Venture Capital and Technology Entrepreneurship in China, 2003

- Ford MBA Research Fellowship -

At the end of 2001, foreign direct investment (FDI) into China totaled US$50 billion, roughly 25% of the world's total FDI. Over the last ten years, this figure has aggregated to over US$300 billion, ten times that of Japan in the same period.[1] Certainly, foreign investors' interest in the vast country and giant market is undeniable. Yet some who have been vested in China for many years step away and decide that making money in this country is almost impossible. Some economists even suspect that China's growing economy may be faced with an impending bubble soon. Without summarizing the many issues and challenges of doing business and investing in China for foreigners, on which there is already considerable literature, this study seeks to focus on private equity and venture capital, evaluating:

- The Chinese Government's new "Rules on the Administration of Foreign Invested Venture Capital Investment Enterprises" and its ramifications on foreign private equity investors,
- Strategies adopted by active investors,
- Current trends in the evolving private equity and venture capital market,
- Types of successful entrepreneurs emerging in China, and finally,
- Two cases of investments representative of these prevailing trends, one of which has proven to be a successful exit for the investor.

Of course, neither mystic nor extensive research can predict the future of the Chinese market. This report aims only to capture an essence of private equity and entrepreneurship in China as a snapshot in time as the Government strives to structurally shape the country into a world class international market, as key foreign and domestic players are defining their roles, and as the first Chinese tycoons and business leaders rise after half a century of communism.

Rules on Foreign Invested Venture Capital Investment Enterprises

In recent years, the Chinese Government has been making its first serious attempt at defining a national legal framework for venture capital and other private equity (PE) investments in China. The "Rules on the Administration of Foreign Invested Venture Capital Investment Enterprises" (VC Rules), soon to be implemented, will legally recognize foreign-invested limited liability companies either wholly owned by foreign investors or jointly held between domestic and foreign

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1 http://www.worldbank.com

investors; these regulations are primarily targeted at unlisted high-tech growth ventures.[2] They reveal the Chinese authorities' sincere commitment to promote a positive environment for investing in China, yet they are not fully tackling the major problems and limitations imbedded in the existing investment regime. The VC Rules simply mandate the establishment of a foreign-invested venture capital company under the existing foreign-invested enterprise (FIE) regulatory structure, without attempting to push for real change in the status quo or relax restrictions under the FIE regime on areas such as simplification of the approval process for multiple investments, transferability of equity interests in invested enterprises, and capital gains issues in times of exits for investors.

The terms of the VC Rules include:

- Stipulations for all investors in the venture,
- Approval processes for the business scope of this investment vehicle, and
- Exit mechanisms.

(Please refer to Appendix I for full text of the VC Rules.) Through these regulations, foreign investors can create a new special-purpose investment company, not unlike a holding company, with interests in multiple enterprises. Invested ventures may take the form of either:

- A limited liability equity joint venture (EJV),
- A limited liability cooperative joint venture (CJV) with legal person status,
- A CJV without legal person status and with liabilities of the CJV contractually allocated as between its investors (i.e. similar to a general or limited partnership), or
- A limited liability wholly owned foreign enterprise, in which there is no Chinese partner.

The VC Rules conform to existing rules for holding companies and foreign-funded financial institutions, imposing financial and other criteria on investors, requiring fund managers' proof of experience, specified amounts of funds under management, and minimum registered enterprise capital (e.g. a wholly foreign owned enterprise must register with at least US$20 million while and a joint venture needs US$25 million). Issuance of the business license is contingent upon 15% of this amount to be paid within three months after the establishment of the enterprise, while the remainder must be paid within three years. Though there is some flexibility in drawing down commitments, investors must observe the tight three-year period irrespective of whether attractive investments are available.

The VC Rules also try to deal with the issue of exit, for which numerous issues have yet to be resolved. Examples of permitted exit mechanisms for foreign private equity funds include:

- Equity transfer to other enterprises or individuals:
  The VC Rules stipulates that equity interests in invested companies are not transferable by foreign private equity investors until the capital subscribed by it has been contributed in full - a restriction that potentially locks up all investments until three years after the date of issue of the business license. Therefore, at this stage, the structure as defined in the VC Rules does not resolve current exit issues. Transfer of equity interests also requires the approval of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), which must in turn obtain the consent of the Ministry of Science and Technology before issuing any approvals. In short, investment and divestment by a

[2] In October 2000, the Shenzhen Government had issued its own set of regulations for venture capital investment to attract both domestic and foreign venture capital investments into the Shenzhen Special Economic Zone. The provisions of the Shenzhen Regulations are slightly more detailed than those of the VC Regulations, but the two sets of regulations essentially cover the same scope.

foreign limited liability company potentially requires more government approvals than investment or divestment by an offshore company.

- Equity buy-back by the invested company through an equity redemption agreement between the company and its private equity investor(s):
  There is currently no real mechanism for equity interest buy-backs other than through a reduction of capital. Article 20 provides that such a buy-back may be affected through detailed rules, which are, however, yet to be issued.

- Share sale on a stock market within or outside China, provided the relevant invested company has satisfied the requirements for listing and has secured a listing successfully:
  The VC Rules still does not yet fully address fundamental capital and currency convertibility problems for foreign investors. Although a foreign PE investor could recover its capital and returns on capital by selling equity interest of an invested company, a EJV could not return money to its investors as a distribution of capital unless it reduced its own capital. A CJV has somewhat more flexibility to reduce its capital over the term of its operation, although the investors to whom capital is returned remain liable for the capital. A wholly foreign owned enterprise suffers from much the same issues as an EJV.

Private equity firms under the VC Rules are regarded as FIEs and thus receive FIE's preferential tax treatment compared to domestic counterparts; they can defer payment of income tax and exemption from stamp duty payments. However, with its entry into the WTO, China will implement a series of tax reforms which may eliminate some of these incentives. Capital gains also raise other tax issues. In general, the foreign PE investor will be subject to Chinese income tax on any capital gain of 30% national and 3% local tax. Further refinement of tax regulations is required for the investment vehicles governed by the VC Rules. Overall, many issues remain to be resolved in this new set of regulations.

Strategies of Active Investors

While the VC Rules are still not refined and implemented, the Government is nonetheless reacting to a relatively recent phenomenon. Private equity as understood in the West did not emerge in China until the 1980s; however, much of its activity has been concentrated in the last few years. At the start of 2002, foreign investments in 2000 and 2001 together account for 37.3% of all venture capital poured into China, while the total number of deals during those two years account for 43.8% of all VC deals in China. Of the sum of 2000 to 2001 capital, 2000 funds are two thirds of the total, reaching US$354 million (RMB 2.93 billion); by 2001, funds have dropped to US$182 million (RMB 1.51 billion) by 14.6% from the previous year. A 2000 to 2001 government study of a sampling of 188 foreign and domestic venture capital firms, with aggregate investments of $536 million (RMB 4.46 billion), made the following observation:

Source of Funds	Number of Deals Closed	Total Amount of Invested Capital	Average Investment Amount per Deal
Domestic	677 companies	US$500 Million	US$0.74 Million
Foreign	9 companies	US$37 Million	US$4.08 Million

In essence, domestic funds (primarily generated through Government coffers) still lead VC activity, although their investments per deal are relatively small.[3] Since many of these funds

[3] Of the VC companies studied, accumulated investments account for roughly 30-40% of total capital under management; in general, VCs usually leave some money in coffers for subsequent rounds of investments.

come either from the Government or from large state-owned enterprises, their investment mission seek to achieve not only financial returns and strategic business objectives, but socio-economic impact as well. With slightly less emphasis on the bottom line, domestic funds can take on lower percentage of equity in companies and allow management greater flexibility to develop business strategies. Many funds, such as the Canton Venture Capital Company, invest as little as up to 15% equity in each company, while maintaining the vision to foster business development in certain sectors to boost local economic growth. Thus they fulfill both roles of venture capitalist as well as government support institution. It is difficult to measure the success of these funds. Anecdotally, the funds that claim to be successful boast of rates of return of roughly 15-18%.

According to another 2001 study conducted by the Government Technology Department, the "China VC Investment Development Report," involving another sampling of 246 VCs, most of whom were domestic funds, the breakdown of invested industries was quite dispersed.

2001 VC Deals Closed by Industry

Industry	# of Cases	Percentage of Annual # of Investments
Software	126	15.69%
Network	75	9.34%
Pharmaceutical	72	8.97%
Biotech	68	8.47%
New Materials	67	8.34%
Telecom	60	7.47%
Optical	51	6.35%
IT	36	4.48%
Semiconductor	7	0.87%
Manufacturing, Retail, & Others	241	30.01%
Total	803	100.00%

Within this sampling of venture capital firms, 803 deals were closed in 2001. Domestic VCs tended to concentrate on companies developing software applications; with the decline in the internet industry, Chinese VCs favored software investments and aimed for IPOs for these companies, banking on early to mature stages ventures rather than seed stage start-ups. By contrast, for pharmaceutical investments in 2001, they preferred seed to early stage companies for their research capabilities. In the semiconductor industry, most deals were closed by Taiwanese VCs. This sector was not popular because of its capital intensive demands and intellectual property problems. Overall, few VCs specialized on only one industry or one technology.

In 2002, venture capital funds in China encountered similar problems as those in 2001 in an environment with many challenges and limited transaction activity. In 2001, for instance, the average annual invested capital of the ten largest and most active VCs was US$40 million, whereas that of 2002 was US$26 million. For foreign VC firms, quality deal sourcing and exit mechanisms continue to be challenges.

2000 gave birth to great hype and many new VC funds, both domestic and foreign. Today, however, the number of domestic funds, especially private community and individually funded vehicles, are dwindling. Funds from domestic VC firms, at US$128 million, comprise about 33% of gross capital of the top 50 largest and most active VC firms in China.[4]

Top Ten Private Equity Funds by Invested Capital

Ranking	Private Equity Fund	Total Amount of Venture Investment (US$ Million)
1	E. M. Warburg Pincus & Co. Asia. Ltd	7,100
2	Walden International	3,900
3	IDGVC	3,000
4	JAFCO Investment(Hong Kong) Ltd	3,000
5	Vertex Management	2,200
6	Legend Capital Limited	2,000
7	Shenzhen Venture Capital Co. Ltd	1,843
8	Acer Technology Ventures ASIA Pacific Ltd	1,550
9	Beijing Venture Capital Co .Ltd	899
10	SoftBank ASIA Infrastructure Fund	844

Private community and individual investments now account for only 20% of that amount. According to a senior manager at a respected Chinese securities firm, only ten out of a portfolio of 100 start-ups survive over the course of a couple of years.[5] Many could not IPO on the second board, failed to meet performance milestones, and did not receive subsequent rounds of funding to continue business operations. In general, domestic investors, including Chinese Government and regional/municipal venture capitalists, have been significantly hit in terms of exits by the delay of the second securities board for high-tech companies.[6]

The second board has been in planning stages for the last five years, yet many of China's leaders still hesitate over such a specialized securities market, which opens up numerous possibilities for financial fraud and illicit money-making opportunities imbedded in the "gray areas" of a system not fully ready for such a medium for exchange.[7] Given these challenges, some in the field feel that private community investments for the time being are not strong enough to weather the tough investment environment and may be a brief stage in the evolution of venture capital and other forms of private equity investing in China.

At the same time, investors in 2002 are quickly adapting to the evolving landscape of the Chinese market. For instance, to jointly bear risks, many VC firms co-invest in ventures and build a solid rapport among a select circle, especially among foreign-funded partnerships; many investors travel together to various regions of China to evaluate companies and review deals. Once alien and distant to local small to medium sized enterprises, venture capital is becoming

4 *Digital Fortune Magazine*, based in Beijing, conducted a survey on the top PE firms in China, sending out 200 surveys; of the 106 returned questionnaires, 35 were foreign and 71 were domestic. These top 50 funds were selected based on a combination of factors, including total fund amount, invested capital, number of deals closed during 2002, track record, reputation, etc.

5 Chen, Lihui. *Digital Fortune*. December 2002.

6 According to York Chen, Managing Director of the China/Hong Kong region for Acer Technology Ventures.

7 Funds invested unlisted companies are hard to evaluate, sell or circulate by other means. In general, the risk of investing in these companies is much higher than that in public companies. Problems with investment circulation have forced some companies to list domestic companies on overseas stock markets. Additionally, there is no guarantee that company stakes will be publicly traded on stock exchanges.

less mysterious as entrepreneurs become better acquainted with this western concept through the media and through industry circles. Amidst this backdrop, new and very active VC players have emerged, while clear investment directions have yet to be forged.

Foreign PE Investment Trends in an Evolving Market

For the time being, a handful of VCs still dominate the scene, with the top 10 VCs' invested capital accounting for 85% of that of the top 20 funds in China.[8] Despite trends in the US, telecommunications is still a hot industry in the Chinese VC market. The telecommunication industry received US$149 million in 2002, making up 38.1% of total invested venture capital in China for 2002. In fact, the three largest deals make up a significant fraction of this sum:

1) Co-investment of US$42 million between Warburg Pincus and Dragon Tech Venture for Harbour Networks, the largest deal of 2002: Harbour Networks, whose CEO is former vice president of Huawei Company, a leading Chinese telecommunication equipment designer and producer, is a spin-off of Huawei and manufactures products still closely linked to Huawei products. By comparison, in 2001, the largest deal was SMIC, which received US$70 million from H&Q Asia Pacific.
2) Joint investment of US$25 million between the Legend Group and three other private equity firms for Fibridge Communication Co: Bribridge, whose founders come from Lucent Technology, the US communication equipment provider, is a provider of optic communication technology.
3) Joint investment of US$14 million by the Singapore Government, Intel Capital, SoftBank Asia for Nanjing Innovation.

