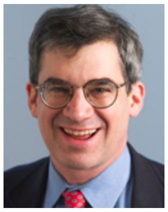
Harvard Business Case

Oriental Fortune Capital: Building a Better Stock Exchange – The Case of ChiNext, the Shenzhen Junior Market

Case Researcher & Moderator: **Dr. Josh Lerner**
Jacob H. Schiff Professor of Investment Banking
Harvard Business School

Case Researcher: **Mr. Keith Chi-ho Wong**
Senior Researcher
HBS-Asia Pacific Research Center

Case Researcher



Dr. Josh Lerner
Jacob H. Schiff Professor of Investment Banking
Harvard Business School

Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and Entrepreneurial Management Units. He graduated from Yale College with a Special Divisional Major that combined physics with the history of technology. He worked for several years on issues concerning technological innovation and public policy, at the Brookings Institution, for a public-private task force in Chicago, and on Capitol Hill. He then obtained a Ph.D. from Harvard's Economics Department.

Much of his research focuses on the structure and role of venture capital and private equity organizations. (This research is collected in two books, The Venture Capital Cycle and The Money of Invention.) He also examines technological innovation and how firms are responding to changing public policies. (The research is discussed in the book, Innovation and Its Discontents.) He founded, raised funding for, and organizes two groups at the National Bureau of Economic Research: Entrepreneurship and Innovation Policy and the Economy. He is a member of a number of other NBER groups and serves as co-editor of their publication, Innovation Policy and the Economy. His work has been published in a variety of top academic journals.

In the 1993-94 academic year, he introduced an elective course for second-year MBAs on private equity finance. In recent years, "Venture Capital and Private Equity" has consistently been one of the largest elective courses at Harvard Business School. (The course materials are collected in Venture Capital and Private Equity: A Casebook, whose fourth edition is forthcoming.) He also teaches a doctoral course on entrepreneurship and in the Owners-Presidents-Managers Program, and organizes an annual executive course on private equity in Boston and Beijing. He recently led an international team of scholars in a study of the economic impact of private equity for the World Economic Forum.

N9-811-105
MAY 23, 2011

This case explores what is arguably one of the most successful efforts to promote the development of a public market for entrepreneurial firms over the past decade.

As you read the case, please consider the following questions:

1. Why has the Chinese IPO market been so hot at the time when IPOs have been so slow at most places in the world?

2. Why have ChiNext tried to have strong listing requirements? Have they focused on the right requirements?

3. How does the competition between the Shenzhen and Shanghai exchanges affect ChiNext?

4. How has the Chinese market changed? What are the implications for how ChiNext's should adjust?

5. What can Western policymakers learn from the Chinese experience?

Josh Lerner

Professor Josh Lerner and Senior Researcher Keith Chi-ho Wong of the HBS-Asia Pacific Research Center prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

N9-811-105
MAY 23, 2011

JOSH LERNER
KEITH CHI-HO WONG

Oriental Fortune Capital: Building a Better Stock Exchange

The year 2011 is the craziest year I have seen as a venture capitalist. Venture investment has gone "wacko." The industry is now beginning to reshuffle but it will take quite some time before cooling down.[1]

— Dr. Wei Chen, Chairman & Founding Partner, Oriental Fortune Capital

Sitting in his modern yet minimalistic office in Shenzhen, China, Dr. Wei Chen was flipping through the magazine which featured his regular column on Chinese venture investment trends. The number of retail investors in China almost trebled from 3.3 million to 9.4 million over the previous decade,[2] and media coverage of securities markets had become increasingly popular. Chen, a veteran manager of domestic VC funds, was a pioneer of venture investment in China and had lived through the capital market's booms and busts since the turn of the century. Currently the founding partner of one of the twenty top VC firms in China, Chen regularly advised the Shenzhen Stock Exchange (SZSE) and other exchanges on regulatory and corporate governance issues.

The venture capital (VC) industry had grown rapidly beginning in the mid-2000s, when new rules and regulations were issued that provided a more structured legal framework for VC firms. But VC investments plunged in late 2008 after the export-oriented Chinese economy was dampened by the global financial crisis. VC activities revived in 2009 around the time that ChiNext, a NASDAQ-style junior market, or a second-tier market, was launched by the SZSE.

Sitting across from Chen was Xiaojin Wang, a Research Fellow of the SZSE's Research Institute. Formerly an economics professor focusing on venture capital issues, Wang joined SZSE in 2006. Since then, Wang conducted a series of studies on the relationship between second-tier markets and the VC industry. Over the course of her research, Wang met Chen regularly to glean insights from a practitioner's perspective. Chen's feedback was instrumental when ChiNext was set up in 2009. Sipping a cup of green tea, Wang reflected on Chen's statement on the investment climate of 2011: "What you said was spot on. That is why the SZSE needs to be careful, whatever move it makes now."

At the moment, many market participants, including those from the VC industry, were debating whether SZSE should relax its listing requirements to allow more companies to gain access to the capital market. One of the major concerns was that a large number of firms were lining up for initial public offerings (IPOs), and at the same time while retail investors were eagerly anticipating the

---

Professor Josh Lerner and Senior Researcher Keith Chi-ho Wong of the HBS-Asia Pacific Research Center prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

opportunity to speculate on newly listed ChiNext stocks. Wang acknowledged that ChiNext had helped numerous startups raise fresh capital to fuel their growth. But at the same time, an overly-relaxed listing and regulatory environment would make these companies more susceptible to corporate governance problems. Wang, therefore, was eager to hear Chen's opinions. Chen, looking at the large golf course outside his office block, said: "Xiaojin, Do you know this was just a piece of barren land when I first came to Shenzhen in 1999. Who would have thought of a golf course being built here? I think one has to be bold or nothing will be built."

Second Tier Markets Worldwide

Early initiatives

Early efforts to create "junior" securities markets, or second-tier markets separate from national stock exchanges, could be traced to the 1950s, when many regional exchanges in the U.S. were closed due to lack of liquidity. In 1962, the New York Mercantile Exchange set up a junior market called the National Stock Exchange so that companies too small for the New York Stock Exchange (NYSE) and American Stock Exchange (Amex) could trade their shares. Yet, very few companies chose to list on the National and it suffered from a lack of visibility, and thus illiquidity.[3] Further hampered by a series of scandals, it was closed in 1968. Three decades later, the Amex launched the Emerging Company Marketplace (ECM) with similar objectives. However, the ECM also faced low visibility, illiquidity, and scandals, and was shut in 1995, only three years after its formation.

But not all efforts to create second-tier exchanges were failures. One of the most successful attempts was by the National Association of Securities Dealers (NASDAQ). Founded in 1971, the NASDAQ was originally an electronic system that provided quotations for buyers and sellers engaged in the over-the-counter (OTC) trades. The NASDAQ gradually enhanced its reporting and trading systems. Its relaxed listing requirements allowed small companies, including Intel, Microsoft, Apple, Cisco, Oracle, and Dell, to obtain much-needed capital that was otherwise unavailable to them. Unrelated to NASDAQ, the Japan Securities Dealers Association (JASDAQ) also set up an electronic platform in 1991, superseding the OTC registration system in place since 1976. Both NASDAQ and JASDAQ were among the few successful junior market initiatives. Originating from pre-existing OTC markets, these exchanges accumulated adequate client numbers and trading volumes. Independent of the predominant national exchanges, they had strong motives to attract new companies and keep them from moving to the main boards.[4]

In Europe, fifteen national stock exchanges, including those in France, Germany, Italy, and the United Kingdom, launched junior boards during the 1980s.[5] Most of them served as the "transition market" between the senior boards and the existing OTC markets. Unfortunately, they suffered from an adverse selection, or "lemons," problem. Companies were expected to grow bigger and "graduate" to the senior boards, leaving less successful ones behind. The junior boards' troubled reputations made them a less attractive venue for new companies. Consequently, these markets were plagued with the problem of an inadequate number of stocks and insufficient illiquidity. By the mid-1990s, most of them were closed.

1990s: The dot-com bubble and its aftermath

During the latter half of the 1990s, the commercialization of Internet services and expectations about their exponential growth led to the "dot-com bubble," a rapid hike of stock prices for technology stocks. The NASDAQ composite index rose from 1,000 in July 1995 to a peak of 5,048 in March 2000. During this period, NASDAQ exceeded the NYSE in turnover volume and the number of IPOs, making it the largest stock exchange in the world.[6] Between 1995 and 2000, more than 40 junior boards were also established across the globe.[7] Apart from a few exceptions, such as the AIM in London, KOSDAQ in Korea, and TSX-Venture in Canada, most of them failed to attract a sufficient number of companies. The dot-com bubble soon imploded and the NASDAQ composite index fell from its peak of 5,048 to a trough of 1108 in October 2002. The shock wave spread worldwide and many junior boards took severe hits. For example, Neuer Markt in Germany and the GEM board in Hong Kong both lost more than 80% of their market capitalizations over this period.

