

TASK A: SMALL AND MEDIUM ENTERPRISE FINANCING

As background for consideration of financing support for SMEs in China, one of the Chinese members of the consulting team has provided the following discussion of the current position of the SME sector of the Chinese economy. Other background papers from the domestic consultants are attached as Appendix B.

Importance of Small and Medium Enterprises in China

SMEs play an important role in the economic development of China. Small enterprises (SEs) contribute to the quick and constant development of the economy, while providing jobs and deepening the overall economic reforms of the country.

First, SMEs are quite important in the economy of China. In the case of industrial concerns, there were totally 7,929,900 enterprises in 1999, and 7,922,000 of them were SMEs, or 99.9% of the total. The total output value of industry was 12.6111 trillion yuan, and 9.4529 trillion yuan of it was produced by SMEs, or 75.0% of the total. SMEs employed 117 million in 1998, or 83.9% of the total employed in industry.

SEs are principally owned by collectives and individuals, whereas large enterprises and medium enterprises are mainly state-owned. (In large enterprises and medium enterprises, state-owned enterprises represent about 70% of the enterprise number and the output value of industry respectively; they also account for 85% of the employees.) This is quite different from market economy countries, in which businesses of all sizes are primarily private enterprises.

Before the implementation of the reform and the open policy in China, microeconomic and privately owned businesses were rare. Even now SEs in China are chiefly invested and managed by organizations rather than individual investors. For example, state-owned SEs are generally managed by the municipal government or county government; collective enterprises are mainly managed by the two-level organizations of town and village.

Hence, even though there has been a quick development of non-public ownership enterprises since the reform and the open policy, public ownership enterprises still represent a large proportion of the total economic activity of this sector. The number of state-owned enterprises and collective SEs is less than a quarter of the total number of SEs. However, the output value they produce amounts to 2/3 of the total. On the number of SEs, individual enterprises hold 76%, collective enterprises 22%, joint venture and foreign-funded enterprises 0.8% and state-owned enterprises 0.6%. On the output value of SEs, individual enterprises hold 25%, collective enterprises 54%, joint venture and foreign-funded enterprises 13% and state-owned enterprises 7%. Thus, the revenue of counties and towns mainly comes from SEs.

The importance of SE activity is different in the various geographic areas of China. The number of SEs in the East is 45% of the total, in the Middle 39% and in the West 16%. But the gross output value of industry produced by SEs in the East covers 60%, in the Middle 26% and in the West 8%. These indicate that the average output value scale in the East is large. It is 2.3 times as much as that of the Middle, 3.3 times as much as that of the West. The output produced by SEs occupies a high proportion in the industrial output value of each region: in the East it represents 69%, the Middle 71% and the West 57%.

SMEs are important parts of national economy, and a crucial force to push it forward. Ever since the policy of reform and opening up has been in place, SEs have developed quickly in China. According to the third survey of industry in 1995, the output value produced by SEs was 70% in food, paper-making and printing, 80% in clothing, leather, recreational and sports goods, plastics and metalwork, 90% in timber and furniture. Furthermore, SEs exported many large-quantity commodities, such as clothing, toys and handicrafts. SEs even produced some new and high technology products. In 1998, the delivery rate of export products of SMEs accounted for 72.2% of independent accounting enterprises.

SMEs are the main channel to create jobs and thereby lessen the unemployment pressure, and they are the basic forces to promote social stability. SMEs exist primarily in labor-concentrated industries. Their capacity of labor and elasticity of employment are in total larger than large enterprises. Since the reform and the open policy, no serious unemployment problem has occurred during the process of industrialization. One of the most important reasons is the quick development of SEs. Between 1978 and 1998, 250 million labors left agriculture. Most of them now work in SEs. At present, there are 140 million people working in industry, and 100 million of them work in SEs, or 75.5%.