These recent deals reveal the tendency for private equity firms to jointly invest in companies. Moreover, they exemplify the trend towards investment in ventures with founders and management team with proven track records and product/service affinity to large international technology firms. Many investors are referring to historical technology product demand, life cycles, and evolution in western countries when assessing deals in China. In a market where business plans abound and new companies proliferate, investors are extremely cautious about proven technology and results. The ventures winning favor thus tend not to be pioneering innovators, but rather relatively safe followers with strong networks and reliable partners.

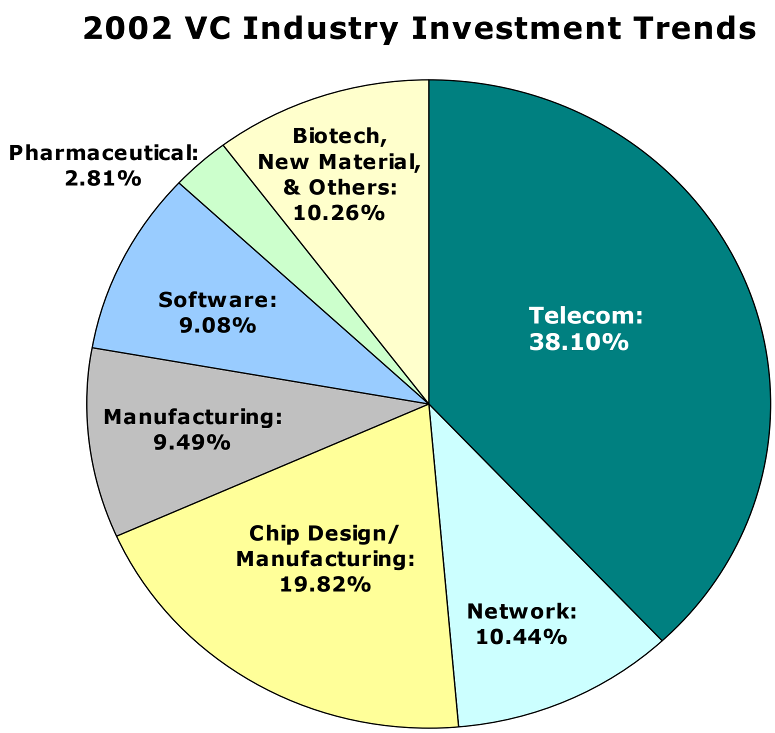
Foreign PE firms seem to favor IT, telecommunication, and chip design/manufacturing sectors, while domestic funds target biotech, pharmaceutical, and new material sectors. With the largest deals led by foreign funds, the telecommunication industry has captured the spotlight for 2002, and investors' interest in network and internet ventures has declined from its 2000 high as US$40.85 million is injected into this field, or 10.44% of the annual gross invested capital. Meanwhile, the chip design and manufacturing industry has risen to second place with US$77.5 million. Although China still has some distance to bridge relative to Taiwan's position as a chip manufacturing center, many local companies are now positioning themselves to compete in this space.

Manufacturing and retail ventures, fourth place in terms of invested capital for 2002, have been surprisingly popular as venture capitalists switch from network and internet businesses to opt for safer, traditional, and more conservative strategies. After all, China, with its abundant and cheap labor supply, coupled with the potential of a vast market, is perhaps best positioned to the world's leading manufacturing center. For instance, domestic investor Xiangcai Guantong

8 Based on *Digital Fortune* survey conducted in December 2002.

Venture Capital, founded this year with support from Xiangcai Securities, is seriously looking at franchise businesses and manufacturing companies. Venture capital flow into the software industry, meanwhile, has dropped, accounting for about 9% of the total invested capital.

The Chinese Government has very actively lent support to the development and expansion of biotechnology, pharmaceuticals, and new material. In part, this emphasis has fueled domestic venture capitalists' drive to fund companies in these sectors. Foreign VCs continue to actively review and perform due diligence on companies in these industries; however, most seem to find these ventures still premature.



In the pharmaceutical industry, for example, few new compounds are discovered by home-grown Chinese firms. At the same time, Chinese consumers often have different pharmaceutical needs from those of their western counterparts, who face dissimilar health problems. Hepatitis, for instance, effects a much greater population in China than in the US. Moreover, the unresolved issue of intellectual property continues to plague drug makers. Without legal protection, pharmaceutical companies can only compete on brand and marketing. Thus, biopharmaceutical deals in 2002 averages only about US$1.25 million each, signifying investors are not yet giving much weight to them within their investment portfolios. Local drug makers may still need to upgrade and seek out effective drug formulas from outside of China, a development that may lead to consolidation in the near future. "There are a lot of small companies in segments without big dominant leaders," observes the founder of Burrill & Co., a San Francisco-based biotechnology private equity firm, "There are opportunities in economies of scale, and in bringing in technology from the outside."

Geographically, while VCs continue to concentrate on major metropolises such as Beijing, Shanghai, and Shenzhen, they are also reaching into the inlands and West China for deals.

China's Venture Capital in 2002 by Region	
Beijing	34.45%
Shanghai	25.18%
Shenzhen	7.93%
Guangzhou	6.35%
Xian	5.27%
Hangzhou	4.87%
Nanjing	4.46%
Chengdu	3.17%
Others	8.32%

Source: *Digital Fortune,* December 2002

Beijing attracted the greatest amount of venture capital in 2002, and was strongest in the areas of telecommunication, software, and network:

- Telecommunication's US$79.80 million was 54% of investment in this sector in 2002,
- Software's US$26.87 million was 75% of the total in its category, while
- Network's US$21.98 million accounted for 54% of the industry's national total.

Shanghai led in the category of chip design and manufacturing, attracting roughly 50% annual VC money in this sector in China. Only US$20.8 million was invested in telecommunication in Shanghai. Shenzhen, which once enjoyed more support from the private equity community, saw its VC funds drop to under 8% of total money invested in 2002 as investors expand to other cities, therefore thinning exposure to Shenzhen. Guangzhou, Xian, Chengdu, Hangzhou, Nanjing have seen significant interest from VCs. An example of a deal successfully closed in one of these "second-tier" cities is Warburg Pincus' US$15 million in Hangzhou's Zhejiang University Networks, a Zhejing University-based company that provides web education.

Exit Strategies

For the private equity funds that have been able to exit from investment holdings, IDG CEO has estimated that China has the highest rate of return globally, reaching 55%. Yet the picture really is not so rosy. As a frame of reference, one may consider that, in comparison to the US$3.9 billion invested in the US during the third quarter 2002 (a four-year record low), the 2002 total for VC investments in China is merely US$390 million, or 10% of the US third quarter amount. Certainly, the foundation for private equity investing has yet to be strengthened, and exit opportunities are particularly rare, while returns for many deals are modest. Since the private equity industry in China is so young, the legal and financial structure for this business is still under construction. In the first half of 2002, China witnessed six exits, two of which listed on Hong Kong Stock Exchange and one on the domestic exchange; others used stock swaps and strategic equity transfers, though these returns were low or negative. Meanwhile, most In 2002, IDG has one of the best track records for successful exits has done the best, with three exits, one of which realized a 3X return with and annual compounded rate of 70%.

Within the broader picture of Asia, some of the more notable deals include: AsiaInfo (NASDAQ), Yozan (Japan), Locus (Korea), and Access (Japan). Some investors, Walden International for example, have been able to achieve timely 2000 sales such as Promatory Communications (for US$778 million) and Sonoma Systems (for US$540 million), both of which have been sold to

Nortel; these two companies have regional presence in Asia. More recently, Cirrus Logic bought semiconductor solutions provider Stream Machine for US$110 million. Major investors in Stream Machine include such notable Asian names as ChinaVest, WI Harper, and Vertex Ventures. This case will be discussed in greater detail later in this study.

The Chinese Entrepreneur

So who are the Chinese entrepreneurs? According to a ranking conducted by Forbes of the wealthiest mainland Chinese businesspeople, most are "home grown" entrepreneurial individuals with years of experience in a particular industry, who have been able to successfully identify a real market need and offer practical solutions. Most are men in their late 30's to mid 50's. Few have built their empires upon venture capital funding.

China Top 25 Entrepreneurs in 2001 by Assets

2001 Ranking	2000 Ranking	Wealth (US$ Million)	Name of Entrepreneur	Company	Business	Int'l Exposure	VC Funding?	Gender
1	2	1,000	Liu Yongxing & Liu Yonghao	Hope Group	Animal Feed	Limited	No	M
2	-	900	Yang Bin	Euro-Asia	Real Estate, Tourism, Flowers	Limited	No	M
3	-	840	Yang Rong	Brilliance China	Minibuses, Passenger Autos	Limited	No	M
4	1	780	Larry Yung Chikin	CITIC Pacific	Infrastructure, Trade, Real Estate	Hong Kong	No	M
5	-	723	Hui Wingmau	Shimao	Real Estate	Limited	No	M
6	-	640	Chan Laiwa	Fuwah	Real Estate	Hong Kong	No	F
7	6	480	Lu Guanqiu	Wanxiang	Auto Components	Limited	No	M
8	5	480	Wu Yijian	Jinhua	Pharmaceuticals, Real Estate	Limited	No	M
9	29	430	Sun Guangxin	Guanghui	Real Estate, Building Supplies	Limited	No	M
10	9	420	Zhang Simin	Neptunus	Pharmaceuticals	Limited	No	M
11	21	320	Liu Hanyuan	Tongwei	Aquatic Feed	Limited	No	M
12	17	300	Rong Hai	Seastar	IT, Retail, Juice	Limited	No	M
13	-	280	Zhang Yang	Interchina	Real Estate, Tourism	Hong Kong	No	M
14	15	265	Tao Xinkang	Xin Gao Chao	Timber	Limited	No	M
15	-	250	Yang Zhuoshu	Zhuoda	Real Estate, Tourism	Limited	No	M
16	11	240	Li Xiaohua	Huada	Health Products	Japan	No	M
17	30	240	Xia Chaojia	Hejia	Agriculture, Valve Production	Limited	No	M
18	-	240	Xu Ming	Shide	Construction Materials	Limited	No	M
19	-	240	Zuo Zongshen	Zongshen	Motorcycles	Limited	No	M
20	-	236	Gu Chujun	Greencool	Environmental Refrigerants	Limited	No	M
21	-	235	Ming Kamsing	People's Food	Animal Husbandry	Limited	No	M
22	-	233	Kwok Ho	Chaoda	Organic Agriculture	Hong Kong	No	M
23	12	216	Chen Jinfei	Tongchan	Real Estate, Finance	US Investments	No	M
24	7	204	Zhang Hongwei	Orient	Real Estate, Finance, IT	Limited	No	M
25	27	202	Zhang Yue & Zhang Jian	Broad	Air Conditioners	Limited	No	M

Source: *Forbes Magazine* (http://www.forbes.com/global/2001)

Indeed the sectors which many private equity firms are considering are not major drivers of the Chinese economy. According to government estimates, the industrial sector accounts for almost 50% of China's 2001 GDP, while agriculture and service industries take up another 40-50%, the small remaining difference going toward sectors such as high-tech, pharmaceutical, biotech, etc.

The entrepreneurs who seem to attract venture capitalists in China are the "overseas Chinese returnees," or Chinese entrepreneurs with education or work experience in more developed countries (including Hong Kong and Taiwan), who understand the experience of more mature markets, can make educated projections about trends in China, and can effectively develop products and services based on prototypes from other countries to serve the specific needs of China's market. The following two cases are examples of deals involving such entrepreneurs.

Case Study I: Stream Machine and ChinaVest

In late 2001, NASDAQ listed Cirrus Logic, a supplier of high-performance analog and DSP chip solutions for consumer entertainment electronics, paid US$110 million in a stock-for-stock transaction for Stream Machine, a five-year-old, privately held, fabless semiconductor company with 55 employees, four patents, and 11 other patents pending.[9] Stream Machine's proprietary compression technology provides high quality video for multiple home entertainment applications, such as digital-video-disc (DVD) recorders, personal video recorders (PVRs), digital camcorders and PC video peripherals. Cirrus Logic, meanwhile, supplies high-performance analog and DSP chip solutions for consumer entertainment electronics that allow people to see, hear, connect, and enjoy digital entertainment. It targets mainstream audio, video and Internet entertainment applications in the consumer entertainment market.

The digital audio and video market is expected to grow into a $4 billion opportunity by 2004. The acquisition of Stream Machine builds on Cirrus Logic's vision of providing "Total Entertainment" solutions, or networked home entertainment applications. Since exiting the hard disk drive (HDD) IC market in May 2001 and acquiring DVD, home networking and digital video encoding IC technology businesses, Cirrus Logic had been repositioning itself as a digital entertainment company and making inroads into China's huge DVD market. By 2002, the company had completed the following three acquisitions:

1) ShareWave, an IC developer for streaming video and audio over IEEE 802.11 wireless networking,
2) LuxSonar, a maker of DVD processors, and
3) Stream Machine.