With the flight of investors from tech stocks, and problems related to persistent illiquidity and multiple scandals, these junior markets faced a shrinking pool of IPO candidates. Many unlisted firms failed to draw enough funding to sustain operations during the 2001 recession. A number of junior boards either closed or merged with other exchanges (See **Exhibit 1**). Wang summarized some of the key insights she gained from the closure of these junior markets:

> One of the main reasons was the lack of IPO candidates. While there were over 40 junior boards around the world, many were located in countries that were either too small or too developed to have enough high-growth businesses lined up for an IPO. Also, all these local exchanges were facing globalized competition as leading exchanges such as NASDAQ, NYSE, and AIM were either attracting clients internationally or expanding their presence across borders through mergers or partnerships.
>
> The other concern was market mechanisms. After seeing the failure of many pioneers which had used an auction system, and the success of the dealer method at the NASDAQ,[8] dealer markets became the mainstream. Yet it is no guarantee of success. We are also aware of the adverse selection problem. If a junior board is set up as a "feeder market" for the senior board, it will soon lose many of its members. Lastly, the listing requirements at the junior boards are becoming less stringent. While this allows more companies to list, the exchanges' credibility may be at risk. We believe the "nominated adviser"[9] system, currently used by AIM and Catalist (of Singapore), may be worth following. But we also acknowledge the example of Hong Kong's GEM board, where newly listed companies violated major regulations once the sponsorship period expired.

The Second Board in Shenzhen: The Early Attempt

By the end of the 1990s, China was negotiating its way into the World Trade Organization, which stipulated a further opening of China's capital markets. The dot-com bubble was also evident in China as numerous domestic Internet firms were listed on the NASDAQ. In 1999, the State Council announced a policy to strengthen the country's innovation capabilities.[10] Soon afterwards, various parties, including the China Securities Regulatory Commission (CSRC), the Shanghai and Shenzhen bourses, academics, and practitioners, took up the issue of capital market liberalization. Wang recalled the groundwork laid down by her colleagues in the late 1990s:

> The initial thought was to create a board specifically for "high-tech" companies. However, they realized that it would be difficult to define what "high-tech" meant. They also found that there was no such thing overseas. Finally, it was named the "Growth Enterprise Board" (GEB) to cater to companies that offered enough growth potential. The second decision was where the board should be located. Both Shanghai and Shenzhen wanted it, but over-competition would obviously result if both were granted exchanges. Most of the multi-tier capital markets overseas, such as the NYSE and the NASDAQ, or Tokyo and Osaka, were formed by market forces. Here, the government segmented the markets for each of the exchanges. Shanghai specialized in state-owned firms and blue-chip companies, following the route of the NYSE. Shenzhen would be the venue for small, high-tech businesses, becoming the NASDAQ of China.

As the GEB was about to launch in 2000, the dot-com bubble burst. The demand for listings dropped severely, if not vanished. SZSE officials also realized that many of the pre-IPO companies were not entirely trustworthy. The investor community was calling for more stringent supervision over issues such as earnings manipulation, insider trading, and the proliferation of shareholder fraud. In light of these concerns, the SZSE decided to postpone the launch of the GEB.

The SME Board: The prologue

Then, in a move that reflected the state-directed pace of gradual development, a new board emerged at the SZSE in 2004. In February, the State Council promulgated a policy to create a multi-tier capital market in China. On May 27, the Small and Medium Enterprise Board (SME Board) was established at the SZSE, under the so-called "Two Remain" and "Four Separate" principles.[11] "Two Remain" meant that the existing securities laws and regulations and the IPO listing requirements governing the main board companies would remain unchanged for those listing on the SME Board. "Four Separate" indicated that the SME Board would have separate trading systems, supervisory mechanisms, stock coding, and price indexes. Wang recounted the lessons SZSE learned from the development of the SME Board prior to the creation of ChiNext:

> First, once a company is listed, a huge amount of money will be raised. The controlling shareholders may be tempted to appropriate the money for their private use. To contain this problem, we decided to create a separate bank account specifically for depositing all the money raised from an IPO. Second, our share issue system was far from mature. While all new IPO issuers needed to have a sponsor to underwrite their stocks, the sponsor finished the job once the company was listed. When we design the new rules for ChiNext, we then made the sponsors responsible for the ongoing monitoring of the performance of a newly listed company for a longer period of time. Lastly, we tightened control of the disposal of shares by the majority shareholders. We introduced a lock-up period under which they were not allowed to sell their shares in the open market.

Despite the "Four Separate" principle, the SME board was basically the same as the Main Board with the same set of listing requirements. Yet the SME board hosted mainly companies that were "smaller" in terms of revenues or assets or that operated in certain high-tech industries such as information technology or biotechnology, unlike the Main Board, where large, state-owned enterprises dominated. Between 2004 and 2009, Wang asserted, no major problems occurred on the SME board and it laid a solid foundation for the subsequent launch of ChiNext.

Proliferation of IPOs

As China's economy recovered steadily in 2010 due in part to a RMB 4 trillion (US$586 billion) economic stimulus program, China also started to lead the world in IPOs. In 2010, a total of 476 Chinese companies were listed across various exchanges worldwide, representing about 62% of all newly listed firms or 57.6% of the total funds raised during the year[12] (See **Exhibit 2** for details). Among all these Chinese IPOs, 45%, or 347, were conducted on the domestic exchanges in Shanghai or Shenzhen, representing 39.4% of the total IPO capital raised in the world[13] (See **Exhibit 3** for details). As a new player, ChiNext was able to list 117 IPOs in 2010, accounting for one-third of the new listings on all of China's exchanges.

ChiNext: China's answer to NASDAQ?

A quick and lucrative exit for VCs/PEs

Opened for trading on October 30, 2009, ChiNext presented a much-anticipated gateway for investors to access high-growth companies, and provided a long-awaited exit for the domestic VC industry which had previously looked to overseas markets in New York, London, or Hong Kong to go public. Among the first batch of 28 ChiNext companies, 23 were backed by venture capital firms. And ChiNext did not disappoint investors. The initial 28 stocks closed on average 76.5% higher than their issue prices at the end of their first trading day.[14] The average IPO Price/Earnings multiple (P/E) stood at 56.6 times at the end of the first trading day, while the overall average for the A-share markets in Shenzhen and Shanghai was 25.[15]

By October 2010, the VCs who had taken their companies public on ChiNext had attained outstanding returns. One measure of success was the ratio of the capital gain achieved by the venture investor via the IPO (the valuation of the VC's stake at the IPO price minus the investment amount) to the amount invested. Newly listed ChiNext companies had an average multiple of 12.1, while the overall multiple of IPOs on China's two stock markets was 10.4, and Chinese companies that conducted their IPOs on NASDAQ only recorded an average multiple of 2.8.[16]

At year-end 2010, 153 companies with a total market capitalization of RMB 736.5 billion (US$ 111 billion) had listed on ChiNext, raising RMB 116.75 billion (US$17.61 billion).[17] Most of these were high-tech companies belonging to one of the seven "strategic emerging industries" designated by the China's central government, such as clean energy, semiconductors, chemical engineering and pharmaceuticals, alternative materials, and new-generation IT services. During the first three-quarters of 2010, the profits for all ChiNext-listed companies grew an average of 26.9% on a year-on-year basis, and revenues increased by 36.5%.[18]

Stock markets in China

After China began pursuing economic reforms in 1979, the state took various steps to liberalize the economy. It abolished state controls on prices and institutionalized the formation of private enterprise. Integral to reforms was the establishment of special economic zones in Shenzhen, Zhuhai, Shantou, and Xiamen, where favorable tax and other policies were offered to foreign investors. This was followed by initiatives to modernize the banking system and establish capital markets. New stock exchanges were set up, first in Shanghai in November 1990, and then in Shenzhen in December 1990. It was hoped that the exchanges would help enhance the corporate governance of companies that listed, which were mainly state-owned-enterprises (SOEs), and relieve SOEs' over-reliance on bank debt.[19] Shares traded on both exchanges were classified into two categories: the RMB-denominated "A-shares," which were restricted to domestic investors; and "B-shares." The latter issues were denominated in RMB but traded in foreign currencies (US dollars in Shanghai and Hong Kong dollars in Shenzhen) and only available to foreign investors until 2001, when they were opened to domestic investors.

The China Securities Regulatory Commission (the "CSRC") was established in 1992 to regulate capital markets. Reporting directly to the State Council, the CSRC performed a role similar to the Securities and Exchange Commission in the U.S. It formulated laws and regulations and exercised supervision and compliance functions for the securities and futures markets. It supervised public offerings and the trading, clearing and settlement of securities, governed information disclosure, and regulated the business activities of industry practitioners.[20] In particular, all companies preparing IPOs had to be approved by the CSRC's Public Offering Review Committees.

Since its inception in 1990, the Shenzhen Stock Exchange (SZSE) had been smaller than its counterpart in Shanghai and targeted a different niche than the Shanghai and Hong Kong exchanges, which typically hosted listings by large SOEs. The Shenzhen special economic zone where the SZSE was located was dominated by small- to medium-sized enterprises in sectors such as information technology, biotechnology, and pharmaceutical research, and SZSE became the main listing venue for these companies. Starting as a regional market with around 100 listed companies during its initial years, SZSE hosted 1,169 companies by the end of 2010 on three boards,[21] the Main Board, the SME (small-and-medium-sized enterprise) Board, and the ChiNext, with a daily transaction of over RMB 102 billion (US$ 15 billion) (See **Exhibit 4** for a summary of the market statistics).

