIE structure that is quite risky and costly to both Chinese and international shareholders may be no longer necessary.

However, there is no perfect legal institution in the world, the class share is also a double-edged sword. Firstly, the dual-class votes may shield corporate managers from the pressure of the control market,[75] which will reduce its positive effect in motivating managers to continually improve the level of governance. Secondly, the ‘tunnelling behaviour’ of the founder-controllers in VC-held companies may be exacerbated by applying the dual-class voting system which may oppress the minorities more seriously. Just as some scholars has incisively pointed out, the advantage of using dual-class share in corporate governance is that it protects entrepreneurial management from the demands of ordinary shareholders; but the disadvantage of it is that it may protect entrepreneurial management from the demands of any shareholders.[76] Even so, the very limited sources of financing in Chinese non-state-owned economy and high demands of public financing still drive Chinese entrepreneurs to welcome institutional investors, especially private equity and

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<https://www.sec.gov/Archives/edgar/data/1549802/000104746914000443/a2218025zf-1.htm#ev17701_shares_eligible_for_future_sales> accessed 16 February 2017.

[74] According to s 126 of the Company Law (2013 Revision), ‘[s]hares shall be issued in accordance with the principles of equitability and fairness. Each share of the same type shall carry the same rights and benefits. Shares of the same type in the same issue shall be issued on the same conditions and at the same price. The same price shall be payable for each of the shares subscribed for by any work unit or individual.’ It is not unreasonable to understand this section as the Chinese law basically does not refuse the use of dual-structure of shares, however, the further specific rules in relation to dual-class shares are still lacking.

[75] Actually, the dual-class share was not officially accepted by the NYSE until 1984, during which the demands of financial instruments facilitating anti-takeover strategies were extraordinarily high and eventually the dual class share was accepted by both the NYSE and NASDAQ. See Xiaomin Jiang, ‘The Dual-Class Share Structure in the US: Development and Debates’ (2015) (9) Securities Market Herald 70, 70-73.

[76] Charles Elson et al., ‘Dual-class Stock: Governance at the Edge’ (2012) (Third Quarter) Directors and Boards 37.

venture capital funds. Hence, the advantages of using dual-class shares in the Chinese companies should outweigh the disadvantages of doing so.

As the countermeasures against the conundrum of dual-class shares, it is recommended that both the regulators and legislators of China should not only clarify the legitimacy of the dual-class share regime, but also impose necessary restrictions on the controlling shareholders and provide effective remedies for victim shareholders when any oppression occurs. On the one hand, as a practical measure, it can be agreed in the articles of association that in the circumstances where the portion of shareholding of the founder-controllers or management layer is below a threshold rate, the super-votes attached to a given class of shares automatically convert to 'one vote per share' as the same as any other common stocks. In this way, the deviation of the interests of the controllers and the company under the regime of dual-class share may be mitigated.

On the other hand, the financial regulators such as the CSRC should be authorised to exercise statutory power in investigating the justification of applying dual-class structures in particular companies which are listed on stock exchanges. As a related requirement, all the listed companies applying a dual-class share structure should timely disclose the information in respect of the accountability, track records of the controllers and the details of the rights and obligations on each class of shares, especially the voting rights of shareholders, otherwise the regulator may intervene in the use of dual-class shares in a given company.[77] Last but not least, it is also important that medium and minority shareholders shall be permitted to claim against the controllers to the courts where it is proven that a given behaviour of a shareholder who exercises super-voting rights is not in the interest of the company as a whole.

Conclusion

This article carries out case studies on the typical corporate governance crises in VC-held companies of China and reviews the on-going reform of class shares in Chinese commercial law. It can be concluded

[77] Ruoying Chen, 'The Practice and Supporting Regimes of Dual-Class Share Structure in Corporate Law: The Related Regulatory Countermeasures in China' (2014) (3) Securities Market Herald 4, 7.

that the essence of the issues discussed above is the conflict between heterogeneous shareholders in corporate governance of VC-held companies. In order to improve the corporate governance of investee companies, the current pilot reform of preferred shares led by Chinese regulator has been functioning as a balancer of majority shareholders' control power and VC shareholders' economic interests in investee companies. The existing guidelines for applying preferred shares issued by the Chinese authorities have established a platform to enhance contractual rights of VC investors and entrepreneurial shareholders for the purpose of reducing the transactions costs in corporate governance. At the same time, considering the dominating status of the SOEs in Chinese economy, however, it may still be naive to believe that the super-vote system can be legally recognised by Chinese company law in a short future. Hence, a relatively realistic observation of the further reform is how the on-going mixed ownership reform of the Chinese SOEs can positively advance the practice of preferred share system. As regard a long-term expectation of corporate governance reform in China, the dual voting system in the Chinese company law system may be introduced when the private economy grows more competitive in the Chinese economy and the spirit of contract is fostered more mature in the market.