Stream Machine was founded in 1996 by two Taiwanese entrepreneurs Cheng-Tie (CT) Chen, formerly with Eastman Kodak and Bell Communications Research, and Fure-Ching (FC) Jeng, formerly with Bell Communications Research. Born in Taiwan, Chen had a B.S. in electrical engineering from National Taiwan University in 1977 and M.S.E. and Ph.D. degrees in systems engineering from the University of Pennsylvania in 1981 and 1983, respectively. As a Research Fellow at the University of Pennsylvania, he conducted several research projects in signal processing and communications. He would later work as Research Associate at Princeton University on sonar signal processing. Since the mid 1980s, he worked on image processing and data compression for Eastman Kodak Research Laboratories and later Bell Communications Research, where he met Fure-Ching Jeng. Jeng had also studied at the National Taiwan University, though his M.S. and Ph.D. degrees as well as research in electrical engineering were done at the Rensselaer Polytechnic Institute in Troy, New York. His research interests included

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9 This is the fourth acquisition announced in five months by Cirrus Logic, representing an aggregate total of $278 million in primarily stock-for-stock transactions.

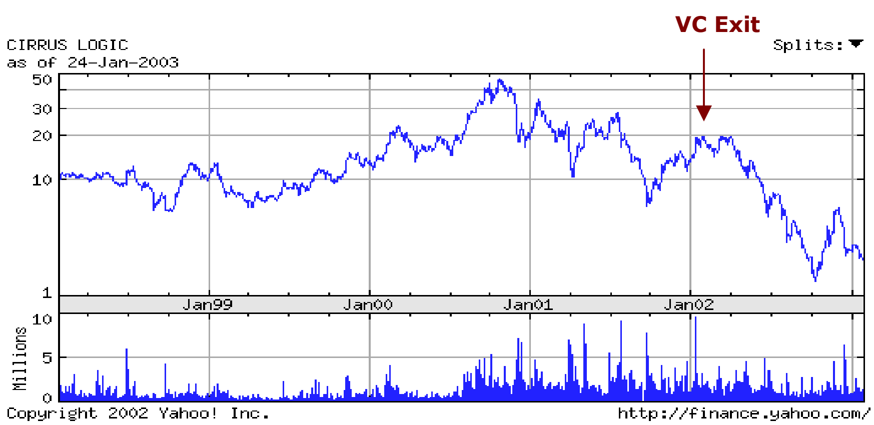
image estimation/restoration, data compression, motion estimation, pattern recognition, statistical estimation, and digital communications. The two men founded the company in Milpitas, California, and later brought on Michael Canning as President and CEO to grow the business. They built a team with experience in digital audio and video, including architecture, algorithms and compression technology. Expanding into China early on, Stream Machine had representative offices in Beijing and Shenzhen.

Of Cirrus' three acquisitions, LuxSonar and Stream Machine have been crucial to Cirrus' strategy in China, bringing an additional 70 and 30 people respectively to Cirrus' existing 10 employees locally. Most in this new team are software, hardware design and application engineers. Cirrus' Shenzhen facility works as a design center for hardware and software to support the DVD and VCD products.[10] Meanwhile, Cirrus has expanded its presence in Shanghai, where most major DVD manufacturers are located. The company had also a five-year wafer foundry service agreement with China-based open foundry Central Semiconductor Manufacturing, located in Wuxi, Jiangsu province, with a 6-inch line with a capacity of 11,000 wafers per month, and a 5-inch line with a capacity of 7,000 wafers. The collaboration will begin with the manufacturing of CMOS-based mixed signal ICs for the consumer market.

"By starting to utilize manufacturing in China, you just take three to four weeks out of this supply window. Now we actually manufacture, test and do everything local to the customers," said Ritchie, a representative of Cirrus, "We benefit from low-cost manufacturing; the local economy benefits because we're buying wafers from China; and local manufacturers benefit because their lead time is half of what it used to be. It's a three-fold win."[11]

One clear winner to walk away from the acquisition of Stream Machine is US private equity firm ChinaVest,[12] lead investor in Stream Machine's last Series C round of financing in 1999 alongside co-investors such as the Mayfield Fund, Tallwood Venture Capital, Vertex Management (II), Bessemer Venture Partners, and the WI Harper Group. With significant equity stake in Stream Machine, ChinaVest realized 2.5X returns through trade sales exit. It cashed out US$19 per share in January 2002 at a time when Cirrus Logic shares were still performing well.

Cirrus Logic Five-Year Stock Performance



10 Lammers, David. *EE Times*. March 19, 2002.

11 Yeung, Eleanor. *Nikkei Electronics Asia*. Hong Kong, December 2001.

12 Founded in 1983, it provides long term investment capital and management expertise to growing companies doing business in China, Hong Kong, and Taiwan. With over US$300 million under management and a diversified portfolio of more than 40 companies, ChinaVest has closed five funds, with ChinaVest VI now under consideration.

At the same time, the subsequent tumble of Cirrus' share value after Quarter 1 of 2002 leads one to question the impact of VCs exits from this deal on all parties involved – Cirrus shareholders as well as Stream Machine founders, employees, and other stakeholders. (See Appendix II for further details on rounds of funding for Stream Machine and ChinaVest's strategy as presented by ChinaVest Vice President and Beijing Representative Jun Zhao.)

Whatever the case, this deal exemplifies the type of overseas Chinese founded ventures which appeal to many foreign venture capitalists in China. The first independent American venture capital firm to be established in Greater China and one of the oldest venture firms operating in the region, ChinaVest's "core strategy is the blending of Chinese entrepreneurship with American managerial and financial discipline."[13] Although still technically an American company – Stream Machine, its Taiwanese founders with extensive technical experience at Bell Communications Research, and its strong presence in China have distinguished it as an attractive venture for investors interested in China.

Case Study II: China TMN

The second case study of China TMN Corporation examines a co-investment deal between three VCs: DragonTech Ventures, Acer Technology Ventures, and Intel Capital. While this deal is still too early for an exit, it is another typical case of current deals closed by foreign VCs in China. (See Appendix III for deal announcement by China TMN.)

China TMN develops and markets software solutions and related services to telecommunications service providers and equipment vendors in China. The company's distributed software generator (DSG) platform enables many telecommunication management network (TMN) applications. The company also offers professional services to global telecommunication equipment vendors. Ranked by the Government at 7th place among IT enterprises and 48th place amongst the top 100 small to medium sized enterprises in China, the company holds many attractions for investors:

- Large local market potential
- Core technology and proven innovation
- Expert international management team with domestic and overseas experience
- Systematic processes for financial accounting and transparency to shareholders
- Sophisticated product management style of three levels (core, network, non-telecom)

Much of China TMN's technology has been proven, because it is a spinoff of DSET Corporation, listed on the NASDAQ. Officially China TMN was established in 2001, but it had already had a four-year history with DSET at that point. DSET Corporation is now a leading provider of Operations Support System (OSS) software solutions designed to minimize operational costs and maximize the value of service offerings for telecommunications providers around the world. DSET's current portfolio of products includes: "IPSource, an advanced IP provisioning, activation and configuration solution enabling providers to deploy, modify and manage services quickly, reliably and profitably; and electronic-bonding gateways that allow competitive service providers to exchange information electronically with other telecommunications providers which significantly reduce the time required to provision services and resolve service outages for their customers."[14]

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[13] http://www.chinavest.com

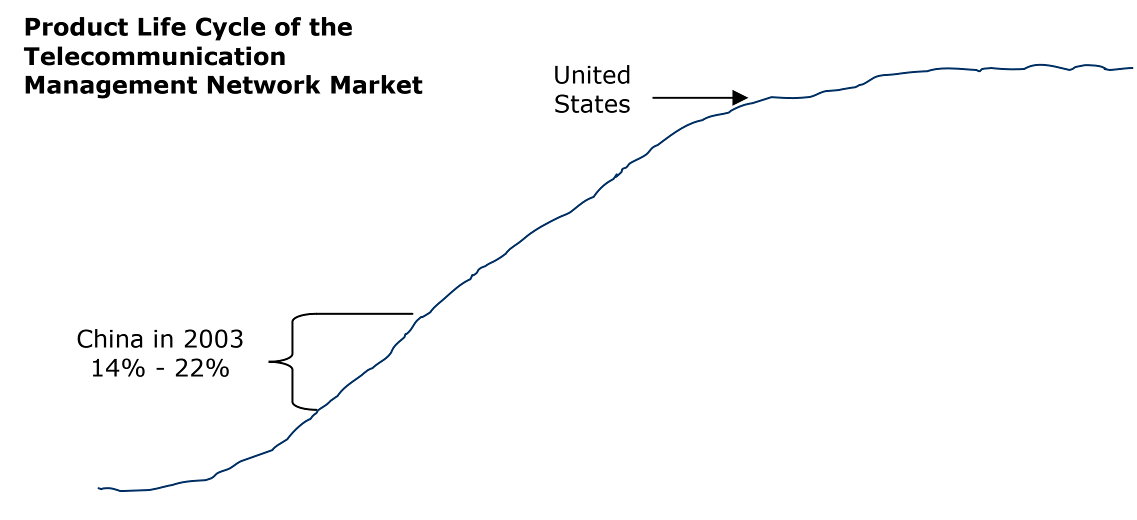
[14] http://www.dset.com

DSET was founded in 1989 by Daniel Shia, a Taiwanese immigrant who had spent his formative years in the US, whose previous experience dealt with computing and DSG for Bell Labs in New Jersey. He envisaged a software solution tailored for all customers who used the internet. Over time, serving as President, Chief Executive Officer, and Chief Technology Officer in addition to Chairman of the Board, Shia championed the innovative concept for an object-oriented distributed communications framework that became DSET's first series of flagship products to be used in the telecom industry worldwide. Yet by the late 1990s, the US telecommunications market desire for telecommunication management network products was starting to decline.

The Telecommunications Act of 1996 had opened the US market for local phone service competition, fostering competition by requiring the incumbent regional Bell operating companies to allow competitive local exchange carriers, or CLECs, to lease portions of the incumbents' networks. As CLECs sought to win customers from existing incumbents by offering better pricing and service, they felt increasing pressure to provide speedy service and high levels of customer care. The management team of DSET saw a new customer base and a new market need, and responded accordingly.

In 2000, Shia stepped down to bring in new CEO Bill McHale. Customer oriented, McHale steered DSET in a new path of conversion from TMN to gateway products for CLECs. DSET began to introduce its electronic-bonding gateways and related products, which allowed CLECs to complete "provisioning" or "service-fulfillment" processed and turn on phone service for customers in days rather than weeks; moreover, DSET’s new line of products assisted CLECs in maintaining seamless service to customers.

Shia, however, continued to nurture his original brainchild of computing software and telecommunication management network. In fact he felt that the mainland Chinese market, without the proliferation of CLECs yet, still had a need for TMN.

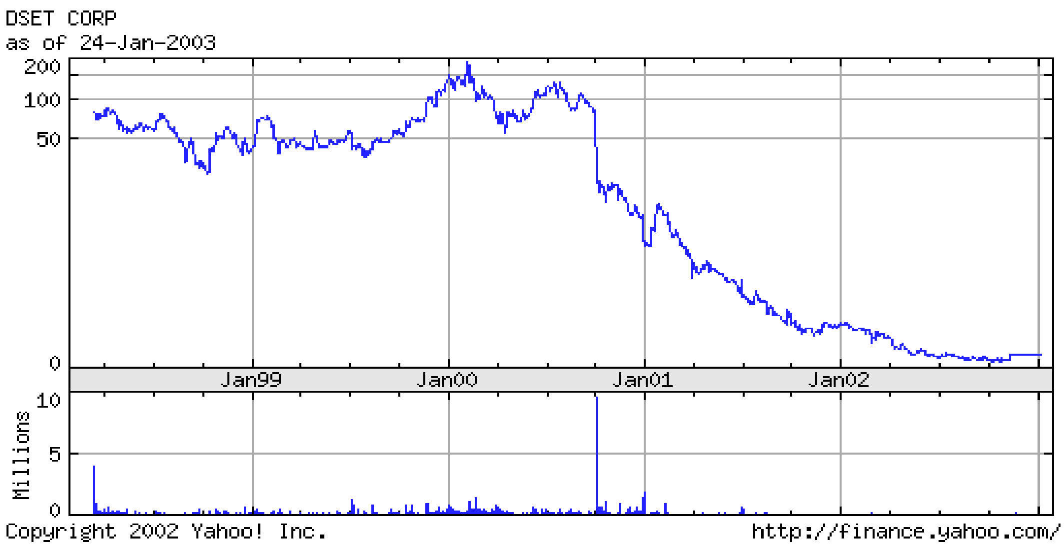


In as early as 1997, Shia had led DSET’s efforts to establish presence in China. It was then that he had met Nong Li, current CEO of China TMN. Educated in China, Li Nong had previously served as General Manager for Chuan Da S&T Company of TongDa Group (Hong Kong), where he led R&D efforts of high-tech projects, one of which secured a patent and won a silver prize at the National New Technology and Product Exhibition in 1996. Earlier in his career, he had worked as the Deputy General Manager at Shenzhen Ji-Da TongDa Group, another hi-tech company. He was a major researcher of a National Great Natural Science Found project – MIS Fiber Threat Model and Fault Tolerance System Analysis.

After an intensive 12-hour planning session between Shia and Li, the two decided to move forward with China TMN, a subsidiary of DSET. Shortly thereafter, the company was founded in Chengdu in Sichuan Province with eight employees. The company began with US$600,000 for research and development, most of which are spent on engineers, then followed by another US$1 million for design and testing.

Between 1997 and 2000, Li had applied three times, unsuccessfully, for the position of CEO at DSET in the US. Meanwhile, DSET shares performed well in the US market, and Li was able to cash out in a timely fashion. He wanted more responsibility in the business. Thus when the VC arm of IDG approached Li to spin his team out of DSET for IDG to invest as a new venture, Li acted quickly.