In recent years, with the adjustment of economic structure and the deep reform in enterprises, state-owned enterprises and collectives have reduced employment, in order to promote efficiency. Meanwhile, the employee in individual and private enterprises has increased 10 million. This indicates that non-public ownership SEs have become the main channel to take in new labor and laid-off workers. Now more and more new workers need jobs; more extra workers transfer from rural areas; workers in state-owned enterprises and collective enterprises are laid off; clerks in governmental organs are reduced. The unemployment pressure is increasing. SEs are just like a "reservoir" of taking in laborers, and its role is turning gradually significant. SEs are the major place for social employment, and they are also the source of revenue in counties and towns. Therefore, if SEs are stable, the employment situation in the whole country will be stable; the local finance will be stable. The society will be guaranteed to be stable as well.

SMEs are the pioneers to help establish the socialist market economy system. They are also the important force to help intensify the reforms. Most of SEs are emerged in the course of reform and the open policy. They are not only the result of reforms, but also the pioneers of reforms. This is due to several reasons: first, in comparison with large enterprises, first, the cost of reforms in SEs is low; second, it is easy to carry out reforms

in SEs; third, the influence of reforms, whatever the results are, is small; fourth, it is easy for SEs to accept a new system. In the process of reforms, SEs are usually taken as the test area, the breakthrough of key reforms and the pioneers of further reforms. Ever since the implementation of the reform and the open policy, the successful experiences in reforms mostly result from SEs. For instance, the measures of contract, lease, annexation, auction and bankruptcy were all tested and initiated in state-owned SEs and collective enterprises of towns and villages. The various reforms in SEs offer precious experiences for the establishment of socialist market economy system. Without the exploration in SEs, it is impossible to shape the co-development of multi-realizations of public ownership and multi-economic elements; it is impossible to establish the socialist market economy system.

The importance of SEs in the development of the economy is still not widely recognized. Some hold that economic increase depends on the development of large enterprises, because large enterprises represent advanced productive forces, while SEs demonstrate backward productive forces. Only large enterprises are competitive in the international markets, therefore, the larger the scale of enterprises, the better. When the Central Government declares the guiding principle of "grabbing the large and releasing the small", the understanding of this principle in some local areas focuses on the large enterprises, and ignores the development of SEs.

Others believe that the development of SEs at the present stage is just an expedient measure, and that SEs are only a transitional form of enterprises. They believe that with the evolution of industrialization, SEs will be annexed by large enterprises, or die out themselves. Through the analysis of the status and roles of SEs, it is clear that these understandings to SEs are not correct, and they detract from a proper appreciation of the role of SEs. It will be important to educate a broader segment of the population on the importance and roles of SEs in the social and economic development of China.

The regulatory regime and policies of SMEs

The regulatory regime of SMEs is divided by the Chinese government according to ownership and regions. Normally there are state-owned enterprises, collective enterprises of town ownership, individual and private enterprises of town ownership, town and township enterprises and foreign-invested enterprises.

The administration of state-owned SMEs in China is subordinated to the Central Government, provincial government (including municipalities), prefectural government (including cities of the prefectural level) and county government (including towns of the county level). Those SMEs subordinated to the Central Government were administered in the past by industrial ministries and industrial corporations, such as the Ministry of Machinery, the Ministry of Metallurgy, the Ministry of Electron, Nonferrous Metal Corporation and Weaponry Industry Corporation. Meanwhile, these organs were also in charge of guiding SMEs at the local level. Since the reform of the Central Government in 1998, the industrial ministries were changed into industrial bureaus under the leadership of the State Economic and Trade Commission. Now these industrial bureaus

have all been canceled, leaving the State Economic and Trade Commission to perform the administrative functions.

The local state-owned SMEs are subordinated to the relevant industrial department, bureau or office in the local government, such as the Machinery Department in provinces, the Municipal Machinery Bureau and the County Farm Machinery Bureau. Now many industrial bureaus of the municipal level and the county level have turned into companies. Its administrative function has been taken by the Economic Commission (or the Economic and Trade Commission, or the Economic Planning Commission) of different levels. Those non-industry SMEs, such as enterprises of architecture, transportation and business, are administered by the relevant Construction Commission, Transportation Bureau and Business Commission.