Key listing requirements at ChiNext

In December 2008, right after the outbreak of the global financial crisis, China's State Council called for the establishment of "the Second Board at a good time."[22] The CSRC then issued a document in March 2009 to lay down rules for the second board (see **Exhibit 5** for an excerpt from the document). Most of the listing requirements were lower than on the Main Board. At the same time, various measures were taken to safeguard investors' interests.

The major difference between the listing requirements for ChiNext and the Main Board was the "profit test" (see **Exhibit 6** for a comparison of the listing requirements on ChiNext, SZSE Main Board, and major junior boards worldwide). To qualify for listing on the Main Board, the issuer (the company to be listed) must have been profitable over the previous three years consecutively, while listing on ChiNext only required two years. Accumulated profits over the three-year period had to be at least RMB 30 million (US$4.6 million) for the Main Board, but only RMB 10 million (US$1.6 million) for ChiNext. A company could also list on ChiNext if it had been profitable only in the most recent year, with a minimum net profit of RMB 5 million (US$0.76 million), provided that it attained no less than RMB 50 million (US$7.6 million) in revenues and achieved more than 30% revenue growth over the last two years prior to the IPO. (See Article 10 on **Exhibit 5** for details).

Other rules and regulations at ChiNext

The CSRC also tightened information disclosure standards for ChiNext. All prospectuses for ChiNext shares had to include a statement that disclosed the "high investment risks" involved, including operation risks, delisting risks, and the subsequent market risks. Additionally, SZSE established its own market risk warning system and set up a continuing investor education program

The ChiNext listing rules also stipulated measures to enhance market efficiency. A one-year "lock-up period" was imposed during which the directors, supervisors and senior management of a ChiNext-listed company could not dispose of their shares. At the expiry of the lock-up period, they could sell only 25% of their shares every 12 months. If they left the company, they were not allowed to trade shares within six months of their resignation. After the six months were up, they could sell half of their shares within the next 12 months, and all the remaining shares thereafter.

Sponsors of ChiNext-listed stocks had to agree to "continuous supervision and guidance" for three full fiscal years after the listing. The "supervision" period for the Main Board stock was only two years. During this period, the sponsor was required to compile a follow-up report within 15 days of the issuer's release of annual and interim reports. The follow-up report consisted of the sponsor's analysis and independent opinion on the issuer's financial performance.

Delisting conditions on ChiNext were also stricter than on the Main Board. If a company recorded audited negative net assets for the most recent fiscal year, or the company's auditor issued an adverse opinion or a disclaimer of opinion on the annual results, a delisting warning would be issued. If the company was unable to publish the annual or interim report two months after missing the statutory deadline, trading in its shares would be suspended. This happened after six months on the Main Board. To ensure adequate liquidity on ChiNext, a delisting warning would be issued to a company if the cumulative trading volume of its share dropped below one million shares consecutively over 120 trading days. Wang commented on these choices:

> We have thought of lowering the requirements substantially, say, accepting companies that are losing money. Apart from the problems of corporate governance and earnings quality, it would lead to an excessive number of companies qualified for IPOs. Can we handle such a huge volume of work? Also, if we let them float on the market, we will face monumental challenges in keeping up our supervisory work. So, we decided to maintain a high enough barrier that only those that are making money can get listed first. Actually, when compared with the Main Board, we have more than halved the profitability requirements from RMB 30 million to RMB 10 million on ChiNext. There was also a 40% drop in the requirements for share capital.

The VC Industry in China

In terms of the relative development of the VC industry, the U.S. is a 45-year adult in his prime years whilst China is just a toddler learning to walk.[23]

— Dr. Wei Chen

China's venture capital industry may have been a toddler in 2011, but it was growing very quickly. From 2001 to 2009, capital raised by VCs in China increased from US$1.32 billion to US$18.8 billion, for an annual growth rate of 39.4%.[24] Investments made by the VCs also grew from US$420 million in 2002 to US$2.7 billion in 2009, a 546.1% increase.[25] Meanwhile, VC investments in the developed world, such as the U.S., the U.K., and France, experienced double-digit percentage declines after the financial crisis of 2008.

In 1985, the State Science and Technology Commission (SSTC) and the Ministry of Finance (MoF) cofounded the first domestic VC firm in China in an attempt to replicate the "Silicon Valley model."[26] Until the early 1990s, however, most of the venture investments were directed at infrastructure and property projects, commissioned primarily by state-owned enterprises.[27] Many of the early, government-sponsored VCs also failed due to a lack of understanding of the capital market,[28] including the SSTC-MoF joint venture which went bankrupt in 1997.

The first turning point came in 1998, when the National People's Congress passed a resolution on the creation of privately-funded VC firms.[29] Many publicly listed companies also formed their own VC funds, foreseeing that a "second board" would soon emerge to offer them a quick exit.[30] Foreign VCs also penetrated the market promptly and brought path-breaking Chinese high-tech firms, such as the then top three largest Internet portals in China--Sohu, Sina.com, and Netease--to the NASDAQ. After the 2001 global market crash, the growth of the VC industry slowed and institutional changes were introduced to strengthen the legal framework. In 2003, China began to allow foreign VCs to set up as investment partnerships, with formal limited partnership for these investors being allowed in 2007.[31]

Another turning point came in 2006. The introduction of the *Provisional Rules Governing Administration of Venture Capital Enterprises* finally gave foreign VCs a clear legal framework to comply with. They started to dominate the market which was once led by government-sponsored VCs. The year also saw amendments to the *Company Law* and the *Securities Law* which allowed open trading of the "non-circulating" shares held by the majority shareholders of listed firms.[32] These changes paved the way for many early-stage investors to exit from the companies that they had invested in. Also in 2006, Chinese authorities effectively stopped Chinese firms from setting up offshore Special Purpose Entities for the purpose of listing overseas. As overseas listings became more challenging, both domestic and foreign VCs began to look to the local bourses as their exit destination. VC investors became more active as the economy grew and the stock market rebounded (See **Exhibit 7)**. The expanding domestic consumer market fostered the success of many consumer labels, boosting the pool of IPO candidates.

Due to strict foreign exchange controls in China, fund structures were complex. Foreign VCs, and domestic VCs raising funds from foreign sources, had traditionally raised capital in dollar-denominated funds. These funds had to face a variety of regulatory reviews, and were restricted in terms of the industries in which they could invest.[33] Domestic VC firms had traditionally raised funds from local sources in RMB, and had greater freedom to invest these RMB funds. By 2009, RMB-denominated funds had exceeded US-dollar funds both in terms of number and total monetary value (see **Exhibit 8**).

By 2011, this situation was in flux. Foreign VC firms had started to obtain permission to raise RMB funds. Meanwhile, the domestic VC industry received investments from China's large social security funds and from other major corporations,[34] while listed companies, both state-owned and privately-owned, were rejoining the VC arena. Nonetheless, domestic funds remained less substantial than the foreign counterparts, in terms of their average size (see **Exhibit 8**). Foreign groups still accounted more than half of the top 20 VCs in China (see **Exhibit 9**).

Wei Chen and Oriental Fortune Capital Co., Ltd.

Shenzhen Oriental Fortune Capital Co., Ltd. (OFC) was an indigenous, privately owned venture capital firm co-founded by Dr. Wei Chen, and also one of the earliest limited partnerships in China. A PhD in accounting from Xiamen University and formerly a visiting scholar at Nyenrode Business University in the Netherlands, Chen was an academic before joining the VC industry. In 1999, he was hired by Shenzhen Capital Group (SCGC), a state-owned VC firm seeded by the Shenzhen municipal government. First hired as a researcher, Chen eventually became the firm's President. Before departing SCGC, Chen maintained the company's position among the top three Chinese VC firms, with investments over RMB 4 billion in capital holdings over 100 companies. In 2006, Chen persuaded several of his SCGC collages to join him as general partners (GPs) at OFC. By early 2007, Chen recruited several limited partners (LPs), mostly real estate developers, and raised RMB 320 million to create OFC's first VC fund. Among the early investments Chen made was 3NOD, one of the largest multimedia audio systems manufacturers in the world, specializing in products such as speakers and headphones, which listed on the Korean KOSDAQ in August 2007, completing an exit in about six months after the injection of capital.

As of March 2011, OFC had raised over RMB 6.542 billion in four RMB-denominated VC funds (the second closed in October 2009 with a total of RMB 758 million, the third in December 2010 with RMB 2.464 billion, and a logistics industry investment fund raised RMB 3 billion). In addition, OFC planned to set up an offshore fund of about US$100 million in 2011. The company had invested in more than 60 companies, of which seven had been publicly listed: three on the SZSE's SME Board, three on ChiNext, and one on KOSDAQ. OFC's investment thesis revolved around the opportunities created by the rapid development of the economy, on the back of fast-growing businesses that developed exceptional technical or business model innovations. The firms' investments focused in five major industries: information technology (IT), advanced manufacturing, new energy and new materials, consumer products, healthcare, and medicine. (See **Exhibit 10** for the distribution of OFC's investments). Within each industry, the OFC team attempted to cover the entire value chain from upstream to downstream activities. For instance, the company's investment in the IT industry started with an E-sports game platform and gradually covered companies that were developing wired and wireless communication infrastructure, network security, and payment applications, as well as content providers. Such a specialized approach allowed OFC to differentiate itself from many of the rival VC firms that pursued a generalized investment approach. Chen believed such a discipline helped OFC achieve exceptional returns, with over 100% growth in THE FUND'S net income in 2008 and over 50% in 2009.