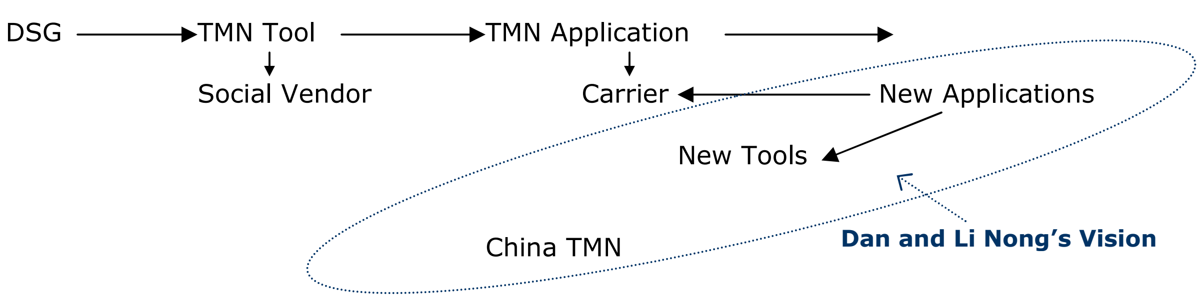
DSET Five-Year Stock Performance



In October 2000, Shia and Li jointly made the decision to spin off China TMN from DSET with the following ownership structure:

- Dan Shia 33%
- Nong Li 33%
- Angel Investors 33%
  (Taiwanese entertainment stars Zhang Yi and Yiang Huei San invested US$ 1 million)

Purchasing the proprietary rights from DSET for the TMN technology, China TMN aimed to provide new tools and applications for telecommunication carriers in China:



Certainly, the company faced numerous competitors in the market, including large local players such as Yi Yang, Zhong Yuan, Ya Xin. To compete effectively, China TMN needed to expand in scale and enhance the quality of its products, both of which would have required more capital. By 2001, China TMN had completed its business plan (originally designed for IDG). Following a number of meetings, Li and Shia successfully raised funding from the following three VCs:

- Acer Technology Venture, a venture capital business unit of Acer Group,[15] is responsible for making all high-tech venture investment decisions, focusing on early stage software or hardware based intellectual property, and technology that enable new applications via the internet platform. Acer's most recent fund, IP Fund One, is a US$260 million limited partnership fund. With under two years in China, Acer has invested in 8 companies as of end of 2002 and often acts as lead investor for many deals.

- DragonTech is a venture capital fund backed by a number of powerful Asian corporate and institutional investors.[16] The fund is committed to provide long term investment capital and management experience to high-growth companies in information technology, biotechnology, and industrial technology ventures in China, Hong Kong, Taiwan, and Singapore. DragonTech has raised over US US$60 million after its first closing. A total of USUS$100 million will be raised after its second closing. Most of its investors are large Asian blue chip companies.

- Intel Capital investments support Intel's mission to be the preeminent building block supplier to the worldwide internet economy. Investments support Intel product initiatives, Intel's new business thrusts, emerging trends and worldwide internet deployment. Intel Capital investments in the Asia Pacific Region are aimed at growing the consumption in internet market segment. Examples of equity investments in this region include those companies specializing in high-end Intel architecture computing and early stage technology utilizing research and development capabilities by local universities in Australia/New Zealand, key e-advisors to government projects and small to medium enterprise opportunities in Southeast Asia, the breadth of communication and networking software and Internet infrastructure companies in India, broadband and wireless applications and content developers in Korea, IT growth and expansion focused on wireless in the PRC/Hong Kong and computer industry design and manufacturing in Taiwan.

The term sheet negotiation process between China TMN and its VCs took one month to negotiate, with two weeks of very concentrated talks surrounding the asking price of US$4 million for 25-30% equity in China TMN, a request that Li today feels priced the company too low. Li believes that his side did not give this negotiation process enough time and consideration, as the investors' side benefited from many concessions and "had the upper hand."[17]

The VCs used a financial valuation model based on China TMN's three-year history, price to equity ratio, other data provided by the management team, and independent due diligence results. (E.g. DSET's 2001 2nd quarter revenues for the product line which China TMN purchased

[15] Established in 1976 in Taiwan, Acer is among the world's top ten branded PC vendors. Acer employs marketing and service operations across Asia-Pacific, Europe, the Middle East, and the Americas, supporting dealers and distributors in over 100 nations.

[16] The Shanghai Industrial Investment Company, the company's key sponsor, is the only window company of Shanghai Municipal Government outside of P.R.C. It is also a major shareholder of Shanghai Information Investment, the key investment body for the Shanghai Infoport Project.

[17] Information is based on interviews in Chengdu, Sichuan.

was US$ 14 million globally.) Moreover, they set revenue objectives for the first two years as follows:

2001	2002
US$700,000	US$2,500,000 (not yet break even)

China TMN has estimated that it would break even at $18 million in revenue while operating under VC funding. At best, its gross profit margin can be up to 92%; the VCs had required that it maintain profit margin of at least 80%. (Since late 2002, however, based on market conditions, this clause has been adjusted down to maintain performance above a certain loss rate rather than to define a set profit margin.)

After US$150,000 in lawyer fees, China TMN finally concluded and signed the contract in April 2002 with the three VCs. Intel Capital proved to be the most demanding of the investors. In the end, 10-15% of the conditions in the term sheet were changed; the drag along clause was the primary concern for the entrepreneurs (no tag along clause). Another change was that the 2002 revenue objective was adjusted up to US$3 million.

Most recently, China TMN has been under pressure to expand quicker to compete aggressively in the local market. In fact, Nong Li is already considering the second round of financing. The company has established a new office in Shenzhen to focus on network management. It has secured contracts with three out of four telecom giants in China. In addition, China TMN is working on two acquisitions:

1) The first for customer relationship management: this company offers few products of its own, but it plays an important role as intermediary for customers (many of whom are competitors of China TMN), with the ability to secure key clients. However, this acquisition target has total overhead expenses and operating costs of over US$6 million.
2) The second company would expand China TMN's product offerings.

The next several years will be crucial to China TMN's survival in the market. If it does not grow quickly enough and achieve the desired scale, it will either be crowded out of the market or be acquired by a larger firm. Whatever the case, China TMN is a fascinating example of a trend in venture capital investing: the move to adapt technologies proven in developed countries to be customized for the Chinese context. As seen in this particular case, even as the TMN technology has reached a plateau in the US, it nonetheless continues to promise vast potential in the Chinese market.

Concluding Notes

From a macroeconomic perspective, venture capital does not appear to exert significance influence on the Chinese market. The industries which it supports are not the key drivers of the economy, comprising only a few percentage points of GDP. In comparison to the level of venture activity in the US, the Chinese industry remains nascent. Deals remain small, while the market is dominated by a handful of large players. Meanwhile, the legal and financial infrastructures necessary for smooth private equity transactions and viable exits have yet to be implemented and tested. Few foreign VCs are making money in fact. Moreover, the most successful Chinese entrepreneurs do not seem to need venture capital; many of them have founded their empires upon other means and resources. Many do not even understand the mechanics of venture capital financing. For select industries that may need such assistance, the Chinese Government funds a plethora of small regional and local quasi-governmental venture capitalists to bolter innovation and to promote change.

What then is the role of foreign VCs?

With education and/or experience in more developed countries, many of the investment specialists working for venture funds bring with them a perspective of more mature markets and hindsight of product life cycles already completed overseas, whereas these products and services have only just begun in China. In essence, many VCs are facilitating the transfer of innovation, ideas, technology, and talent from abroad to the local market. In such a tough global economic environment, most of the survivors opt for companies with proven technologies/sciences and solid track records. When a more prosperous time returns, perhaps they would become bolder in their investment strategies to embrace pioneering concepts?

All in all, despite the many challenges, the role of venture capital continues to play a crucial role in the evolution of the Chinese market, while things are still constantly changing, new concepts are easily embraced, the customers are eager, and the shape of the economy still so malleable. In such times, the impact of innovators, pioneers, and leaders are great. There remains quite a bit of room for venture capital to grow in China.

Appendix I

Rules on Administration of Foreign Invested Venture Capital Investment Enterprises

MOFTEC Draft of August 8, 2002
Translation Copyright by Debevoise & Plimpton

Blacklined to show comments and proposed changes from D&P

Chapter I General Provisions

Article 1 These Rules are formulated in accordance with the PRC Sino-Foreign Cooperative Joint Venture Law, the PRC Sino-Foreign Equity Joint Venture Law, the PRC Foreign Enterprise Law, the Company Law and other relevant laws and regulations in order to encourage foreign companies, enterprises and other business organizations or individuals (the "Foreign Investors") to make venture capital investments in China and to establish and perfect the venture capital investment mechanism of China.

Article 2 "Foreign invested venture capital investment enterprise" (a "FIVCIE") as used in these Rules means an enterprise without legal person status (a "Non-Legal Person FIVCIE") or a limited liability company (an "LLC-type FIVCIE") established within the territory of China by Foreign Investors, independently or together with companies, enterprises or other business organizations organized under Chinese law (the "Chinese Investors"), in accordance with these Rules to be engaged in venture capital investment business.[18]

Article 3 Investors of a Non-Legal Person FIVCIE shall be jointly liable for such FIVCIE's liabilities. Alternatively, such investors may also agree in their venture capital investment ~~agreement~~contract (the "VC Investment ~~Agreement~~Contract")[19] that ~~an~~(a) each investor assuming primary responsibility as provided under Article 7 (the "Principal Investor") will be liable jointly ~~liable~~with the FIVCIE for the FIVCIE's liabilities ~~while~~ to the extent the properties and assets of the FIVCIE are insufficient to discharge such liabilities[20] and (b) the liability of each other investor for the liabilities of the FIVCIE to the extent the properties and assets of the FIVCIE are insufficient to discharge such liabilities will be limited to the amount of its respective capital commitment or~~,~~ as may be otherwise provided in the VC Investment ~~Agreement~~Contract.[21]

The responsibility of each investor of an LLC-type FIVCIE to such FIVCIE's liabilities shall be limited to the amount of its respective capital commitment.

Article 4 "Venture capital investment" as used in these Rules means a specific type of investment activity pursuant to which equity investments are injected mainly into enterprises that have not been

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[18] Does this mean that a non-legal person FIVCIE may have only Foreign Investors?

[19] We discuss at Article 8 the point that a Non-Legal Person FIVCIE does not need both a "VC Investment Agreement" and a "joint venture contract". One "VC Investment Contract", in form suitable to serve as the Non-Legal Person CJV joint venture contract is sufficient, both in customary fund practice and as a matter of Chinese law.

[20] In international fund practice (and in Chinese partnership practice) it would be expected that partnership creditors must exhaust the partnership entity's assets before proceeding against individual investors. W ethink it helpful to make this clear in the Rules.

[21] Does "*will be limited … * as may be otherwise provided *in the VC Investment Contract*", mean that by contract the limited liability investors might be given a liability to third partie that is less than their capital commitments? If not, this should be clarified.

publicly listed (the "Investee Enterprises") and venture capital management services are provided in order to obtain capital appreciation benefits. "Equity investments" include, with respect to any Investee Enterprise and for the purpose of these Rules, its common stock, warrants or options to acquire its common stock, and other securities convertible into or exchangeable for its common stock (but only to the extent the Investee Enterprise may lawfully issue such warrants, options, or convertible or exchangeable securities).[22] FIVCIEs organized under these Rules are not subject to the general limitation on the aggregate amount that a company may invest in other companies as provided in Article 12 of the Company Law.[23]

Article 5 FIVCIEs shall observe applicable Chinese laws and regulations and shall not harm the social and public interests of China. The legitimate business activities and the legal rights and interests of the FIVCIEs are protected by Chinese law.

Chapter II Establishment and Registration

Article 6 A FIVCIE shall meet the following requirements:

1. It has a clear organizational structure;

2. It has not less than 2 but not more than 50 investors and shall have at least one Principal Investor qualified under Article 7;

3. The minimum amount of the total capital commitments from all investors shall be US$30 million. Except for ~~the~~one or more Principal Investors ~~provided~~qualifed under Article 7, each other investor's minimum capital ~~contribution~~commitment[24] shall not be less than US$1 million. Generally at least 25% of the capital commitment and at least 25% of the actual capital contribution made by all investors to a ~~Non-Legal Person~~ FIVCIE must be made by Foreign Investors.[25] Foreign Investors shall make their capital contributions in freely convertible currencies and Chinese Investors in RMB;

4. The source of capital shall comply with the provisions of relevant laws and administrative regulations;

5. It has a clear and legitimate investment ~~direction~~objective[26] and ~~investment strategy; and~~

6. It meets all other conditions required by relevant laws and administrative regulations.

Article 7 An investor assuming primary responsibility, or a Principal Investor, shall meet the following requirements:

1. venture capital investment is its main business;

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[22] This sentence eliminates the possibility of confusion later in the rules as to the scope of the term "equity investments". Note that all of these are standard venture capital investment tools.

[23] We think it would be helpful to clarify here that the "up to 50% of registered capital" investment cap under Article 12 of the Company Law does not apply to FIVCIEs.

[24] We believe the change from "minimum capital contribution" to "minimum capital commitment" better reflects what we believe to be MOFTEC's intention.

[25] As originally drafted this sentence suggests that there is no minimum foreign investment content in an LLC-type FIVCIE. We have revised it so that the 25% requirement applies to all FIVCIEs.

[26] We suggest this change because we think that this will have meaning to investors, and the use of the term "investment strategy" would cause fund sponsors to fear that it would require them to reveal the methods they use to evaluate potential investments, which is usually regarded as trade secrets.