The administration of collective enterprises of town ownership

In conformity to the relationship of subordination, collective enterprises of town ownership can be divided into five levels: the provincial level, the prefectural level, the county level, the residential district level and the neighbour committee level. And the administrative function is performed by the above-mentioned departments responsible for the work. In other words, the industrial bureau of the municipal level and county level is in charge of both the state-owned SMEs and the collective enterprises within the system.

There are some institutions that are in charge of the administration of town collective enterprises: (1) the Second Light Industry System. Enterprises in this system were mainly emerged through the merger of public and private enterprises in 1950's. They are administered by the Second Light Industry Ministry or Bureau with branches in districts and counties. Now most part of them has turned into companies. (2) Municipal Supply and Marketing Cooperative. It is responsible for the administration of collective enterprises in commerce in cities. Now quite a few of it have been changed into companies. (3) Municipal Credit Cooperative. (4) There are collective enterprise offices in some places to take care of various collective enterprises.

Besides, many state-owned enterprises establish collective enterprises to solve the unemployment problem of the children of their workers. These collective enterprises are administered by the relevant state-owned enterprises.

The administration of individual and private enterprises of town ownership

Individual and private enterprises of town ownership are administered by industrial and commercial department of various levels. However, the technicality, quality, sanitation and environmental protection of products are managed by the relevant governmental organs. Town and township enterprises in rural areas may be set up by towns, villages, groups (groups of villagers), cooperatives and individuals. In recent years, many collective enterprises have turned into stock companies or stock cooperative enterprises; some have got independent; some are still attached to the previous organs.

The Township Enterprise Bureau of the Agriculture Ministry is in charge of the administration of town and township enterprises in the Central Government. The institutions of the provincial, municipal and county level are called Town and Township Enterprise Bureau. But it is separated from the Agriculture Department.

Administration of foreign-invested enterprises: Foreign-invested enterprises include joint ventures (including Hong Kong, Macao and Taiwan), cooperative enterprises and wholly foreign-owned enterprises. Joint ventures and cooperative enterprises are administered by the previous organs that the Chinese party is subordinated to. Wholly foreign-owned enterprises need to register in the industrial and commercial institutions. Foreign Economy and Trade Ministry makes the policies towards foreign-invested enterprises.

The present policies on the development of SMEs

Even before the reform and the open policy in 1978, the Chinese government had encouraged some SEs to develop by offering preferential policies to them. For example, there was the policy of putting the same emphasis on SEs and large and medium enterprises in 1950s. In the early 1960s there was a policy of encouraging districts and counties to set up "Five Small-Scale Industries" (small-scale steel plants, small-scale coal mines, small-scale fertilizer plants, small-scale cement plants and small-scale machinery plants) to solve the problems of the Great Leap Forward and national disasters. In the late 1960s residential districts were encouraged to set up factories to solve the unemployment of housewives of urban workers. In the middle and late 1970s enterprises were encouraged to establish service companies to offer job opportunities for youngsters coming back from the countryside. Even after 1978, preferential policies were offered to town and township enterprises so as to solve the unemployment of extra labor after the reform in rural areas.

Tax Benefits to SMEs

Although the present preferential policies put into practice are not made merely for SEs, the beneficiaries are basically SMEs. This is particularly evident in the preferential policy of income tax for enterprises in the tax reform of 1994. The income tax rate for ordinary enterprises is 33%; for those enterprises with profits below 30,000 yuan, the income tax rate is 18%. For those enterprises with profits between 30,000 yuan and 100,000 yuan, the income tax rate is 27%.

The income tax of town and township enterprises can be reduced by 10%, depending on the tax that is due. This part of tax will be used to compensate the expense of social activities. In addition, governmental loans are mainly offered to enterprises producing export products, having cooperation between the East and the West, and going through technique transformation (Spark Project programs).