When OFC first started its operation in 2007, Chen focused on pre-IPO stage projects which delivered immediate results to impress his LPs. As the global financial crisis began to affect China in late 2008, OFC started taking on more early-stage projects as rapid exits became unrealistic under the prevailing economic conditions. By the end of 2010, 20% of OFC's portfolio companies were in their early stages, and around 40% each in the growth and the pre-IPO stages. To accommodate the new strategy, Chen preferred to set a VC fund's lifetime to around five to seven years and an investment cycle to two to three years, in contrast to the shorter life span of many domestic VC funds. As a result, the company could keep the right balance of different projects while allowing adequate time to improve the performance of early-stage investments.

Another feature of OFC's investment strategy was its close attention to state policy. Chen said, "I watched the prime time TV news broadcast on the state TV channel every night. I listen to what the

(Communist) Party says, and I follow in the Party's footsteps." It was essential to keep track of changes in state policy. For instance, he singled out the emergence of many solar and wind energy companies as a result of the government's urge to substitute alternate energy sources for traditional fossil fuels.

ChiNext: The reality check

Positive notes

By April 2011, eighteen months into its operation, ChiNext established itself as a market with adequate liquidity that offered investors substantial returns. ChiNext also helped small-and medium-sized companies, most of which were privately-owned, access capital from a source other than the state-owned banking system. Wang explained how ChiNext helped these companies:

> In the past, many companies opted for an overseas listing because it was a lot faster to get listed. We used to have a few hundred companies lining up for an application but only around 100 were approved each year. But now it's the opposite. There were over 300 IPOs completed in China in 2010 and over 90% were in Shenzhen. We now have two separate departments to look at these applications. As a result, many companies complete their IPOs in a year. The fastest one took only around 100 days.
>
> We knew they couldn't wait for too long as they desperately needed new capital to expand production capacity. Most of these companies were in the "Technology, Media, and Telecommunication" sector where product life cycles were extremely short. Getting market shares was also a top priority. Therefore, these companies really needed the money from their IPOs. Also, as many of the developed economies are still recovering from recession, Chinese companies are eyeing "golden" opportunities to move overseas, or engaging in cross-border mergers and acquisitions.

The creation of ChiNext therefore provided a timely exit for the domestic venture capital firms who previously had limited options to recoup their investments other than going to markets such as NASDAQ, Hong Kong, or London. The emergence of ChiNext also meant that local entrepreneurs did not need to deal with legal and regulatory hurdles overseas, where language, cultural, and geographic distances often complicated efforts to raise capital on foreign exchanges. Chen illustrated the situation:

> In the old days, VCs or sponsors were looking to NASDAQ, Hong Kong, Korea, or Singapore. These days, the entrepreneur or the sponsor does not need to exhaust too many options because the domestic markets offer much higher valuations. The legal complexity and costs brought by Sarbanes-Oxley also made NASDAQ less attractive to Chinese entrepreneurs.

The "home effect," as Wang called it, was apparent in China, particularly as local governments at provincial, municipal or even prefecture levels were eagerly pushing local companies to list on ChiNext. Funds raised in the capital markets were seen as direct investments into these localities, and a publicly-listed firm could contribute more tax revenues. More importantly, IPOs provided comparatively lower-cost capital to fund indigenous research and development (R&D) projects that could not only give a boost to individual companies' but also raise the nation's capacity for innovation. Wang reported the impact on companies' R&D output after listing:

We conducted a research project together with the "Torch High Technology Industry Development Center," a government agency under the Ministry of Science and Technology, to analyze the impact of an IPO upon the research capacity of newly-listed companies. First, we identified 188 ChiNext companies (out of a total of 209 as of April 2011) that could be classified as genuine "high-tech enterprises." In fiscal year 2010, these companies spent a total of RMB 3.6 billion, or an average of RMB 19 million, on R&D, representing an increase of 38.1% on a year-on-year basis. Remember, all these companies had been listed for less than a year, so these increases could likely be attributed to their IPOs. If we focused on those companies in the "strategic emerging industries," the increase in R&D expenditures was even higher at 45.8%.

Negative effects

One of the problems common to ChiNext-listed companies was an "equity glut" from founders or top management. A lock-up period limited a company's founding shareholders and top management from selling their shares for a year, but the rule could be circumvented if they resigned their positions. After resigning, they could not sell any shares within the next six months but were allowed to sell half of their shares in the twelve months after the IPO. As a result, more than 60 senior executives from 37 ChiNext-listed companies had resigned from their posts by October 2010, just one year after ChiNext was launched.[35] Eventually, the rules were changed so that officers leaving a company were prohibited from selling shares within eighteen months from their departure day.[36] Meanwhile, limits on the controlling shareholders had become even more stringent since ChiNext's inception. Controlling shareholders had to promise that they would not transfer the companies' shares issued prior to the IPO within three years of the listing. They could, however, sell their shares one year after the listing, provided that the transaction was between a parent and a subsidiary and was approved by the SZSE.

While the high P/E multiples on ChiNext led to favorable valuations for both the owners looking for extra funding and the early stage investors seeking a favorable exit, the sponsors faced difficulties determining the issuance prices. Among the first 36 listed companies, most raised twice as much as their initial target (see **Exhibit 11**).[37] Seeing share prices skyrocket on the opening trades often left the majority shareholders with a feeling that the sponsors had failed to maximize the potential proceeds. On the other hand, regulators were concerned about the excessive funds raised from the IPOs, fearing possible embezzlement by the majority shareholders. In response, the SZSE added more restrictive rules on companies' disposal of IPO proceeds. The exchange stipulated that a maximum of 20% of the proceeds in excess of the original listing prices could be used for repaying debts or as working capital. The use of more than RMB 50 million or 20% of the extra proceeds for these purposes would be subject to shareholders' approval.

The Road Ahead: Options Available

Listing requirements

The most pressing issue that SZSE faced was whether ChiNext should lower its listing requirements. Wang told Chen about some of the rumblings she had overheard in the market:

Should the requirements be lowered so that even companies losing money or lacking an adequate operation history can get listed on ChiNext? Many Internet companies, such as, Baidu, dangdang.com, or youku.com, were either losing money or not making enough profits to qualify for any of the markets in China. So, they opted for NASDAQ or NYSE. If the requirements remain the same, ChiNext may lose more and more new IPOs to exchanges overseas. But, you know, we're always a believer in gradualism. We are used to doing things step by step. We may lower the requirements, but maybe not in the near future.

Chen replied:

Believe it or not, I'm calling for higher listing barriers on ChiNext. First, there are just far too many Chinese companies that qualify. I guess there are at least several thousand, if not a hundred thousand. As a VC, I welcome this arrangement as it means fewer backlogs in applications. It can speed up the approval process and quality firms can get to the market faster. Of course, a VC always wants an easier exit. So, the listing requirements should also be lowered, not on ChiNext, though, but on a third board, probably. Or ChiNext's listing requirements should depart substantially from those of the SME board. Either way, the existing ChiNext or the new third board can allow new ventures that lack operation history, or profits, or substantial revenues, to be listed and to receive much needed funding. Otherwise, we would never see an indigenous "Microsoft" or "Google" emerge on any of our local boards, but only those companies entrenched in traditional business models, or carrying substantial fixed assets, as stipulated by the listing requirements.

Delisting stocks

Another area where Chen thought that ChiNext needed to look at was its mechanism for delisting underperforming stocks. Despite the provision for a delisting warning, there was no specific rule governing how exactly a stock would be delisted. Chen noted:

In the absence of a clear path for delisting, the risk and reward of investing in a ChiNext-listed company is asymmetric. We will get a bigger and bigger bubble on ChiNext as retail investors see buying a ChiNext stock as a sure bet. The speculative frenzy in the secondary market jacks up the current or trailing P/Es, and eventually leads to higher P/Es for future IPOs. The upside for a VC investment in a pre-IPO company then came primarily from the price hike after its IPO, instead of the growth of the company's fundamentals. So there was little incentive for a VC to seek out new projects that could offer tremendous growth potential. They would rather look for companies that had proven business models or track records. On the other hand, underperformers will not be delisted but undergo endless "restructuring." Yet a "restructured" company often ends up having an even higher share price than before. This leads to unrealistic investor expectations that the government or the state would always bail out failed businesses, not with cash, but through "administrative procedures." ChiNext will soon no longer be able to fulfill its mission of encouraging growth and innovation.