2. during the three years immediately preceding the time of application it had aggregate capital under its management of not less than US$100 million, of which at least US$50 million have been used for venture capital investments, provided that for a Chinese Investor to become qualified under this Article 7.2, the two U.S. dollar amounts referenced to in the first half of this Article 7.2 shall be reduced to RMB100 million and RMB50 million, respectively;

3. it has at least 3 professional management personnel who possess at least 3 years experience in the venture capital investment area;

4. it has risk taking capabilities; and

5. it has a legitimate source of capital.

If an investor controls, is controlled by, or is under common control with an entity (the "Affiliated Entity") that satisfies ~~all requirements set forth above under~~clauses 1 through 3 of this Article 7, such investor may also apply to become a Principal Investor [so long as the proposed FIVCIE is to be managed by such Affiliated Entity ~~has agreed to guarantee~~or by an entity controlled by such ~~investor's ability to perform its contractual obligations~~Affiliated Entity as contemplated by Article 19].[27] As used in this paragraph, a party is "controlled" by another party if the controlling party owns more than 50% voting power[28] of the controlled party.

Neither the Principal Investor nor its Affiliated Entity referenced above has been prohibited from being engaged in venture capital investment business or been subject to penalty for commitment of fraud by the judiciary authority or any other relevant administrative or supervisory authority in its respective country of domicile.

In the case of a Non-Legal Person FIVCIE, at least 1% of the total capital commitment from all investors to the FIVCIE and at least 1% of the total actual capital contributions from all investors to the FIVCIE shall be made by ~~its~~the Principal ~~Investor(s)~~Investors and ~~such~~each Principal Investor~~(s)~~ shall be liable jointly ~~liable~~with the FIVCIE for the FIVCIE's liabilities to the extent the properties and assets of the FIVCIE are insufficient to discharge such ~~FIVCIE~~liabilities.

27 We think two concepts from the earlier draft became mixed up here – (1) the need to ensure that the Principal Investor has access to the management skills and experience appropriate for a venture capital fund, and (2) the idea that the required large foreign investor (the Article 5.2 Investor) could invest directly or through a subsidiary whose capital contribution was guaranteed by the large foreign investor.

Indeed, neither the persons organizing the General Partner nor their Management Company will ever be willing to "guarantee" the General Partner's obligations, because this would make them liable for all the debts of the fund.

The guarantee issue is not relevant in the context of the Principal Investor. The issue with the Principal Investor is not the need for a guarantee of the availability of investment funds to the Principal Investor (the "General Partner", in international terms), but the extent to which the General Partner has prior fund management experience. Where the General Partner is newly organized for a particular fund, which we believe is the case in the majority of international funds, the General Partner is usually organized by the persons who control the Management Company that will operate the fund, and the approach if the prior draft of the Rules we think was the correct one – that the management skill and venture capital experience requirements could be satisfied through the General Partner itself, or through its affiliated management company.

Our changes we think solve this problem by returning the language to the approach of the earlier draft and discussions.

28 We think MOFTEC may want to make it clear that the Chinese original means "more than" not "at least".

In the case of an LLC-type FIVCIE, at least 30% of the total capital commitment from all investors to the FIVCIE and at least 30% of the total actual capital contributions from all investors to the FIVCIE shall be made by its Principal Investor(s).

Article 8 [29]When applying to establish a Non-Legal Person FIVCIE in China, the investors shall enter into a VC Investment ~~Agreement~~Contract which will contain provisions on, among other things, the usage and the size of the venture capital funds and the rights and obligations of each investor. The VC Investment Contract shall be in a form suitable for use as the required non-legal person cooperative joint venture contract for the FIVCIE and shall become the "FIVCIE contract" of such Non-Legal Person FIVCIE for the purposes of these Rules. Investors may, in accordance with the provisions of the VC Investment Contract, elect to further adopt the articles of association for a Non-Legal Person FIVCIE. Such VC Investment ~~Agreement~~Contract (and the articles of association, if elected by the investors) shall not become effective until approved by the Ministry of Foreign Trade and Economic Cooperation (the "Examination and Approval Authority"). ~~Investors shall, in accordance with the provisions of~~Once the VC Investment ~~Agreement, enter into a Sino-foreign non-legal person cooperative venture capital investment contract~~ Contract (and the articles of association ~~and establish~~, if applicable) are approved, the Principal Investor or Principal Investors shall take all necessary steps required for the formal establishment of the Non-Legal Person FIVCIE ~~in order~~pursuant to ~~be responsible for the implementation of~~ the ~~venture capital investment activities~~PRC Sino-Foreign Cooperative Joint Venture Law, the related implementing rules, and these Rules.

Article 9 The following procedures shall be followed when applying to establish a FIVCIE:

Investors shall submit to the Examination and Approval Authority the application for establishment and other relevant documents through provincial level authority responsible for the administration of foreign trade and economic cooperation where the proposed FIVCIE will be ~~located~~registered. The Examination and Approval Authority will, within 45 days of ~~its~~ receipt by such provincial level authority[30] of the complete application materials and upon consultation with and consent by the Ministry of Science and Technology, make a written decision as to whether the application is approved or not. If the application is approved, a Foreign Invested Enterprise Approval Certificate will be issued.

Within one month of receipt of the Foreign Invested Enterprise Approval Certificate, the approved FIVCIE shall apply to register with the appropriate office (the "Registration Authority") of the State Administration for Industry and Commerce ~~(the "Registration Authority")~~.

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[29] We have modified this provision consistently with our comment in footnote 2 above. In international practice, there are two agreements, an agreement to invest in the fund (typically called a "subscription agreement") and the organizational agreement of the fund (which is always either a partnership agreement or the articles of association of a limited liability company that for tax purposes is treated as a partnership). It is this second agreement that details the ongoing rights and obligations of the Investors – when they have to put money in, when they can take it out, what are the respective rights and duties of the Principal Investor and the other investors, how interests can be transferred, what happens on dissolution and liquidation, and the like. That is the agreement of principal interest to MOFTEC or other regulatory authority. We have provided that this agreement must be in a form such that it may also be the required non-legal person CJV contract. The subscription agreement normally serves little or no further purpose once the main agreement has become effective.

Also, the CJV law appears to be silent on whether a non-legal person CJV would need the articles of association. But it is implied from the 1991 SAT tax notice that a non-legal person CJV may or may not have articles of association. Therefore, we would suggest that a Non-Legal Person FIVCIE would have the discretion to decide whether it adopts its articles of association and be required to submit such articles of association for examination and approval if it elects to adopt one.

[30] The investors cannot control the transfer of documents from the provincial authority to MOFTEC. Thus the 45-day requirement would not mean anything if it starts only when MOFTEC gets the documents from the provisional authority. If 45 days is too short when making allowance for the transfer of documents from the provincial authority to MOFTEC, then we request that MOFTEC keep the words we have suggested and change 45 days to 60 days.

Article 10 The following documents shall be submitted to the Examination and Approval Authority when applying to establish a FIVCIE:

1. the application for establishment signed by the Principal Investor(s);

2. the FIVCIE contract and the articles of association signed by all investors (only articles of association need to be submitted for a proposed wholly foreign-owned FIVCIE; in the case of a proposed Non-Legal Person FIVCIE, ~~a~~only the VC Investment ~~Agreement shall also~~ Contract needs to be submitted unless its investors have also adopted articles of association for such FIVCIE); [31]

3. a written declaration from the Principal Investor(s) (on its or their satisfaction of the qualification requirements under Article 7, the authenticity of all materials submitted, and its or their willingness to strictly comply with these Rules and the requirements of other relevant Chinese laws and regulations);

4. a legal opinion issued by a law firm on the legal existence of the Principal Investor(s) and as to the above-referenced declaration having been duly authorized and executed on behalf of the Principal Investor(s);[32]

5. the explanation of the Principal Investor(s)' venture capital investment business, the capital under management for the past three years, the capital actually invested by such investor(s), and the biographies of such investor(s)' venture capital investment professionals;

6. copy of each investor's incorporation or registration certificate, credibility certification issued by banks, and a copy of its legal representative's capacity certification;

7. if the qualification of a Principal Investor is based on the provisions of the second paragraph of Article 7, the application package shall also include relevant documents with respect to the qualified Affiliated Entity ~~and the written letter issued by such Affiliated Entity to guarantee such Investor's ability to perform its contractual obligations~~; and

8. other relevant documents in support of the application that may be requested by the Examination and Approval Authority.

Article 11 All FIVCIEs duly approved for establishment shall contain in their names the words "Venture Capital Investment". Without approval [from the Examination and Approval Authority]~~,~~ no ~~[~~foreign invested entity other than an approved FIVCIE~~]~~[33] may contain in its name the words "Venture Capital Investment". In the case of a Non-Legal Person FIVCIE with investors having limited liability pursuant to Article 3 of these Rules, its name shall also contain the words "with limited liability investors".[34]

Article 12 When applying for registration of establishment or any change thereafter, FIVCIEs shall submit relevant documents to the Registration Authority in accordance with the PRC Administrative Rules on Registration of ~~Enterprise~~ Companies, with such modifications or omissions as the

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31 See the second preceding footnote.

32 This language more accurately reflects what lawyers would be able to say about the declaration.

33 We believe this language is what was intended in the draft.

34 We think the proposed addition would be appropriate for better protection of the FIVCI'E's creditors. It is consistent with international practice.

Registration Authority deems necessary in the case of a Non-Legal ~~Persons and the detailed implementing measures~~Person FIVCIE.[35]

Chapter III Capital Contributions and Related Changes

Article 13 Capital contributions by investors of a Non-Legal Person FIVCIE shall be made pursuant to the following provisions:

1. Investors shall agree in their VC Investment ~~Agreement~~Contract on their capital contribution schedules. ~~Investors~~However, investors may make their capital contributions in installments based on the progress of the venture capital investments made by the FIVCIE. The amount of the capital contribution to be made in each installment shall be determined independently by the Non-Legal Person FIVCIE in accordance with its VC Investment ~~Agreement~~Contract and its ~~venture capital investment plans~~agreements with its Investee Enterprises.[36] The Non-Legal Person FIVCIE is responsible for circulating capital call notices to its investors in order to raise funds necessary for its proposed investment projects. The investors shall agree in their VC Investment ~~Agreement~~Contract on the liabilities and other related measures in connection with an investor's failure to timely contribute its capital.

2. During the effective term of a VC Investment ~~Agreement~~Contract, the investors generally may not reduce the amount of their committed capital. However, the investors may reduce the amount of the uncontributed portion of their committed capital upon approval by the Examination and Approval Authority[37] if such reduction is agreed by ~~the~~ investors ~~that have~~ collectively ~~contributed~~representing more than 50%[38] of the aggregate capital commitments to the FIVCIE and the Principal Investor(s), the FIVCIE has been in existence for at least ~~50% of the total contributed capital to the FIVCIE and~~ two years, and the Principal Investor(s)~~,~~ have certified that they do not expect to be able to identify satisfactory additional investments for the FIVCIE and that the reduction will not ~~cause~~ interfere with the performance of the FIVCIE's commitments to ~~be in breach of the legal requirement of a minimum amount of US$30 million~~

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35 We would like to discuss with SAIC whether the PRC Enterprise Legal Person Registration Rules or the PRC Companies Registration Rules should be applicable. The two sets of rules were issued in 1988 and 1994, respectively, and seem to be governing exactly the same category of issues. In addition, the Companies Registration Rules only provide how a non-legal person branch can get registered. Presumably a Non-Legal Person FIVCIE would have to go through the registration procedures currently applicable to a non-legal person CJV, but we suspect those provisions are not well defined.

36 We think this change reflects more accurately what the reality is. The important thing is that calls for contributions are made when necessary to support fund investment commitments.

37 In the fund business, capital commitments not called within certain stated period of time (typically 5 years) will automatically terminate. If a fund sponsor or General Partner does not think it can find profitable investment projects for its investors, it will usually inform the investors and permit the earlier lapse of the unused commitment. This is international standard practice. Nobody is willing to remain committed to a fund if the GP or the managers admit they cannot find suitable investment opportunities. For this reason, we believe a fund must have the discretion to decide when to stop further investing and to release its investors from their unutilized capital commitment. On the other hand, we see no barrier to imposing some kind of "good faith" obligations on a fund by saying that they cannot do this unless the fund has been in existence for at least 2 years.

Note also that any different rule is particularly burdensome on small funds that are at or near the original minimum size of $30 million. This would be a mistake, because it would be the smaller funds that are typically the most adventurous and most likely to take risks in attempting to invest in China's future. The difficulty in obtaining investor commitments for a fund should be sufficient guarantee that the fund will not be formed to make one small investment and then liquidate – even if that one investment is successful, the promoters of the fund would be unlikely to receive what they consider to be sufficient compensation for the work they had to do to organize the fund.

38 The Chinese original is not clear on whether "at least 50%" or "more than 50%" is actually meant.

~~committed capital, and is further approved by the Examination and Approval Authority, provided~~ ~~that the restrictions set forth in this sentence~~its Investee Enterprises. This paragraph shall not apply to ~~the reduction by the~~returns of investors~~ of their~~' contributed ~~capitals~~capital pursuant to Article 26. Investors shall agree in their VC Investment ~~Agreement~~Contract on the conditions, procedures and specific steps for the reduction of the amount of their committed capital.