For the newly established town and township service enterprises, if the number of the new employee recruited within the year is more than 60% of its previous staff, their income tax can be exempted for 3 years after the investigation and approval of the tax authority. By the time the exemption comes to an end, if the enterprises can still add more

than 30% of its previous staff, its income tax can be reduced by 50% for 2 years, with the investigation and approval of the tax authority. According to the Tax Law, the value added tax of exported goods has to be paid. The Value Added Tax Rule originally set rates of 17%, 13% and 6% respectively. When this new taxation was applied, the increased tax was too burdensome. Therefore, the State Council had to lower down twice the rate of return tax in May and October of 1995. After the adjustment, the present rules concerning the return tax rate are: first, the return tax rate for exported coals and agricultural products is 3%; second, the return tax rate for exported industrial products based on the material processing of agricultural products is 6%, and this also applies to other products whose tax is levied by 13%; third, for those products, whose tax is levied by 17%, its return tax rate for exported products is 9%.

If enterprises are set up in the new and high technology development areas approved by the State Council, their tax can be levied by rate of 15%. For the newly established new and high technology enterprises in the new and high technology development areas approved by the State Council, their tax can be exempted for 2 years since the year of production.

When enterprises or institutions go through technique transformation, they may get profits from this technique transformation and from the relevant technicality inquiry, technical support and technique training. The income tax of these possible profits can be exempted if the annual income is lower than 300,000 yuan.

For enterprises set up in areas regarded by the country as "the old, the minority, the frontier and the poor", their income tax can be reduced even exempted for 3 years after the approval of the tax organ. If enterprises in autonomous regions require special support, their tax can be reduced regularly or exempted after the approval of provincial government.

To service trades for agricultural production in rural areas and towns, the income tax of its income from technical support and labor is currently exempted. The income tax of technical service income of research institutes and colleges, such as technology transfer, technical training, technicality inquiry, technical service and technical contract, is also temporarily exempted.

To the independent accounting enterprises engaged in the trades of inquiry, information and technical service, the income tax is exempted for the first two years of operation. To the independent accounting enterprises engaged in the trades of transportation and telecommunication, the income tax is exempted for the first year and half of the tax is levied in the second year.

To the independent accounting enterprises engaged in the trades of public utilities, commerce, goods and materials, foreign trade, tourism, storage, residential service, food, education, culture and sanitation, the income tax can be reduced or exempted for one year.

The income tax of school factories in colleges and schools can be reduced or exempted, as well as those of welfare enterprises set up by civil administrations. Enterprises with more than 35% of handicapped employees (including the blind, the deaf, the mute and the limb disabled), are exempt from income tax. Enterprises with 10%-35% of handicapped employees pay income tax at half the normal rate.

The State Council declared on July 1, 1998 that, to small-scale commercial enterprises with the annual sales below 1.8 million yuan, their value added tax is reduced from 6% to 4%.

Recognition of the Importance of SMEs

Until 1998, the development of SEs was not considered to be important. Many leaders in China still saw SEs as the manifestation of backward productive forces in the course of industrialization, and believed they are a transitional form when the economy of a country is not advanced enough. Since early 1998, however, the economic situation of China has greatly changed, and there is an obvious acknowledgement to the importance of SEs.

During the first quarter of 1998, the Central Bank urged the branches of each specialized bank to establish loan department for SMEs. In May, President Jiang Zemin said that the development of SMEs should be considered an important part of economic strategy. In July, the State Economy and Trade Commission established the Medium and Small Enterprise Department. In June 1999, rules were issued for the establishment of credit guarantee companies to facilitate bank loans to SMEs. New legislation is being drafted to encourage greater investment in SMEs. All these actions indicate that the Chinese government will strengthen the dynamics of supporting SMEs, integrate the various policies and measures concerning SMEs, and consider the policies for SMEs in a more systematic way. This indicates that policies towards SMEs have moved into a new period of respect and support.