Before formalizing the delisting mechanism, the listing requirements were tightened. In 2010, more than 60 IPO applications to the ChiNext board were rejected by the CSRC.[38] Measures under consideration were either to delist underperformers directly or to demote them to the OTC market, now running in Beijing's Zhongguancun Science Park and available exclusively to institutional investors. Wang contended:

First, local governments regard these IPOs as one of their major achievements (which directly link to their performance appraisals). So they don't want these companies to be delisted. They will try their best to go through restructuring. That's actually a major headache for us. Once the companies go into restructuring, a lot of insider trading activities follow. Second, if a firm is delisted, the minority shareholders' interests are not well protected under the current legal or regulatory framework. It's very difficult for them to sue the majority shareholders. The minority shareholders can easily see all of their investments wiped out. They may then take to the streets to demonstrate or petition to higher levels of government. There will be a lot of social instability. This is the last thing we want to see.

Secondary offerings, information disclosure, and other issues

Chen then remarked on the limitations on, and in many cases simply the unavailability of, secondary offerings in China's capital market. This was a drawback, Wang replied, saying:

> In the West, all you need [to do a secondary offering] is to get it approved by the board under most circumstances. In China, the Securities Law stipulates such a deal must go through the shareholders' general meeting, and then secure the approval of the CSRC. This is too rigid and does not help companies that need funds to expand their production capacity or market share. We need to think of a more effective way to help Chinese companies become more competitive in the global market. But to do so, we need to change the law. And this could be a lengthy process.

To make ChiNext a more efficient market, Chen also believed that more thorough information disclosure should take place. ChiNext-listed companies should be required to report not only all information to the Exchange, but also on its own website or via other direct channels to investors. At the same time, both investors and entrepreneurs needed more education on what an IPO meant and how its proceeds should be used. Until recently, most entrepreneurs treated an IPO as a short-cut to greater fortune and fame. Yet, they were less aware of the fiduciary responsibilities of being a director. Conversely, Chen felt retail investors should also be aware that becoming a shareholder of a listed company did not equate to winning a lottery. And they should familiarize themselves with the factors that led to the volatility of share prices.

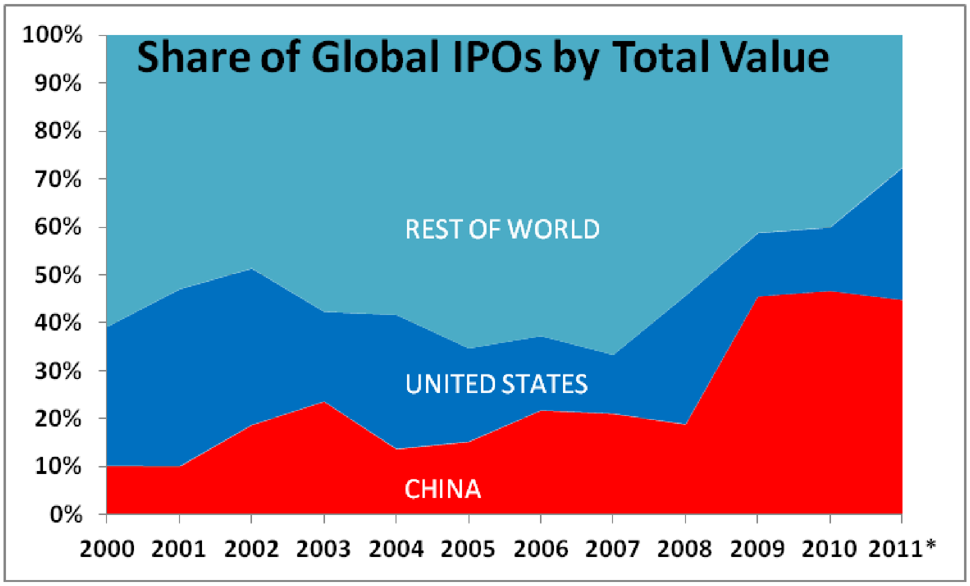
Wang echoed Chen's comments and revealed that progress was being made on broadening information disclosure channels. Wang's major concern, however, remained about the occurrence of a major scandal at a ChiNext-listed company. Be it insider trading or false accounting, any scandal, Wang feared, would jeopardize the credibility SZSE worked so hard to establish. Chen, however, replied: "You shouldn't be too afraid of having a scandal on ChiNext. It will happen for sure, it's just a matter of when it happens and how large it is. Instead, you should prepare yourself and try to learn how to reduce the possibility of having a scandal, and to mitigate risk so as to protect the interests of both investors and entrepreneurs."

Exhibit 1 Major Junior Markets Closed After 2001

Country	Market	Year founded	Year closed	Companies Listed (2001)	Market Cap in 2001 (US$ bn)	Companies Listed at its closure	Market Cap at its closure (US$ bn)
Germany	Neuer Markt	1997	2003	327	18.32	240	10.41
Italy	Nuovo Mercato	1999	2005	45	9.34	40	10.19
Belgium	NASDAQ Europe	2001	2003	48	5.43	41	3.57
Switzerland	SWX New Market	1999	2003	15	1.14	9	0.67
Denmark	KVX Growth Market	2000	2003	13	0.93	10	0.63
Ireland	Developing Companies Market	1997	2005	4	0.03	3	0.49
Japan (Osaka)	New Market Section	1999	2003	4	0.02	4	0.03

Source: Lan, X., (2008) "The Reform and Polarized Development of Overseas Growth Enterprise Market in the New Century" (in Chinese), *Securities Market Herald*, Apri 2008.

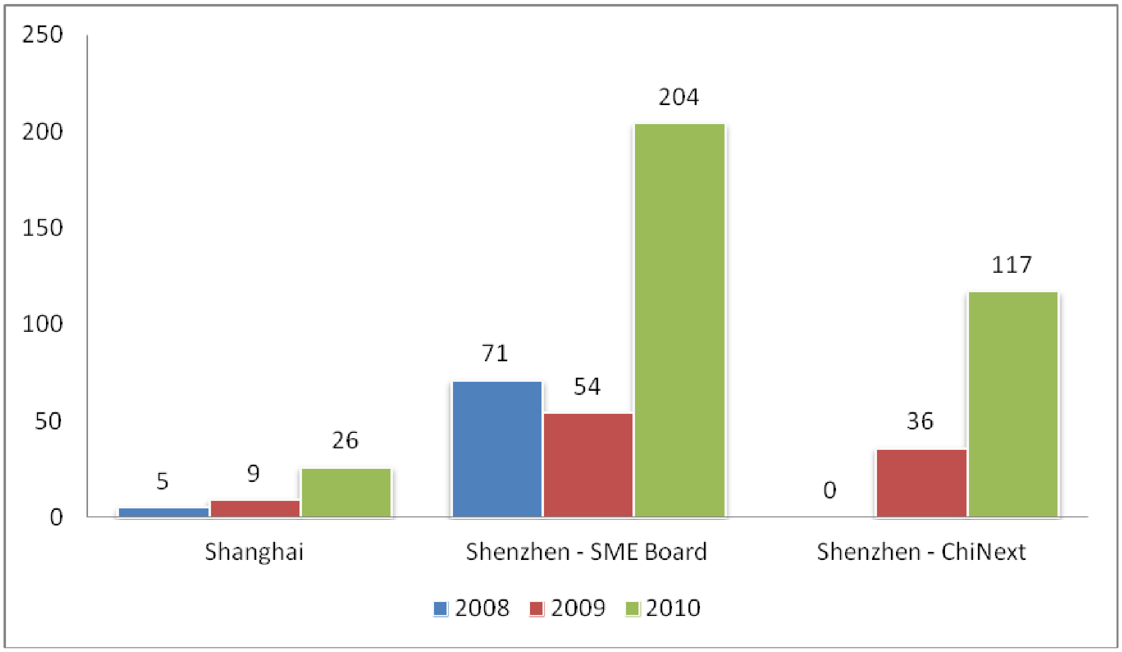
Exhibit 2 IPOs originated from China vs. the rest of the world



Source: Created by casewriters with data from Thomson Reuters Financial.

Note: * Through 5/8/2011

Exhibit 3 Number of IPO deals across various stock exchanges in China, 2008-2010



Source: Adapted from Lu Yibing, and Xiang Wei, "Capital raised from IPOs in 2011 exceeds RMB 600 billion?" (in Chinese), *Shenzhen Wanbo*, January 5, 2011, A04.

Exhibit 4 SZSE Market Summary, 2003-2010

	2003	2004	2005	2006	2007	2008	2009	2010
Listed companies	505	536	544	579	670	740	830	1,169
Market capitalization (RMB billion)	1,265	1,104	933	1,779	5,730	2,411	5,928	8,641
Total volume (RMB billion)	1,215	1,642	1,327	3,873	18,764	9,938	19,873	24,742
Daily average volume (RMB million)	5,042	6,757	5,485	16,073	77,539	40,401	81,448	102,242

Source: The Shenzhen Stock Exchange, *Shenzhen Stock Exchange Factbook 2010*, p. 3-4.

Exhibit 5 An excerpt from "Interim Measures on the Administration of Initial Public Offerings and Listings of Shares on the ChiNext"

Chapter II Offering Conditions

Article 10: The issuer that applies for IPO of shares shall meet the following conditions:

1. The issuer must be a duly incorporated company limited by shares and must have been in operation for more than three consecutive years.

For any company limited by shares which has been transformed as a whole from a limited liability company by converting its original book value of net assets into shares, the required operation period may be counted from the date of establishment of the limited liability company.