3. During the existence of a Non-Legal Person FIVCIE no Principal Investor may voluntarily withdraw from such FIVCIE unless such Principal Investor is, with the consent of ~~all~~ other investors collectively representing more than 50% of the aggregate capital commitments to the FIVCIE,[39] replaced by a new investor qualified under Article 7.[40] ~~If~~The VC Investment Contract may contain provisions dealing with involuntary withdrawal by a Principal Investor ~~does need to~~ or transfer ~~its~~of the interest ~~[~~of a Principal Investor, provided that in each case the ~~FIVCIE], it~~replacing investor shall be qualified as a Principal Investor under Article 7 and the withdrawal or transfer shall not ~~harm~~adversely affect the ~~interest~~creditworthiness of ~~such~~the FIVCIE~~ and any third party~~.[41] In the case of ~~such~~ a replacement of a Principal Investor or transfer of a Principal Investor's interest to a new Principal investor, the VC Investment ~~Agreement, the Non-Legal Person FIVCIE contract~~ Contract (and the articles of association , if applicable) shall ~~all~~ be amended accordingly and be submitted for approval by the Examination and Approval Authority.

A transfer of the committed capital or contributed capital by any investor other than the Principal Investor(s) shall be consented to ~~by~~in the ~~Principal Investor(s).~~manner provided in the VC Investment Contract, and the transferee shall satisfy the relevant requirements under Article 6. In the case of such a transfer, the VC Investment ~~Agreement, the Non-Legal Person FIVCIE contract~~ Contract (and the articles of association, if applicable) shall ~~all~~ be amended accordingly and be filed with the Examination and Approval Authority for its record.~~ The Principal Investor(s) shall not refuse any proposed transfer by any such other investor without sufficient reason.~~ [42]

4. With the consent of the Principal Investor(s), a duly established Non-Legal Person FIVCIE may admit new investors (who are not Principal Investor(s)) that satisfy the requirements under these Rules and the provisions under the VC Investment ~~Agreement~~Contract. In such case, the VC Investment ~~Agreement, the Non-Legal Person FIVCIE contract~~ Contract (and the articles of association , if applicable) shall ~~all~~ be amended accordingly and be filed with the Examination and Approval Authority for its record.

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39 Unanimity here is a bad idea, because one unhappy investor could hold up all of the other investors for a money payout, or, in the alternative, force the dissolution of the FIVCIE.

40 It is normal international practice in the venture capital fund organizational document to force either the liquidation of the FIVCIE or the replacement of the Principal Investor if the Principal Investor is bankrupt or is legally dissolved. These rules should not be seen to change that practice, and should not be written to suggest that the other investors cannot force the withdrawal of the principal Investor for improper behavior. That is why we have limited this to **voluntary** withdrawal or transfer.

41 The original language of "shall not harm the interest of such FIVCIE and any third party" has been revised. The FIVCIE's interest can be taken care of by the investors themselves, therefore there is no need for the Rules to afford any extra protection. The "third party interest" is a very subjective test; we believe the proposed "creditworthiness" test would achieve the same result, but in a more objective and recognizable way.

42 We revised this provision because it is not consistent with international practice. Typically, the Principal Investor retains control over transfers by other investors, and other investors accept this. In any case, it should be left to the investors to decide. MOFTEC's interest is that any successor should be qualified under these Rules.

Article 14 Capital contributions by investors of an LLC-type FIVCIE shall be made pursuant to the following provisions:[43]

1. Investors may make their capital commitments available to an LLC-type FIVCIE in installments. The US$30 million minimum amount of total committed capital shall be paid in to the LLC-type FIVCIE by all investors with 5 years of the issuance date of such FIVCIE's business license.

2. Considering the fact that an LLC-type FIVCIE would require capital only to make investments and to pay management expenses, such a FIVCIE may initially establish its registered capital at the level of US$5 million, 15% of which shall be paid in by the investors within 3 months of the issuance date of such FIVCIE's business license, and the balance of which shall be fully paid in by the investors within 3 years of the issuance date of such FIVCIE's business license.

3. If the investors of an LLC-type FIVCIE wish to make capital contributions to such FIVCIE in excess of US$5 million, such FIVCIE shall first file an application to increase its registered capital by at least the amount of the additional contribution to be made by its investors. An LLC-type FIVCIE may file for a registered capital increase only if the registered capital increase would not thereafter exceed the remaining unutilized capital commitments of all of its investors.

   The Examination and Approval Authority will, within 30 days of submission of the above-described application for increase in registered capital, approve such application. However, the Examination and Approval Authority may refuse to approve such application if it determines that the LLC-type FIVCIE is not operating in compliance with applicable laws or has failed to perform its filing obligations provided under Article 33 or 34.

   If an increase in registered capital is approved as provided in the preceding paragraph, the amount of the requested increase shall be contributed within one year of the approval date unless the LLC-type FIVCIE earlier certifies to the Examination and Approval Authority that the increase was requested to make an investment that such FIVCIE is no longer obligated to make and that it does not intend to make. In such case, the Examination and Approval Authority will authorize the reduction of registered capital to the extent of the approved increase. No reduction in registered capital pursuant to the preceding sentence shall operate as a defense to any claim against the FIVCIE that it breached its obligation to make an investment in an prospective Investee Enterprise.

Chapter IV Organizational Structure

Article 15 A Non-Legal Person FIVCIE shall establish a joint management committee. An LLC-type FIVCIE shall establish a board of directors. The joint management committee or the board of directors shall be constituted as provided by investors in the contract and/or the articles of association of the FIVCIE and shall manage the FIVCIE on behalf of the investors. If a Non-Legal Person FIVCIE has only one Principal Investor, its VC Investment Contract may provide that the Principal Investor will itself exercise all the functions that might otherwise be assigned to a joint management committee.[44]

Article 16 Management and operating structures shall be established under the joint management committee or the board of directors and shall, within the authority set forth in the contract and/or ~~the~~ articles of association of the FIVCIE, be responsible for the day-to-day management and operations of

[43] We did not comment on this Article because we believe very few (if any) investors will form an onshore China fund in the firm of an LLC.

[44] This requirement reflects international fund management reality. There is normally one General Partner and the remaining investors are all passive. We propose this sentence to make sure that the Rules are not interpreted to require that investors other than the Principal Investors have management rights.

the FIVCIE and execute the investment decisions made by the joint management committee or the board of directors.

Article 17 The key management and operating personnel shall meet the following requirements:

1. possessing capacity for civil acts and such capacity is not limited for any reason;

2. having no criminal records;

3. having no record of bad business practices;

4. having working experience in the area of venture capital investment and having no record of violations of rules governing financial operations; and

5. other requirements relating to their management qualifications that may be required by the Examination and Approval Authority.

Article 18 The management and operating personnel shall periodically report to the board of directors (or the joint management committee) on the following matters:

1. authorized major investment activities;

2. mid-year and annual operating reports and financial reports;

3. other matters required by applicable laws or regulations; and

4. other relevant matters provided in the contract and/or ~~the~~ articles of association of the FIVCIE.

Article 19 The joint management committee or the board of directors may elect not to establish any management or operating structure, but to contract with a venture capital investment management company [(a "VC Management Company")] so that all day-to-day management and operating activities of the FIVCIE will be carried out by such a VC Management Company. If this will be the case, the FIVCIE and the VC Management Company shall enter into a management contract pursuant to which the parties will stipulate their respective rights and obligations. Such management contract will become effective only if it has been consented to by all investors and approved by the Examination and Approval Authority.

The VC Management Company engaged to manage a FIVCIE shall meet the following requirements:

1. it has a sound corporate administration and management system;[45]

2. it has at least 3 professional management personnel who possess at least 3 years experience in the ~~venture capital investment~~ area of management of venture capital funds; and

3. it has a well developed internal control system.[46]

45 We very strongly recommend that this requirement be deleted. It needs to be understood that VC management companies are basically a group of bright people with a very small administrative support staff. The focus of investors is on ideas and evaluative skills, not administrative or back office capacities, of the management team. For the purpose of venture capital funds, so long as the experience requirement of clause 2 is met, venture capital investors should be allowed to choose their own managers.

46 This is a requirement more appropriate for a bank or other organization that is handling high volumes of fund flows on a regular basis. We recommend deleting this and in clause 2 changing the words to read "experience in the management of venture capital funds".

~~The establishment of any foreign invested~~ If the VC Management Company is to be foreign invested and established under Chinese law, its establishment shall be approved by the Examination and Approval Authority.[47] All foreign invested VC Management Companies duly approved for establishment under Chinese law shall contain in their names the words "Venture Capital Management". Without approval [from the Examination and Approval Authority], no [foreign invested VC Management Company][48] may contain in its name the words "Venture Capital Management".

The VC Management Company will manage the funds of the FIVCIE pursuant to the terms and conditions of the management contract; identify investment opportunities and negotiate investment terms for such FIVCIE, or make venture capital investments on behalf of such FIVCIE; and provide relevant management consulting services.

A VC Management Company may be engaged to manage more than one FIVCIE.

The VC Management Company shall periodically report to the joint management committee or the board of directors on all items required to be reported by the management and operating personnel pursuant to Article 18.

Article 20 Investors of a Non-Legal Person FIVCIE may agree, in accordance with customary international practice, on how to allocate the profits among themselves in the FIVCIE ~~contract~~VC Investment Contract. Investors of an LLC-type FIVCIE may agree to provide performance-based compensation to the management personnel in the FIVCIE's articles of association in accordance with applicable law.

Chapter V Operation Management

Article 21 FIVCIEs may be engaged in the following businesses:

1. using ~~all of~~[49] its own capital to make equity investments in areas opened to foreign entities by the State;

2. providing consulting services relating to venture capital investment;

3. providing management consulting services to their Investee Enterprises; and

4. conducting other businesses as may be approved by the Examination and Approval Authority.

Funds of FIVCIEs shall be used primarily to make equity investments in their Investee Enterprises.

Article 22 FIVCIEs may not be engaged in the following activities:

1. investing in areas that are prohibited by the State to be invested by foreign entities;

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47 The additional language is to make it clear that the VC Management Company need not be organized under PRC law. If MOFTEC requires that any VC Management Company be organized under Chinese law, few if any funds will be formed.

48 We are not sure that the original Chinese is clear. We believe the intent is to state that no foreign invested VC Management Company organized under PRC law may use the words "Venture Capital Management" without the permission of the Examination and Approval Authority.

49 Please note that the words "using ALL of its own capital to make equity investments" are too strict. Funds use a small portion of their capital to pay fund management fees and any operating expenses not covered by their managers.

Also, please note that these Rules already block FIVCIE investment in prohibited investment categories (see Article 22.1). Therefore Article 21.1 could stop after the word "investments."

2. investing, directly or indirectly, in securities of publicly held companies, options, futures or any other financial derivatives~~,~~ not included in the definition of "equity investments" under Article 4,[50] provided that after an Investee Enterprise becomes publicly listed, ~~shares and options~~equity investments in the Investee Enterprise previously acquired by the FIVCIE concerned and rights issuances to be acquired by the FIVCIE concerned shall not be subject to this restriction;

3. investing, directly or indirectly, in real estate ~~not for its self-use~~development or unimproved real estate; [51]

4. borrowing to make investment;[52]

5. investing with capital not owned by itself;[53]

6. extending loans or guarantees, except for corporate bonds with at least one year's maturity[54] and convertible bonds, in each case issued by an Investee Enterprise of the FIVCIE ~~(this provision however takes no position on whether an Investee Enterprise may under Chinese law issue such convertible bonds)~~;[55] and

7. any other activity prohibited to be engaged according to other applicable laws or regulations.

Article 23 A FIVCIE usually derives its income (the "Equity Disposition Gain") primarily from the successful sale or other disposition of its equity investments in Investee Enterprises. The Equity Disposition Gain means the amount of income realized by sale or other disposition by a FIVCIE of its equity investment in an Investee Enterprise in excess of such FIVCIE's original amount of investment into such Investee Enterprise and costs incurred by the FIVCIE in making or maintaining the investment that would normally be permitted to be added to acquisition cost to determine the FIVCIE's investment basis for income tax purposes.

When a FIVCIE sells or otherwise disposes of an equity investment in an Investee Enterprise, it may choose appropriate exit mechanisms in accordance with applicable laws. Such exit mechanisms include:

1. to transfer to other enterprises or individuals all or any part of its equity interest in an Investee Enterprise (and such transfer may include, if otherwise permitted by law, a

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50 Please note that technically warrants to purchase stock, stock options, convertible preferred stock and convertible bonds are all "financial derivatives", and are all commonly used for investment purposes by venture capital funds. If this provision is not clarified as shown, funds will be reluctant to organize in China if foreign funds can invest in options, warrants or convertible securities issued by Chinese companies.

51 The word "indirectly" could be applied to limit the ability of FIVCIEs to invest in any companies that have material real estate components to their business. A hotel operator or even a port operator might be one such example. We believe our suggested change captures the desired restrictions.

52 We again request that a FIVCIE should be able to incur short-term borrowings (say maturity of no more than 90 days) to enable it to fund commitments to Investee Enterprises if one investor is late delivering its funds upon a capital call. This would be a narrow exception, unlikely to be abused.

53 It would be helpful if this prohibition was restated to make more clear the nature of the conduct to be prohibited, since the typical fund, if it cannot borrow, must be investing its own equity funds.

54 We would be interested to know why corporate bonds have become a permitted instrument for VC funds to invest.

55 Our suggested definition of "equity investment" in Article 4 makes the deleted language no longer necessary here.

distribution of the equity interests in such Investee Enterprise to the investors of such FIVCIE in proportion to their respective interests in that investment);

2. when agreed by the Investee Enterprise, to enter into an equity interest repurchase agreement pursuant to which the Investee Enterprise will buy back the equity interest held by the FIVCIE on certain terms and conditions;

3. the Investee Enterprise to go to public on domestic or foreign stock exchanges when it meets the listing conditions under applicable laws. FIVCIE will then be able to transfer its equity interest in the Investee Enterprise on the stock market; and

4. other mechanisms permitted by Chinese laws or regulations.