EQUITY FINANCING OF SMEs

Along with China, most of the other governments of the world have recognized the importance of small and medium-sized enterprises in providing innovation, economic growth, and job creation. To encourage the development of this sector of their economies, most major nations have programs to increase the availability of both equity and debt financing for these enterprises.

Equity is investment in a company that does not need to be repaid. The investor usually expects to profit by selling the equity interest at a later date, after its value has increased as a result of increased profitability. Debt financing, or loans, have a requirement for repayment, and the investor profits from interest which is paid during the life of the loan. Most government support programs are available for all companies within a stated size range, whether their business is based on technology (sometimes

referred to as "Venture Capital" investment) or whether it is based on more traditional, older technology (sometimes called simply "SME" investment).

Most international support programs are available for both SME financing (which is the subject of project Task A) and venture capital financing (the subject of project Task B). Therefore, this paper will describe the major support programs of these other nations, and discuss the "best practices" that are apparent from their successes and from the evolution of their programs, without differentiating between SME and venture capital.

The existing support programs that will be considered have all been developed in countries with a different relationship between government and the private sector than that which exists in China. These programs assume that the role of government is to attract private investors to put money into investment funds that invest in SMEs and venture capital. Governments do this either by increasing the potential rate of return to the private investors, (by reducing taxes, lending money to investment funds on favorable terms, investing in the funds with a limited return objective, etc.) or by reducing the risk of investment by the private investors (guaranteeing against loss, offering a credit against tax liabilities from other income, etc.) In China, the role of government has thus far been as a direct investor in these funds, rather than a supporter of non-governmental sources.

To understand these practices and to evaluate their effectiveness, we will consider them in the context of the system in which they operate. However, when we come to use these "best practices" as a basis for recommendations for China, we will try to draw basic lessons from them, and apply these lessons to a pattern in which government has been the principal source of the financing.

Based on our study of the efforts of government to stimulate new enterprise development, we can summarize: (A) some General Conclusions about the Effectiveness of these programs, (B) the Basic Characteristics of Successful Programs, (C) Alternative Support Mechanisms, and finally (D) Best Practices of Government Support.

A. General Conclusions about Effectiveness

Small companies create most new jobs in most countries, and equity capital is critical to the development of high-growth companies. Consequently, most countries have programs to encourage venture capital and SME investment, using a combination of tax incentives and government participation in venture capital investment funds (often on a basis that increases returns to private investors).

Government programs that encourage small enterprise development can dramatically impact a nation's economy. Decisions and action by Israel, Ireland, Australia and others have converted agricultural economies to ones based on high-growth technology-based businesses. In the United States, a government program of support for venture capital investment fueled an explosive growth in new business formation in the 1960s, and has continued to make a major impact for over forty years.

The aim of most government support programs is to encourage investment in small enterprises by non-governmental sources. Creative government programs cost the taxpayer a very small amount of money compared with the amount of new investment they stimulate.

Private Investors generally make venture capital investments with a small subset of a large portfolio, and are able to invest anywhere in the world. Government support aims to make investment in that nation's SME economy attractive when compared with all other global investment opportunities.

To attract non-governmental sources of financing, an economy must have laws and regulations that allow the formation and operation of entities that make direct investments in small businesses. Furthermore, they must protect the rights and property of investors, and assure transparent and predictable rules that apply to all. Administration and regulations must be fair and practical, and must not delay business activities.

Development of local enterprises are vitally stimulated by the operations of foreign technology-based businesses in the country. For example, Ireland dates its economic conversion from the opening of the first Intel chip-manufacturing plant.

Technology-based businesses need an educated workforce, with well trained business and scientific management. Education is therefore a key.

New enterprise development is most prolific in countries that have a culture of entrepreneurship that rewards and appreciates success while forgiving failure when it is a result of an honest creative intent. For example, the U.S., Israel and China have such a culture, while Japan and Germany in general do not.

Even in countries like the United States, Australia, Ireland and Israel, in order to attract non-governmental sources of venture capital investment, programs have been heavily promoted by well-known leading citizens, both inside government and in the private sector.