2. The issuer must have been profitable in the most recent two consecutive years, with accumulated profits no less than RMB 10 million and in steady growth; or the issuer must have been profitable in the most recent year with net profits of no less than RMB 5 million and revenues of no less than RMB 50 million, and its revenue growth rate for either of the most recent two years must have been no less than 30%. Net profits shall be calculated based on the amount before or after deducting non-recurring profits and losses, whichever is smaller.

3. The issuer must have net assets of no less than RMB 20 million at the end of the most recent accounting period with no uncovered losses; and

4. The issuer must have a total share capital of no less than RMB 30 million after the IPO.

Chapter III Offering Procedures

Article 32: The sponsor that sponsors an issuer's share offering and listing on the ChiNext shall conduct due diligence investigations and make prudential judgment on the issuer's growth and render special opinions thereon. The sponsor shall also explain the issuer's innovative capability in its special opinions if the issuer is an innovative enterprise.

Chapter IV Information Disclosure

Article 40: The issuer shall make a statement in a prominent position in its prospectus as follows: "The shares to be offered in the contemplated IPO will be listed on the ChiNext which is characterized by high investment risk. Companies on the ChiNext are susceptible to inconsistent performance and high operation risk and delisting risk which expose investors to high market risk. Prospective investors should be fully aware of the investment risk associated with the ChiNext and the risk factors disclosed by the Company and should make the decision to invest only after due consideration."

Chapter V Supervision and Legal Liabilities

Article 51: The stock exchange shall establish the systems of listing, trading and delisting as well as other relevant systems appropriate to the characteristics of the ChiNext. It shall urge sponsors to fulfill their continuous supervisory obligations and shall impose regulatory measures on violations of applicable laws and regulations as well as the rules of the stock exchange.

Article 52: The stock exchange shall establish a market risk warning system and a continuing investor education system appropriate to the characteristics of the ChiNext and urge issuers to establish and perfect an investor protection system and an internal control system for preventing and correcting illegal and irregular acts.

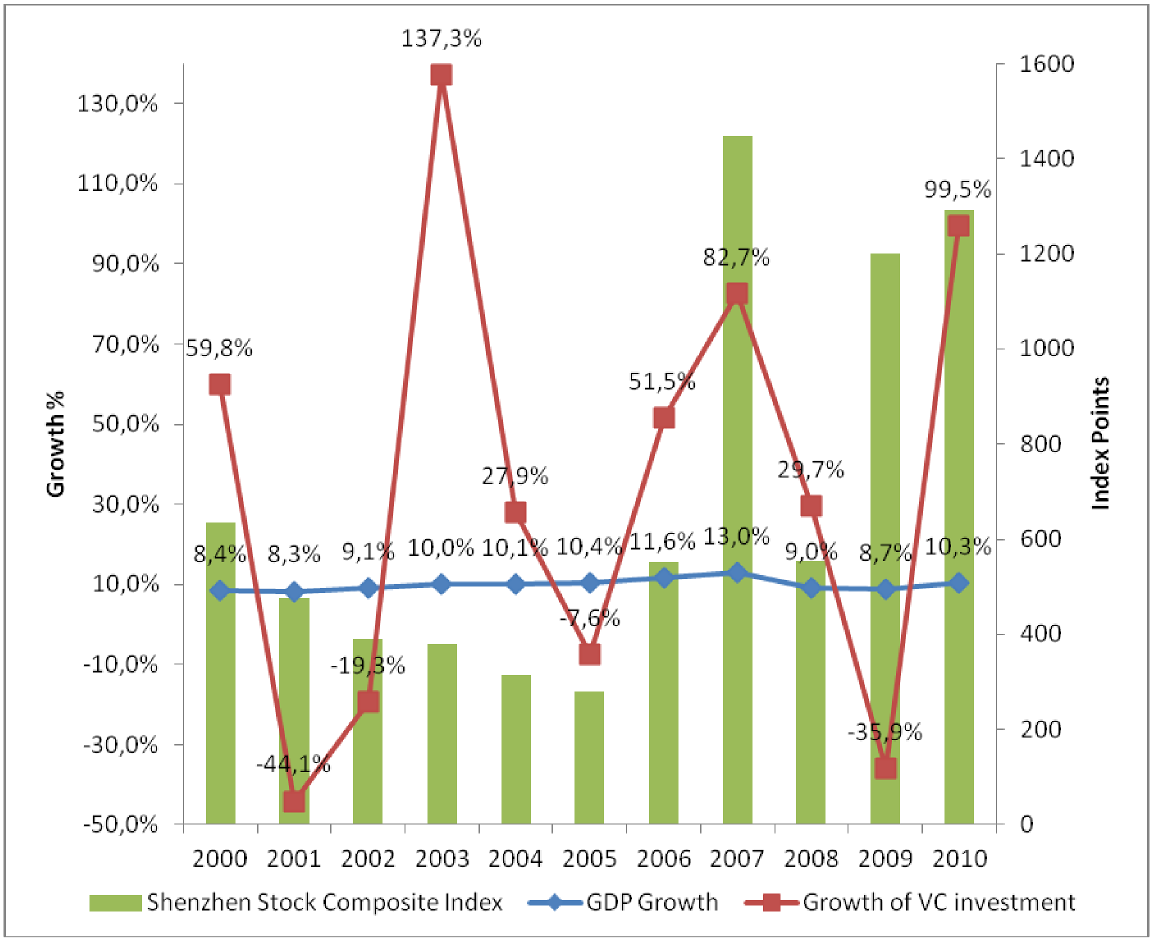
Source: The Shenzhen Stock Exchange.

Exhibit 6 Comparison of Key Listing Requirement for Major Second Boards

	SZSE: ChiNext	SZSE: Main Board	Hong Kong: GEM	Hong Kong: Main Board	NASDAQ Global Market	AIM, London	KOSDAQ, Korea	Catalist, Singapore
Liquidity requirements								
Shareholders Spread	200	NA	100	300	400	NA	500	200
Publicly held shares	25% of issued capital; 10% if capital > US$61mn (RMB 400mn)	25% of issued capital; 10% if capital > US$61mn (RMB 400mn)	25% of issued capital	25% of issued capital	1.1mn shares	NA	30% of issued capital; OR 10% of 100mn-500mn shares	15% of issued capital
Market capitalization of public float	NA	NA	US$3.8mn	US$6.4mn	US$8-20mn depends on standards	NA	NA	NA
Stockholders' equity	Post IPO: US$4.6mn (RMB 30mn)	Pre IPO: US$4.6mn (RMB 30mn)	NA	NA	US$0-30mn depends on standards	NA	US$1.6-3.2mn depends on standards	NA
Operating history	3 years	3 years	2 years	3 years	0-2 years depends on standards	NA	0-3 years depends on standards	NA
Financial requirements								(3)
Profits	Aggregated US$1.5mn (RMB10mn) for last 2 years; **OR**	Aggregated US$4.6mn (RMB30mn) for last 3 years; **AND**	NA	US$6.4mn for last 3 years; **AND** US$2.6mn last year (1); **OR**	US$0-1mn depends on standards	NA	Ordinary profit	NA
Cash flow	NA	Aggregated US$7.6mn (RMB50mn) for last 3 years; **OR**	Aggregated US$2.6mn for last 2 years;	NA	NA	NA	NA	NA
Revenue	US$7.6mn last year (with net profits of US$0.76mn & 30% revenue growth for last 2 year)	Aggregated US$46mn (RMB300mn) for last 3 years	NA	US$64mn last year if market cap > US$512mn (2)	NA	NA	NA	NA