Article 24 In the case of a Non-Legal Person FIVCIE, each investor may calculate and pay income tax separately on its allocable share determined pursuant to the VC Investment Contract of the FIVCIE's items of income, gain, loss and deduction pursuant to the State's relevant tax laws and regulations.[56] Alternatively, the Non-Legal Person FIVCIE may, by application to and upon approval by local tax authorities, elect to jointly calculate and pay income tax for all investors pursuant to the tax laws and regulations.

In the case each investor of a Non-Legal Person FIVCIE calculates and pays its income tax separately, each investor shall calculate and pay or be subject to withholding of the applicable income tax on its Equity Disposition Gain and income derived from other business activities in accordance with tax law and the related detailed implementing rules. The foreign investors of a Non-Legal Person FIVCIE that has established its own management and operating structures shall constitute foreign investors with permanent establishments within the territory of China. Such foreign investors shall pay income tax at the rate of 30% on income derived from the Non-Legal Person FIVCIE, provided that such enterprise income tax rate will be reduced to 15% if such FIVCIE is established in any Special Economic Zone. Foreign investors of a Non-Legal Person FIVCIE that has elected not to establish any management or operating structure, but has instead engaged a VC Management Company to carry out its day-to-day management and operating activities shall constitute (insofar as their investments in the FIVCIE are concerned) foreign investors with no permanent establishments within the territory of China. Such foreign investors shall pay income tax at the rate of 10% on its allocable share, determined as provided in the first paragraph of this Article 24, of the income derived from the Non-Legal Person FIVCIE.[57] Profit (dividends) income received by foreign investors of ~~a~~any Non-Legal Person FIVCIE from such FIVCIE's Investee Enterprises shall be exempt from any income tax.

All Equity Disposition Gains and income derived from other business activities of an LLC-type FIVCIE or a Non-Legal Person FIVCIE that has been approved to jointly calculate and pay the income tax for its investors shall be calculated and subject to the income tax obligations in accordance with the provisions of the tax law and the related detailed implementing rules. FIVCIEs referred to in the preceding sentence that are established in any Special Economic Zone shall pay enterprise income tax at a reduced rate of 15%. Profit (dividends) received by any FIVCIE referenced in the first sentence of this paragraph from its Investee Enterprises shall be exempt from any income tax.

Losses realized by a FIVCIE through sale or other disposition of its equity investment in any Investee Enterprise and losses recorded from other business activities may be deducted from the FIVCIE's taxable income realized during the same period of time and the FIVCIE, if it is an LLC-type FIVCIE, or a Non-Legal Person FIVIC that is jointly filing and paying tax for its investors, or the individual investors in a Non-Legal Person FIVCIE, if they have elected to calculate and pay separately as provided above, shall be entitled to the benefit of such loss carry-forwards and carry-backs as would

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[56] This phrase is an internationally accepted way of describing the tax treatment of individual investor in a partnership-like structure.

[57] We would like to hear from the authorities how this is expected to work in practice and after than we may have additional thoughts to contribute.

be generally available to foreign invested enterprises under the tax law and the related detailed implementing rules. ~~Profit (dividends) received by any FIVCIE from its Investee Enterprises shall be exempt from any income tax.~~

Enterprise income tax and local income tax shall both be prepaid on a quarterly basis and ~~then~~ settled on an annual basis in accordance with applicable tax law.

Article 25 ~~The distributable~~When a FIVCIE has income ~~received by~~for distribution to its foreign investors~~ may be applied by the FIVCIE in accordance with applicable law~~, it is entitled to ~~be~~have all such income converted into hard currency for outward remittance by the FIVCIE ~~based on~~in accordance with applicable law. The FIVCIE shall submit to the appropriate authority a profit distribution resolution adopted by the board of directors or the joint management committee, evidence of payment of applicable taxes, and proof ~~of legitimacy of~~that the income arises from the FIVCIE's legitimate business.

Article 26 ~~Of~~The portion of the ~~income~~proceeds derived by a Non-Legal Person FIVCIE from sale or other disposition of its equity investment in an Investee Enterprise~~, the amount~~ equal to ~~such FIVCIE's original amount~~the cost of ~~capital contribution to~~its investment in such Investee Enterprise may be distributed ~~directly~~ to ~~the~~ its investors in accordance with their allocable shares under the VC Investment Contract so long as (a) the ~~US$30 million minimum amount of total committed~~distribution does not cause a reduction in the remaining uncontributed capital commitments of the FIVCIE investors and (b) the FIVCIE is able to meet all its investment commitments to Investee Enterprises from cash remaining on hand or from unutilized capital ~~from all~~ commitments of the FIVCIE investors ~~of such FIVCIE [was already] [has been?] paid in~~.[58] Such distribution will constitute a reduction by the investors of the amount of their contributed ~~capitals~~capital. A Non-Legal Person FIVCIE shall stipulate in its VC Investment ~~Agreement~~Contract the specific methods for such distributions and shall, at least 20 days prior to any such distribution, submit to the Examination and Approval Authority a statement of reduction in the total amount of capital contributed by all investors by the amount of such distribution, together with its certification ~~that the remaining uncontributed capital commitments of the FIVCIE investors and any available cash held by the FIVCIE are at least equal~~as to ~~all investment commitments~~its compliance with clauses (a) and (b) of ~~the FIVCIE then outstanding~~this paragraph. However, no such ~~reduction~~distribution pursuant to the preceding sentence shall operate as a defense to any claim against such Non-Legal Person FIVCIE that it breached its obligation to make an investment in an prospective Investee Enterprise.

Any inaccurate certification submitted by a Non-Legal Person FIVCIE pursuant to the preceding paragraph shall have the same legal consequences as the making of inaccurate statements in the reports to be filed by a FIVCIE under Article 33 or 34.

When a FIVCIE has capital to be returned to its foreign investors pursuant to this Article 26, it is entitled to have such capital converted into hard currency for outward remittance by the FIVCIE. The FIVCIE shall submit to the appropriate authority a return of capital resolution adopted by the board of directors or the joint management committee and a copy of the statement and certification submitted by the FIVCIE to the Examination and Approval Authority under the first paragraph of this Article 26.

Article 27 Investors shall agree on a term for the FIVCIE in the FIVCIE contract and articles of association which generally shall not exceed 12 years. Upon expiration, the term may be extended if approved by the Examination and Approval Authority.

Upon approval by the Examination and Approval Authority, a FIVCIE may be dissolved before its term expires and its contract and articles of association will be terminated early. No such approval is required, however, if all investments of a Non-Legal Person FIVCIE have been sold or otherwise

[58] The procedure suggested in the August 8 draft simply will not work for funds. Our proposed changes reflect the fact that it is absolutely necessary that a fund be able to return the amount of its original investment without regard to the amount of contributed capital that has been contributed to or that remains in the fund. If this principle cannot be implemented in the revised Rules, funds will not use such new Rules to invest in China.

disposed of, the debts of such FIVCIE have been discharged, and the remaining assets of such FIVCIE have been distributed to its investors, but a written notice of any such dissolution shall be given to the Examination and Approval Authority by such FIVCIE at least 30 days before the dissolution is to become effective.

All dissolving FIVCIEs shall be liquidated in accordance with relevant regulations.

Chapter VI Inspection and Supervision

Article 28 Investment activities by FIVCIEs within China shall be handled with reference to the provisions of the Foreign Investment Guidelines and the Guideline Catalogue of Foreign Investment Industries.

Article 29 [59]When investing in any Investee Enterprise that falls into the encouraged or permitted industry category for foreign investments, a ~~FIVCIE may apply directly to the Registration Authority where such Investee Enterprise is located after it has obtained~~ FIVCIE shall first file a ~~Foreign Invested Enterprise Approval Certificate following~~summary of the ~~filing~~ proposed investment with ~~and verification by~~ the local authority responsible for the administration of foreign trade and economic cooperation where such Investee Enterprise is ~~located~~registered and such authority will issue a Foreign Invested Enterprise Approval Certificate to the proposed Investee Enterprise within 15 days of receipt of such investment summary unless it determines that the proposed investment does not fall into the encouraged or permitted industry category.[60] After the Foreign Invested Enterprise Approval Certificate is issued to the proposed Investee Enterprise, the FIVCIE may then apply directly for registration of the proposed investment with the Registration Authority where such Investee Enterprise is registered. The FIVCIE shall provide the following documents to the Registration Authority:

1. a declaration from the FIVCIE that it has adequate amount of funds for the proposed investment;

2. a legal opinion issued by a law firm on such declaration;

3. a copy of the FIVCIE's approval certificate and business license; and

4. other documents or materials that may be requested in connection with company registration procedures pursuant to applicable Chinese laws, regulations, and rules.

The Registration Authority will ~~decide whether it will~~ register ~~or refuse to register [~~the proposed investment by the FIVCIE~~]~~ if it is in ~~accordance~~compliance with relevant provisions under the Company Law applicable to the Investee Enterprise and the PRC Administrative Rules on Registration of Companies. For any investment authorized for registration pursuant to a Foreign Invested Enterprise Approval Certificates, a Foreign Invested Enterprise Legal Person Business License will be issued to the Investee Enterprise concerned.[61]

Article 30 When investing in any Investee Enterprise that falls into the restricted industry category for foreign investments, a FIVCIE shall first apply to the provincial level authority responsible for the

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[59] We modified this paragraph for clarity, to separate the local MOFTEC filing and the local SAIC office registration.

[60] It seems that no matter how little a percentage a FIVCIE invests in an Investee Enterprise, the Investee Enterprise will automatically become an FIE as a result of the FIVCIE's investment. Is that the intended result? We believe that it should be possible for an Investee Enterprise with less than 25% aggregate foreign ownership to elect not to be treated as an FIE.

[61] We have modified this sentence on the assumption that MOFTEC will agree that an Investee Enterprise with less than 25% aggregate foreign investment may elect not to be treated as an FIE.

administration of foreign trade and economic cooperation where the proposed Investee Enterprise is located and submit the following documents:

1. all documents listed under Article 29 above;

2. the investment agreement that it has signed with other investors in the proposed Investee Enterprise; and

3. the articles of association of the proposed Investee Enterprise.

The provincial level authority responsible for the administration of foreign trade and economic cooperation shall, within 45 days of receipt of such application, decide by a written response whether or not it approves the proposed investment. If the investment is approved, a Foreign Invested Enterprise Approval Certificate will be issued to the Investee Enterprise concerned.[62] The Investee Enterprise shall then apply for registration with the Registration Authority based on such written response and the Foreign Invested Enterprise Approval Certificate.

The Registration Authority will ~~decide whether to register or refuse to~~ register the proposed investment ~~based on~~if it is in compliance with relevant provisions under the Company Law applicable to the Investee Enterprise and the PRC Administrative Rules on Registration of Companies. For those authorized for registration pursuant to a Foreign Invested Enterprise Approval Certificate, a Foreign Invested Enterprise Legal Person Business License will be issued to the Investee Enterprise concerned.[63]

Article 31 Investments by FIVCIEs within China in service areas that are gradually liberalized for foreign investments shall be examined and approved in accordance with applicable national rules. ~~Where~~In case of any conflict between these Rules and the ~~laws or administrative rules provide otherwise on the examination and approval procedures and measures for~~ foreign investment ~~projects, such laws or~~ rules or regulations issued by the various government authorities set forth under Article 38, these Rules shall govern.[64]

Article 32 [65]Any increase ~~or transfer~~ by a FIVCIE of its investments in any Investee Enterprise shall ~~also~~ be handled in accordance with the procedures set forth under Articles 29, 30 and 31. Any transfer by a FIVCIE of its investments in any Investee Enterprise that falls into the encouraged or permitted industry category for foreign investments shall become effective upon the completion with the Registration Authority provided under Article 29 of a normal registration of ownership change procedure generally applicable to enterprises in such encouraged or permitted industry category. Any

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62 See the second footnote to Article 29.

63 See the last footnote in Article 29.

64 We think it desirable to make it clear that these new Rules supercede inconsistent provisions of the existing FIE rules or regulations issued by the relevant ministries. We propose to delete the second sentence as it is clear that certain provisions under these Rules (such as those on approval procedures, government deliberation periods, and various approvals, registrations and filing requirements) are intended to prevail over "the laws or administrative rules" that may "provide otherwise on the examination and approval procedures and measures for foreign investment projects".

65 We think an increase in investment and a transfer of investment interest in an Invetsee Enterprise are different in terms of the nature of transactions and the documents required for registration or approval, among other things, and would therefore require different treatments. It is important for the procedures for transfers to generally mirror the registration and approval requirements when the FIVCIE makes the original investments. From the investors' viewpoint, a fund should be free to sell unless the purchaser cannot lawfully invest in the industry involved. If it is possible that the regulatory authorities can second-guess the decision of the fund to sell, outside of established investment rules (for example, the sale would result in total foreign ownership of the Investee Enterprise exceeding the limits imposed by law or regulations), investors will not invest.

transfer by a FIVCIE of its investments in any Investee Enterprise that falls into the restricted industry category for foreign investments shall become effective upon approval by the provincial level authority responsible for the administration of foreign trade and economic cooperation provided under Article 30 and the completion with the Registration Authority provided under Article 30 of a normal registration of ownership change procedure generally applicable to enterprises in such restricted industry category.

Article 33 When a FIVCIE makes or transfers an investment in any proposed Investee Enterprise, it shall file a report with the Examination and Approval Authority for its record within one month after its completion of the applicable procedures set forth under Articles 29, ~~30~~30, 31 and ~~31.~~32.