Virtually all successful government-supported programs have been managed by independent investment managers: even the early U.S. and Israeli government-sponsored investment funds were led by private managers who could accept the risk of failure and the motivations of success better than government employees.

B. Basic Characteristics of Successful Programs

Governments typically support equity investment funds that invest directly into companies in order to support their growth and development. Successful programs do not allow investments in stock trading operations. Use of government-supported funds to invest in trading operations has little if any impact on economic development, and divert management attention away from their main task of making direct investments.

The principal reason given for allowing investment funds to purchase shares from current shareholders in trading operations is that this provides a means of investing funds on hand that are awaiting investment directly into companies. To avoid this, most successful funds have agreements with their investors that provide for investment into the fund only as required for direct equity investments.

Governments define the kinds of companies in which funds they support are allowed to invest. All provide that funds can invest only in companies that are smaller than a stated maximum size, as measured by number of employees, sales volume, profitability, net worth, or combinations of these.

In addition, some governments only support funds that invest in technology-based investments, sometimes even limiting the areas of technology that can qualify. This is based on government's belief that encouragement of technology is of such fundamental importance that any government support should be directed to this sector. Other programs, including the largest in the world, do not target specific sectors. The underlying belief is that funds will be invested in high-growth businesses in a variety of sectors, which will lead to a stronger and more balanced economy.

Whether sectors are targeted or not, governments typically do not allow investment of government-supported funds in socially undesirable areas, such as alcohol, tobacco, gambling and firearms. There are usually restrictions on investments in real estate, because of the wider availability of financing mechanisms available for this sector.

While government's motivation is economic development and job creation, successful programs recognize the importance of investments making a return to their investors, and a turnover of investments through the eventual sale, either back to management, to another company, or to other investors. In the most successful programs, governments set broad limitations, allowing investment managers to make investment judgments. Government's developmental objectives are realized by the fact these investment funds are investing within the stated limits of size or sector.

Management of equity investment funds is virtually always delegated to professional managers who are not government employees and who are compensated by a combination of salary and a significant participation in the profits from investments they make. The compensation structure provides a potential for much greater compensation from profit participation than from salary.

Successful equity investors must be willing to take risks that will result in occasional failures, and must base investment decisions on their judgment of future prospects of small enterprises. They are not only trained and experienced in this kind of investing; they are also willing to have their compensation and future employment dependent on the success of their management of investment funds. The potential rewards that are commensurate with this risk are much higher than those of public employees, who have a much lower risk of failure. Since their principal compensation is based on investment

results, independent managers are more resistant to external pressures to invest in companies that do not meet their standards of investment potential.

While some programs are funded entirely with government resources, most successful support programs utilize a "public-private partnership" to encourage investment by non-governmental sources. This not only increases the total amount of equity to be invested by the fund, but increases the likelihood that fund management will be carefully selected and will operate to produce the highest risk-adjusted rate of return. Non-governmental investors share responsibility for selecting fund management, and can oversee the fund operations and investment decisions. As will be noted below, a fund based on a combination of public and private investment can utilize a greater variety of government support mechanisms, which in turn can significantly reduce the cost of government support.

Successful programs are characterized by transparency and honesty at every level:

- Program regulations are clear and complete.
- Selection of funds to be supported is based on published criteria.
- Selection process is transparent and objective.
- Administration of the selection process and monitoring of funds by government is managed by honest and well trained officials.
- Reporting of investments by fund managers and independent examination by government confirms that regulations are being followed.
- Fund managers work closely with companies in which they have invested, to add value and to insure that program regulations are being observed.
- Appropriate action is taken when regulations are not observed.

Successful programs have strong and public support from the highest levels of government. In addition to the economic encouragement provided by government support, it is important for the highest levels of government to stimulate investment in SMEs and to encourage fund managers to use the support program to accelerate the formation of new investment funds. Major private investors must be approached with an emphasis on both the potential investment return and the importance to the economic development of the nation. This can best be accomplished by persons of recognized stature, both public and private.