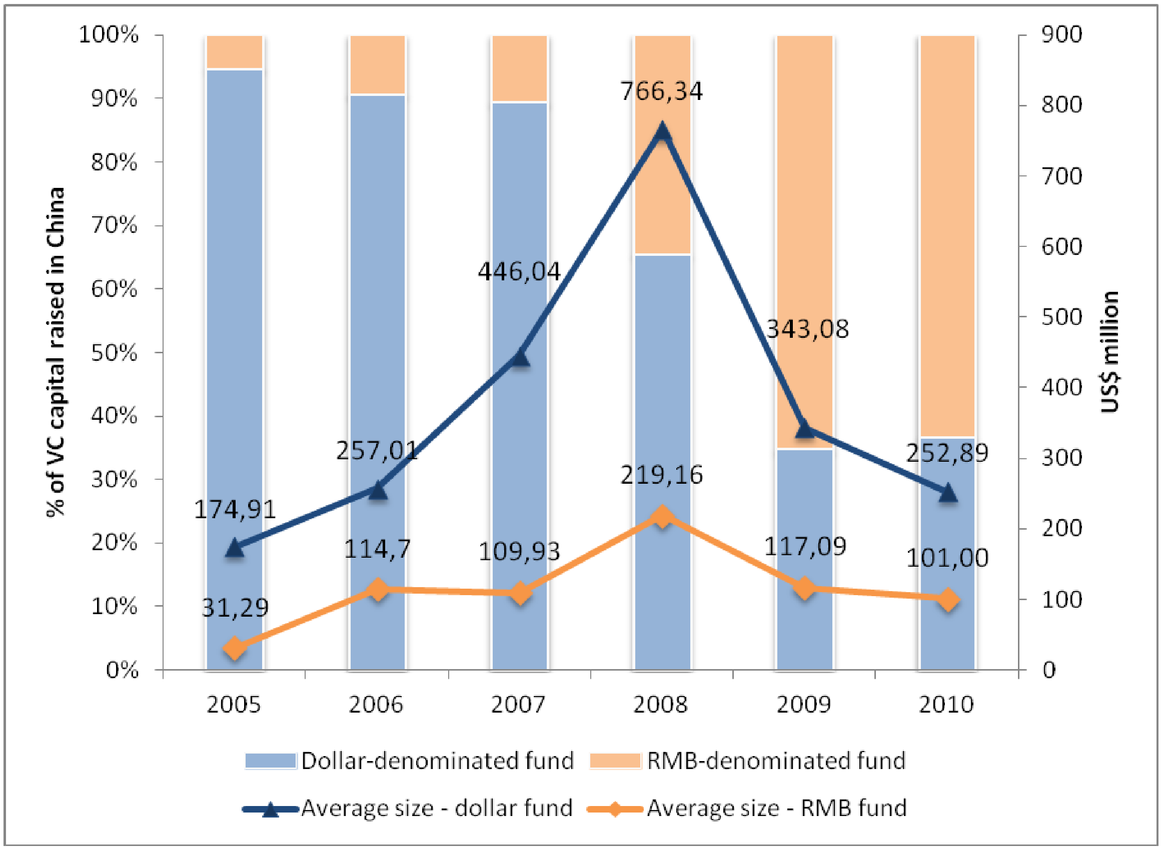
Source: Compiled by casewriters with data from the websites of SZSE, Hong Kong Exchanges and Clearing Limited, NASDAQ, AIM, KOSDAQ, Singapore Exchange, and Grant Thornton (2008), "Global growth markets: the changing face of world finance", p. 18-19. Note: (1): under the "Profit Test"; (2) under the "Market Cap/Revenue Test"; (3); sufficient working capital was required.

Exhibit 7 Growth of GDP and VC Investments in China, and stock performance on SZSE



Source: Created by casewriters, using data extracted from zero2ipo on http://www.pedaily.cn/Item/124782.aspx, retrieved April 2011, and data in *Shenzhen Stock Exchange Fact Book 2010*.

Exhibit 8 Relative importance of Dollar-denominated funds and RMB-denominated funds in China's VC industry



Source: Created by casewriters from data provided by Zero2ipo Research Center, via pedaily.cn, February 1, 2010, http://www.pedaily.cn/Item/123755.aspx, accessed April 2011, and PEdaily.cn, January 30, 2011, http://www.pedaily.cn/Item/205073.aspx, accessed May 2011.

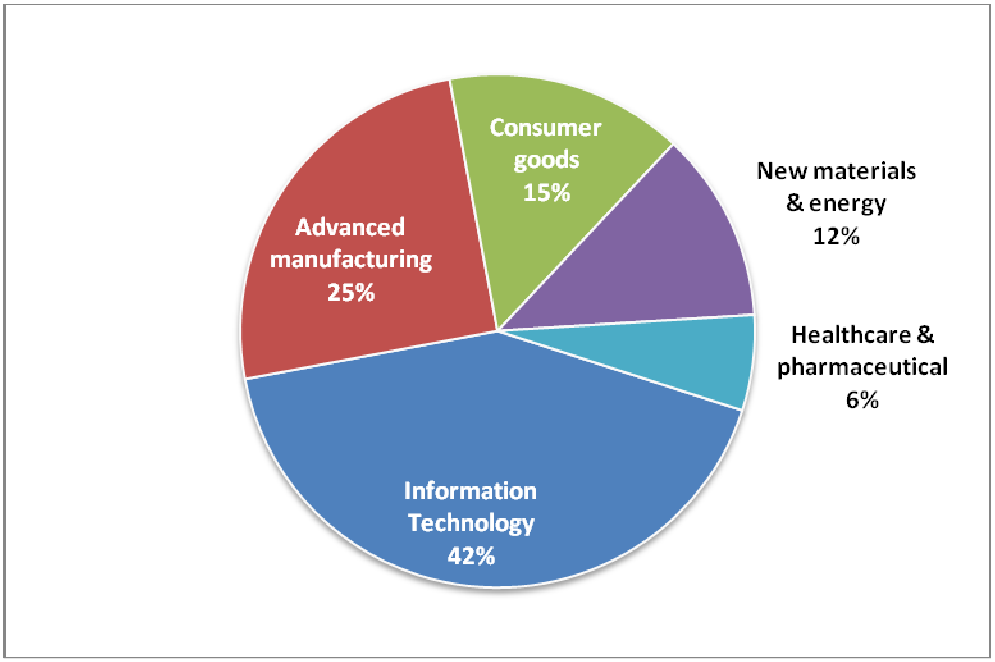
Exhibit 9 Top 20 VC Firms in China, 2010

Rank	Name of VC Firm	Origin
1	Shenzhen Capital Group Co., Ltd.	Domestic
2	Sequoia Capital China	Foreign
3	IDG Capital Partners	Foreign
4	SAIF Partners	Foreign
5	Shenzhen Fortune Venture Capital Co., Ltd.	Domestic
6	Jiangsu Govtor Capital Group	Domestic
7	Shanghai NewMargin Ventures	Domestic
8	China Science and Merchants Capital Management Limited	Domestic
9	Shenzhen Co-win Venture Capital Investment Limited	Domestic
10	Legend Capital	Domestic
11	Green Pine Capital Partners Co.	Domestic
12	CDH Venture Ltd.	Foreign
13	Shenzhen Oriental Fortune Capital Co., Ltd.	Domestic
14	GGV Capital	Foreign
15	SIG Asia Investment, LLLP	Foreign
16	Intel Capital Corporation	Foreign
17	Softbank China Venture Capital	Foreign
18	Kleiner Perkins Caufield & Byers - China	Foreign
19	DT Capital Partners	Foreign
20	Walden International	Foreign

Source: Zero2IPO Group, *China Venture Capital & Private Equity Annual Ranking 2010*, December 10, 2010, http://www.zero2ipogroup.com/f/research/20111129403333991S.pdf, retrieved April 2011.

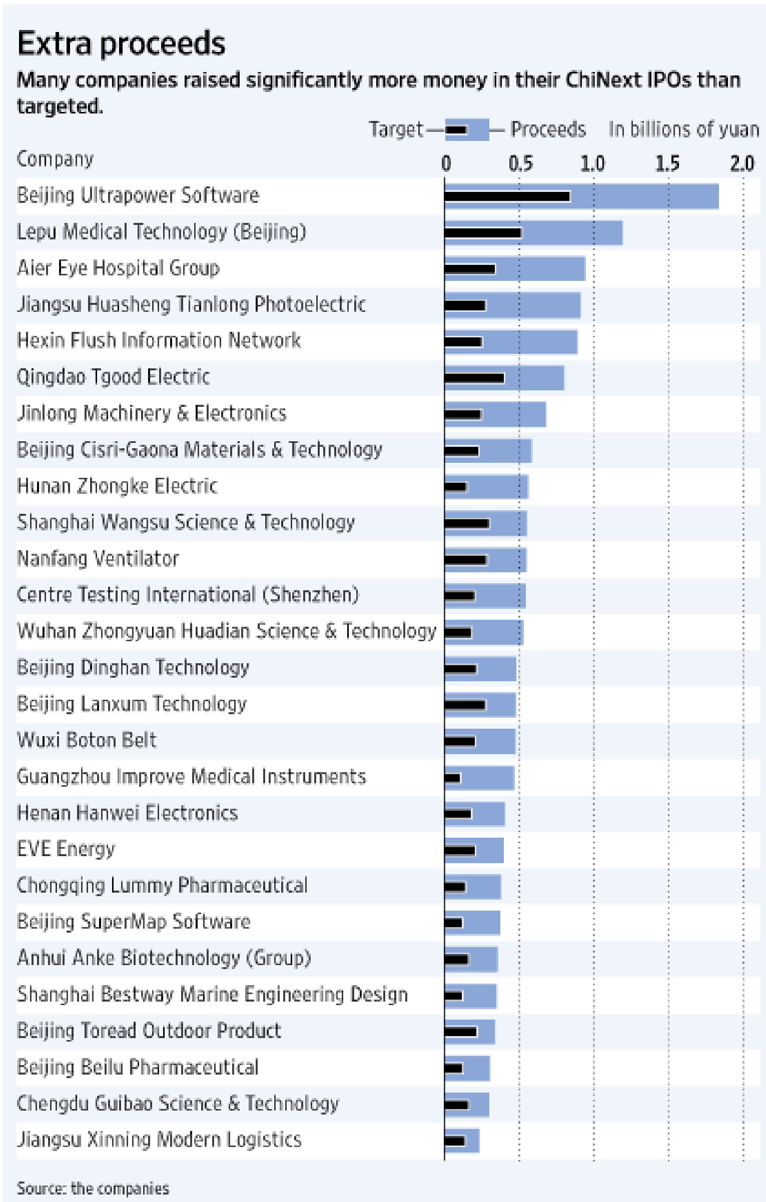
Note: The ranking is based on an undisclosed ranking scheme that includes, among other measures, the amount of managed capital, the amount of newly raised funds, the number of investment deals, the amount of invested capital, the number of exits, and return on investment.