Article 34 FIVCIEs shall, on a semi-annual basis and within the first month of each such immediately following semi-annual period, file a report on its investment and operating activities with the Examination and Approval Authority for its record. Such reports will constitute one of the mandatory documents when FIVCIEs are called for the joint annual inspection.

Each Non-Legal Person FIVCIE shall in addition file a report in each March on its fund raising and utilization information for the last year with the Examination and Approval Authority for its record.

Failure to comply with the filing requirements set forth in this Article will be dealt with accordingly by the Examination and Approval Authority after consultation with relevant departments of the State Council.

Article 35 An Investee Enterprise will be entitled to the preferential tax treatments available to Foreign Invested Enterprises if the effective equity percentage held by foreign investors of the investing FIVCIE or the combined equity percentage of foreign investors of such FIVCIE and all other foreign investors is at least 25% of the Investee Enterprise's registered capital. Otherwise, the Investee Enterprise will not be entitled to the preferential tax treatments available to Foreign Invested Enterprises.

Article 36 Liability will be pursued in accordance with law if any key member of the management and operating team of a FIVCIE is engaged in illegal practice. In serious cases, the management and operating personnel concerned shall be prohibited from conducting venture capital investments and the related investment management activities.

Chapter VII Miscellaneous

Article 37 Establishment of FIVCIEs in mainland China by investors from Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan area shall be handled with reference to these Rules.

Article 38 The Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science and Technology, the State Administration for Industry and Commerce, the State Administration of Taxation, and the State Administration of Foreign Exchange shall be responsible for the interpretation of these Rules.

Article 39 These Rules shall take effect from _________________, 2002. The Tentative Rules on Establishment of Foreign Invested Venture Capital Enterprises jointly issued by the Ministry of Foreign Trade and Economic Cooperation, the Ministry of Science and Technology, and the State Administration for Industry and Commerce on August 28, 2001 shall be annulled simultaneously.

Overview of Technology Investment in China

- Three Basic Business Elements of a Technology Company
  - "Technology", "Product", "Market"

Technology → Product → Market →

- Major roadblocks in China are the links between three elements:
  - Lack of production supply chain
  - Inefficient and even non-existing market channel
  - Time-to-market is too long
- Past Successful Business Models
  - Agency and SI, short-cut avenue into market but now traffic jam
- Emerging Business Models
  - "AsiaInfo Model": Channel acquires Tech, Big fish swallow Small

CHINAVEST 中國

Venture Capital Exit Strategy

- Venture Capital has the dream to build sustainable, long-lasting "money-making" machine, eg. Automobile
  - A smaller technology-oriented company is like Parts
  - A bigger market channel oriented company is like Assembly
- As for exit for VC, you can either sell Whole Car (IPO) or sell Parts (trade sales)
- At present in China due to limited market depth, niche Parts producer can hardly get to scale and survive alone
- Assembly with imported Parts (SI) seems a proven successful business so far, like Asiainfo and Legend
- Next phase, Assembly must be enhanced by better Parts, most likely through acquisition

CHINAVEST 中國

Stream Machine Acquired by Cirrus Logic

- $110M stock-for-stock transaction
  - Aug 2001, Cirrus Logic announced the definitive agreement to acquire Stream Machine
  - Dec 2001, acquisition completed
- Selling points of Stream Machine
  - Proprietary encoding technology (MEPG-2)
  - Market experience in China
- ChinaVest was the lead investor of Series C in Sep. 1999
- Co-investors include Mayfield, Vertex and Bessemer
- A successful exit case through trade-sales
  - ChinaVest realized 2.5x return

CHINAVEST 中國

Stream Machine and Cirrus Logic

CHINAVEST 中國

Stream Machine

- Fabless semiconductor design company focusing on video compression and decompression (CODEC) chips and a leading supplier of MPEG-2 technology
  - DVD, PVR, Digital Camcorders and PC video peripherals
- Founded in 1996 by a group of technologists from Bell Labs
- Offices in BJ, SZ and CA with 55 employees in 2001
  - Chinese customer is Amoisonic
- Completed two rounds of financing, $4M in 1996Q4 and $13M in 1998Q2
- 2000 Financial: $2M revenue, $12M net loss
- In Sept Qrt 2001
  - Revenue was about $618K
  - Operating expense was $3.6M

CHINAVEST 中國

Cirrus Logic

- A premier supplier of high-performance analog and DSP semiconductor solutions for consumer entertainment electronics that allow people to see, hear, connect, and enjoy digital entertainment
- Named Red Herring 100 of Year 2002
- Nasdaq listed (CRUS), with a market cap 1 billion
- Revenue (2001) = $779M
- Net Income (2001) = $143M

CHINAVEST 中國

Cirrus Logic – Stock History

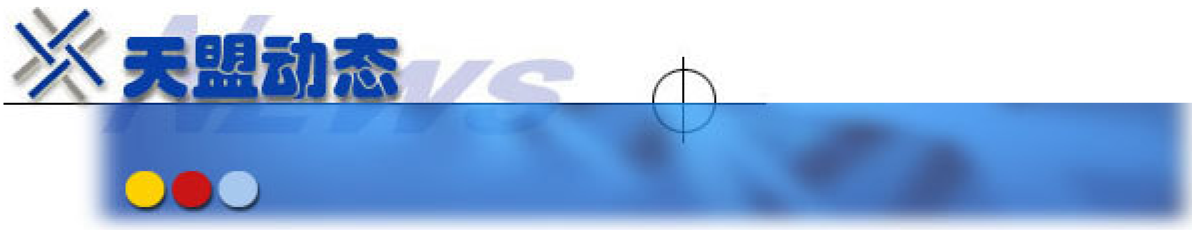
ChinaVest 中國

Observations and Conclusions

- Three "High Trading" points
  - "End of July": July 19th, acquisitions of LuxSonor Semiconductors ($65M) and ShareWave ($92M), and July 23rd, Qrt rev announcement of $179.7M, declining from $199.7M of the qrt before
  - "End of September": Panic sales, monkeys escaping from the falling trees
  - "Exit": Early January at a price of $19 per share.
- Is this Stream Machine acquisition successful to all parties?
- Has VC exit affected company's stock performance?

ChinaVest 中國

Appendix III



CHINA TMN ANNOUNCES INVESTMENT FROM ACER TECHNOLOGY VENTURES, DRAGONTECH VENTURES AND INTEL CAPITAL

天盟网络技术公司宣布从宏基科技投资、龙科投资、英特尔投资公司获得投资

CHENGDU, PRC, May 10, 2002 - China TMN Corporation, a specialist in telecom management network (TMN) and distributed network management software, today announced that it had received an investment from Acer Technology Ventures, DragonTech Ventures and Intel Capital. The investment will help China TMN develop its next generation of software and expand its operations into western China.

2002年5月10日中国成都--

天盟网络技术公司，一家专业从事电信管理网络（TMN）和分布式网络管理软件的研究、开发、销售高科技公司，今天正式宣布得到宏基科技投资公司，龙科投资公司，英特尔投资公司的投资。此次投资将帮助天盟网络技术公司下一代软件的开发和其在西部的业务扩张。

China TMN has deployed its solutions for major telecommunications companies within China and internationally. Its products include access network management solutions and systems for connected data collection, GSM network management and broadband network management. It also produces TMN software tools used by telecommunications equipment manufacturers to develop applications.

天盟网络技术公司已为许多中国和国际上重要的电信公司提供了网络管理解决方案。其产品包括接入网管系统，联机数据采集系统，GSM网络管理系统和宽带网络管理系统。同时也为电信设备制造商提供TMN软件工具及开发应用。

"Telecommunications is one of the key engines driving China to the next stage of its development," said Li Nong, chief executive officer of China TMN. "We are delighted to have investment from companies with such insight into the market segments in which we operate. We particularly welcome the opportunity to draw on the management and market resources from our investor Acer Technology Venture, DragonTech Ventures, and Intel Capital as we develop new products and expand into new markets."

"电信是推动中国下阶段发展的一个重要的发动机",
天盟网络技术公司的首席执行官李农说道:"我们很高兴从对我公司的运作和市场分割具有如此洞察力的投资公司那里得到投资。当我们在开发新产品和进入新的市场时，我们特别感谢由龙科投资公司，宏基科技投资公司，英特尔投资公司给我们带来管理和市场资源的机会。"

"With the current shift from infrastructure building to quality of service in the telecom industry, network management will play a key role for best utilization of network resource, improvement of quality and efficiency, and better services to the customers," said York Chen, Managing Director of Acer Technology Ventures. "Telecom network management is a promising area with high technical barrier of entry. With some industry expertise and technology breakthrough, we believe that China TMN has a strong position to be one of the leading players in this area."

"随着当今电信产业从基础结构的建设向服务质量的发展，网络管理将在最好的利用网络资源，提高质量和效率，最好的客户服务上扮演重要角色,"宏基投资公司的执行董事陈约克先生说:"由于具有高科技进入壁垒，电信管理网络是很有前途的领域。随着行业专门技术的突破，我们相信天盟网络技术公司将有很强的优势成为此行业的带头人"。

"According to the Ministry of Information Industry, China telecommunications industry capital spending reached US$28 billion last year, and it is expected to grow at double digit annual growth rate for the next five years. Meanwhile, with the increasing demand of network management and optimization, China's telecom network management market is expected to grow at a higher rate," said Roman Shaw, president of DragonTech Ventures. "With cutting edge technologies and proved execution capabilities, TMN is well positioned to capture these tremendous market opportunities. DragonTech is going to provide strong support to the company from all aspects."

"根据中国信息产业部的信息，去年中国在的电信产业的投入是280亿美元，预计在今后五年里将以每年两位数的增长率发展"，龙科投资公司总裁邵洛曼说道，他还谈道："随着天盟网络技术公司所掌握的尖端技术和已被证实的运行能力，它必将在巨大的市场机会中得到很好的位置。龙科投资公司将给天盟网络技术公司提供强有力和全方位的支持。"

"In the last several years we have seen vivid examples of the power of advanced telecommunications to revolutionize business and society," said Wee Theng Tan, president, Intel China. "Intel Capital invests in companies, like China TMN, that are making it possible for that revolution to expand its reach, especially to places where world-class telecommunications can make an extraordinary difference."

"在今后的几年里，我们会看到先进电信技术对商业和社会带来的巨大变革的生动例子"，英特尔中国公司总裁陈伟锭(Wee Theng
Tan)先生说，"在英特尔投资公司所投资的公司中如天盟网络技术公司，它们将很有可能引领这样的变革扩展到世界一流的电信技术可带来巨大变化的领域"。

About China TMN Corporation

关于天盟网络技术公司的介绍

China TMN Corporation supplies a wide range of software solutions to telecommunications providers and telecommunications equipment manufacturers. Founded in 2001, the company is based in the Chengdu High Tech Development Zone. Further information about China TMN is available on the Internet at http://www.chinatmn.com.

天盟网络技术公司为电信运营商和电信设备制造商提供范围广泛的网络管理解决方案。天盟网络技术公司成立于2001年，坐落在成都高新技术产业开发区。更多信息请参看天盟网络技术公司的网站：http://www.chinatmn.com.

About Acer Technology Ventures

关于宏基投资公司的介绍

Acer Technology Ventures is the venture capital business arm of the Acer Group, with six offices in Silicon Valley, Taipei, Singapore, Bangalore, Shanghai and Beijing. Currently, Acer Technology Ventures manages a USD260 million IP Fund One, which is a Cayman registered limited partnership fund with limited partners like J.P. Morgan, Citi Capital, ABN AMRO, Jafco/Nomura, Trigem, DBS, GIC, CDIB and some Acer affiliates. Investment focus of Acer Technology Ventures includes telecommunications, software and fables IC designs. Further information is available on the Internet at http://www.acervc.com (English) or http://www.acervc.com.cn (Chinese).

宏基科技投资公司是宏基集团中的风险投资公司，其属下六个公司分别设在硅谷，台北，新加坡，Banglore,上海，北京。现在，宏基科技投资公司管理着2.6亿美元的网际协议资金，此资金是Cayman 有限公司和他的合伙者 - J.P.Morgan，Citi Capital, ABN AMRO, Jafco/Nomura, Trigem, DBS, GIC, CDIB和一些宏基分支组织合作登记注册的。所投资的主要重点将在电信行业，软件业，IC 设计构想方面。更多信息请参看网站http://www.acervc.com (英语)或http://www.acervc.com.cn (中文)。

About DragonTech Ventures

关于龙科投资公司的介绍

DragonTech Ventures is a Greater China focused venture capital fund mainly covers communication, enterprise software and fabless semiconductor sectors. It has offices in Hong Kong, Beijing and Shanghai. The sponsor and anchor investor of DragonTech Ventures is Shanghai Industrial Group, the sole window company of Shanghai Municipal Government. Further information is available on the Internet at http://www.dragontechventures.com

龙科投资公司是针对中国大陆的一家大型风险投资公司，资金主要投入在信息领域，软件企业和半导体元器件制造行业。该公司在香港，北京和上海设有公司和办事处。龙科投资公司的发起人和战略投资者是作为上海市政府唯一窗口公司的上海实业集团。

About Intel Capital

关于英特尔投资公司的介绍

Intel Capital, Intel's strategic investment program, focuses on making equity investments and acquisitions to grow the Internet economy, including Internet infrastructure, content and services in support of Intel's strategic interests.

英特尔投资公司, 作为英特尔公司战略投资项目, 重点是通过投资和收购促进互联网经济发展。包括互联网的基础架构建设、内容和服务以配合英特尔长期战略利益。