C. Alternative Support Mechanisms

Governments can increase availability of capital for investment in SMEs either by investing public funds or by making it more attractive for private capital to invest in these companies. As noted above, the most successful government support programs have been based on public-private partnerships, in which investment decisions are made by independent fund managers, and where there is significant equity participation by private investors. The objective of investors is to generate the highest risk-adjusted rate of return on their capital. Consequently, government can attract private capital either by increasing

the potential rate of return to investors in a venture fund, or by reducing the investor's risk of loss. Specific plans range from:

- Direct investments in SMEs or Venture Capital financings. Many governments have started with this approach, but most have concluded they have neither the staff nor the motivation to manage such a program, which involves a great number of individual investment decisions, and continuing support for investee companies.
- Direct participation, or "seeding" of venture funds, as France provides for investors in younger companies. Government invests on the same basis as private investors, thus increasing the size of the fund and allowing greater diversification of its investments. A variation is the German plan of co-investment with venture funds.
- Government Loans or loan guarantees to licensed venture funds that would invest within government guidelines, or guarantees of fund borrowings. The U.S. Small Business Investment Company program (SBIC) and the program of the U.S. Overseas Private Investment Corporation (OPIC) use this kind of support, offering loans or loan guarantees in an amount of twice the private capital of the fund. Since the interest rate on the government debt is well below the profit expectations of a venture fund, the excess returns flow to the private investors, increasing, or "leveraging" their potential rate of return.
- Leveraged equity participation by government in private equity funds. This practice has been offered as an option by the U.S. SBIC program since 1994, and by the Australian Innovation Investment Program. Government provides two thirds of the capital of a venture fund, but takes only a government interest rate plus 10% of the fund's profits. Any excess profits flow to the equity investors who have provided only a third of the fund's capital. This again enhances, or "leverages" the profit potential to the private investor.

A particularly successful variation was the Israeli Yozma fund, which invested in the early Israeli venture capital funds ten years ago. Investing 40% of the total, the Israeli government agreed that the funds could repurchase the government share within a five year period, at cost plus a nominal interest rate. This again provided "leverage" for the private investors, without subjecting them to the risk of an obligation that would take precedence over their own investment in the fund.

- Loss insurance. Governments have provided guarantees against loss for investors as a way of encouraging them to invest in venture funds. The U.S. State of Oklahoma guarantees investments in state-sponsored seed and early stage investment funds. OPIC guaranteed principal and interest on two-thirds of the investment in some of its funds, thus assuring the investors they would at worst recover their investment at the end of the ten year life of the fund.
 - Tax credits, as Canada has offered, as a direct offset of a percentage of the investor's capital investment, so long as the fund invested in the target sectors of

the economy. Alternatively, governments have offered a reduction in tax liability on profits earned from investments in SMEs.

D. Best Practices

The support programs of major countries are summarized in the attached memorandum, along with programs that now have been discontinued. From the trends of these countries and discussions with those responsible for many of these programs, we conclude that the best practices of government support in these countries have been based on public-private partnerships, in which investment decisions are made by independent fund managers, and where there is significant equity participation by private investors. This allows the following balance:

1. Government can generally target the investments of the fund to areas in which there is a public policy objective, by size or industry sector, geographic location, or other criteria, as a condition of providing financing.
2. Private capital increases the total amount available for investment, so government does not have to provide all the funding.
3. Independent managers are focused on making investments that are sustainable and can be sold, thus allowing the funds to be reinvested or returned to government and the private investors. With a purely public fund, the temptation is to have job creation or economic development as a sole objective, which can result in permanent investment in marginal companies.
4. Private investors share the risk and take responsibility for oversight of the investment program.
5. Fund managers can be compensated with a share of profits, providing motivation that can attract good people.
6. Successful government-supported funds can provide a track record for the manager to raise a completely private fund the next time.