Exhibit 10 OFC Investments by Industry Sector



Source: Oriental Fortune Capital.

Exhibit 11 Extra proceeds raised from ChiNext IPOs



Source: Wynne Wang, "Shenzhen Exchange Tightens ChiNext Rules", *Wall Street Journal*, January 7, 2010, http://online.wsj.com/article/SB10001424052748703882804574641682869069924.html, retrieved April 2011.

Endnotes

[1] Liu Hongyi, Zu Qincheng, Yan Yan, "2011: A new era of RMB-denominated funds" (in Chinese), howvc.com, March 18, 2011, http://www.howvc.com/Html/investment/institution/fund/948799_4.html, accessed April 2011.

[2] Shenzhen Stock Exchange, Shenzhen Stock Exchange Fact Book 2010 (Shenzhen: Securities Information Co., Ltd., 2011), p. 9, http://www.szse.cn/main/files/2011/04/18/935296451656.pdf, accessed April 2011.

[3] Reena Aggarwal and James J. Angel, "The rise and fall of the Amex Emerging Company Marketplace", *Journal of Financial Economics* 52 (May 1999): 257-289.

[4] Ibid.

[5] Sebastian Rasch, "Special Stock Market Segments for Small Company Shares in Europe - What Went Wrong?" Centre for European Economic Research (ZEW) Discussion Paper No. 94-13, April 1994, http://econstor.eu/bitstream/10419/29442/1/309597625.pdf, accessed April 2011.

[6] Wang Xiaojin and She Jian, "Research report on the development and trends of Growth Enterprises Markets overseas", Research Report No. 0164 of the Research Institute of the Shenzhen Stock Exchange, May 2008, http://www.szse.cn/main/files/2008/07/08/053711193035.pdf, access March 2011.

[7] Ibid.

[8] Most of the early junior markets were auction markets, where buyers and sellers traded their stocks by announcing their bid and ask prices on an open auction. NASDAQ, however, was a dealer market in which buyers and sellers did not trade directly but through dealers. The dealers held the shares under their account and earned profits through the bid-ask spreads between buyers and sellers. Usually, the bid-ask spreads on an auction market are smaller than in a dealer market, given adequate information transparency. However, a dealer might have more incentive to "make the market" by completing more trades, thus, enhancing the liquidity of the stocks. For further information on how the market mechanism influenced the growth of junior markets, see Reena Aggarwal and James J. Angel, "The rise and fall of the Amex Emerging Company Marketplace", *Journal of Financial Economics* 52 (May 1999): 257-289.

[9] The "nominated adviser" (Nomad) was a system first introduced by AIM in 1995. Each company applying for an AIM listing needed to appoint a Nomad to guide it through the IPO approval process and oversee its operation through its listing on the exchange. A Nomad, usually the underwriter of a newly-issued stock, had to assess whether a company was appropriate for listing on AIM, to conduct the due diligence process, and to assume on-going responsibilities in supervising an AIM company's compliance with information disclosure, corporate governance, and trading requirements. Source: *AIM Rules for Nominated Advisers*, London Stock Exchange publications, (London, UK, February 2007), http://www.londonstockexchange.com/companies-and-advisors/aim/publications/aim-rules-for-nominated-advisers.pdf, accessed April 2011.

[10] The document was titled "Decision of the Chinese Communist Party Central Committee and the State Council on Strengthening Technical Innovation, Developing High Technology and Realizing Industrialization", issued on August 22, 1999. An English version of the complete text can be found on http://www.chinalawedu.com/news/23223/23228/22843.htm.

[11] *Securities Times*, "The Small & Medium Enterprise Board Approved", May 28, 2004, http://www.szse.cn/main/en/smeboard/aboutsmeboard/200409026295.shtml, accessed April 2011.

[12] Chang Lan, "Chinese firms representing more than half of the world IPOs" (in Chinese), PEdaily.cn, April 12, 2011, http://www.pedaily.cn/Item/208915.aspx, accessed April 2011.

[13] Ibid.

[14] *PE Asia*, "ChiNext promises big things for VC in China", December-January 2009-10, p. 10, via Asia Alternatives Management LLC, http://www.asiaalt.com/articles/ChiNext_1209.pdf, accessed February 2011.

[15] Ibid.

[16] Po Feng, "Annual Statistics & Analysis of China's VC/PE Investments-2010", ChinaVenture, March 8, 2011, http://report.chinaventure.com.cn/r/f/321.aspx, accessed May 2011.

[17] Xinhua News Agency, "ChiNext raises 117bn yuan for 153 companies by 2010", *People's Daily Online*, January 9, 2011, http://english.peopledaily.com.cn/90001/90778/90857/7254354.html, access March 2011.

[18] Ibid.

[19] China Stock Market Handbook Editorial Board, *China Stock Market Handbook*. (Saratoga, CA.: Javvin Press, 2008), p. 3.

[20] China Securities Regulatory Commission, Annual Report 2009 (Beijing: China Securities Regulatory Commission, 2010), p.7, http://www.csrc.gov.cn/pub/csrc_en/about/annual/201011/P020101105493830315968.pdf, accessed April 2011.

[21] Shenzhen Stock Exchange Fact Book 2010, p. 6.

[22] The document was titled "Several Opinions of the General Office of the State Council on Providing Financial Support for Economic Development", issued on August 12, 2008. An English version of the complete text can be found on http://www.lawinfochina.com/NetLaw/display.aspx?db=law&sen=rLdDdW4drhdDdWhdrhdydW4d/hdDdWcd9DdxdWndrLdxdWudrLdvdWnd9hd6dWud/ddTdWud9Dd+&Id=7227&.

[23] Hao Fengling, "The uniqueness of VC/PE in China" (in Chinese), Pedaily.cn, January 1, 2011, http://www.pedaily.cn/Item/203543.aspx, accessed April 2011.

[24] Ibid.

[25] Ibid.

[26] Steven White, Jian Gao, and Wei Zhang, "Financing new ventures in China: System antecedents and institutionalization", *Research Policy* 34 (August 2005): 894-913.

[27] David Ahlstrom, Garry D. Bruton, and Kuang S. Yeh, "Venture Capital in China: Past present, and future", *Asia Pacific Journal of Management* 24 (2007): 247-268.

[28] Zero2IPO Research Center, "China state-funded VC: How far can you go?", Pedialy.cn, March 11, 2011, http://www.pedaily.cn/Item/207143.aspx, accessed April 2011.

[29] Wei Xiao, "The New Economy and Venture Capital in China", *Perspectives*, September 30, 2002, http://www.oycf.org/Perspectives2/18_093002/Economy_Venture_China.htm, accessed April 2011.

[30] White, Gao, and Zhang, 2005.

[31] *The Regulation on the Administration of Foreign-Invested Venture Capital Enterprises* regulated the establishment of VC firms within China using foreign capital. More details from Takeshi Jingu and Tetsuya Kamiyama, "China's private equity market', Nomura Capital Market, Review 3 (2008), p.6, http://www.nicmr.com/nicmr/english/report/repo/2008/2008aut03.pdf, accessed April 2011, and Morrison & Foster, et. al., "China's New Foreign-Invested Venture Capital Regulation", AltAssets, http://www.altassets.net/private-equity-knowledge-bank/country-focus/asia/afghanistan/article/nz4030.html, accessed May 2011.

[32] Before the amendments of the Company Law and the Securities Law in 2004, shares in a Chinese company were divided into two classes: the "circulating" and the "non-circulating." The "circulating" shares could be traded on the open market whereas the "non-circulating" shares residing in the hands of the majority or the controlling shareholders were non-tradable. Such a classification limited the liquidity of a company's shares and led to over speculation. Moreover, the founders were unable to dispose their holdings and were, therefore, not given adequate incentives. After the amendments, majority shareholders could sell their shares after passing a resolution in the shareholders' general meeting, with adequate compensation given to minority shareholders in the forms of either cash or options. Source: Casewriters' interviews with Xiaojin Wang, Shenzhen, March 15, 2011.

[33] Paul Gompers, Shaohui Chen, Jessin Lin, and Shelley Ling, "Shenzhen Capital Group: A Pioneer in China's VC Industry," HBS No. 90211-029 (Boston: Harvard Business School Publishing, 2010), p. 3.

[34] Wang Guan, "Review and Forecast of PE market in China, 2009" (in Chinese), PEdaily.cn, February 1, 2010, http://www.pedaily.cn/Item/123755.aspx, accessed April 2011.

[35] Olivia Chung, "ChiNext strategy – list and run", *Asia Times Online*, November 9, 2010, http://www.atimes.com/atimes/China_Business/LK09Cb02.html, accessed February, 2011.

[36] Ibid.

[37] Wynne Wang, "Shenzhen Exchange Tightens ChiNext Rules", *Wall Street Journal*, January 7, 2010, http://online.wsj.com/article/SB10001424052748703882804574641682869069924.html, accessed April 2011.

[38] Daniel Ren, "Restructuring not an option for lossmakers", *South China Morning Post*, March 12, 2011, p. BIZ3.