International Practices of Investment Support by Government

(see Summary Table Next Page)

[1] Direct Investment

- **Brazil** The Brazilian development bank, BNDES has made direct equity investments and loans to SMEs. It is now shifting its focus to investing in funds managed by independent managers.

Government Support Programs for SME Equity Financing and Venture Capital								
	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]
	Direct	Investment in	Loans/	Leveraged	Loss	Tax	Tax	Discontinued
Country	Investment	Funds	Guaranties	Investment	Insurance	Credits	Advantage	Programs
Australia				X				X
Belgium		X						
Brazil	X							
Canada	X	X				X		
Finland					X			
France		X						
Germany		X			X			
Hungary	X	X (preferred)					X	
India	X	X (preferred)						
Ireland	X	X (preferred)						X
Israel				X			X	
Korea			X					
Mexico	X	X						
Netherlands				X				X
Sweden								X
UK				X				X
USA			X	X				
Intl Dev Insts.		X						

- **Canada** Canada has a tradition of government involvement in the promotion of business. This is evidenced in the venture capital arena by its two principal programs. The Business Development Bank invests directly in SMEs, but most support is extended through funds (see below).
- **Germany** Germany's BJTU program provides matching funds for individual investments in small high-tech firms, plus a 50% equity guaranty for the first five years of an investment in such concerns.
- **Hungary** Two state-owned venture funds have been invested, but have not produced meaningful results. The government is now organizing additional funds, in combination with the European Union, regional development agencies, international development organizations, and private sources.

- **India** Small Industries Development Bank of India (SIDBI) set up a venture fund in 1994 to invest directly in small companies, and to invest in venture funds. Total size is US\$ 27.5 million. More recently, SIDBI has concentrated on supporting investment funds (see below).
- **Ireland** A government agency now called Enterprise Ireland is a consolidation of three former agencies that together have invested in over 500 companies in Ireland. Due to the difficulty and cost of managing a direct investment program, Enterprise Ireland has moved steadily toward support of investment funds with private investors and managers (see below).
- **Mexico** Two development banks, NAFIN (manufacturing) and Bancomext (export financing) promote SME development by providing capital and business assistance. NAFIN invests directly in SMEs and in venture capital funds (SINCAS), along with wealthy individual investors and public market listings.

[2] Investment in Funds

- **Belgium** Belgium's Investment Company for Flanders (GIMV), established in 1980, is credited by OECD as pioneering the concept of government-funded venture capital run by independent private management. Most of its investments have been in high technology companies, and it has been successful enough to attract private capital, which now represents a minority ownership of the fund. The other two regions of Belgium have government funded investment funds, but these are principally (but not exclusively) investing in industrial companies. Operations of these two funds are more closely controlled by the government.
- **Brazil** As noted above, the Brazilian Development Bank is shifting from direct investment to investment in independent investment funds.
- **Canada** In addition to direct investment in SMEs, Canada invests in seed capital funds, and makes loans to these companies. About half of all venture capital investments in Canada are made by Labor-Sponsored Venture Capital Corporations (LSVCCs), which are mutual funds that make direct equity investments, and are managed by private fund managers. Investors in the LSVCCs receive tax benefits (see below). Provincial governments also sponsor privately-managed venture capital funds.
- **France** Using a portion of the proceeds of the privatization of France Telecom, the French government will provide up to 30% of the capital for a private venture capital firm, providing it agrees to invest at least half its funds in concerns less than seven years old. The government investment is proportional to the fund's agreement to invest in such concerns, i.e. if half the

funds are so invested, the government will invest 15% of the total fund capital; if all the funds are so invested, the government will invest 30%.

- **Hungary** (See above)
- **India** SIDBI has a three tier strategy of Venture Capital support:
 - State/Regional Level:** Participated in setting up 12 regional/state funds for high-tech investing in SME sector. Although open to private investors, all matching funds have come from local government sources.
 - National Level:** Established National Fund to Support Information Technology (NFSIT) in 2000 with initial capitalization of US\$50 million, and eventual capitalization of US\$ 100 million. SIDBI proposes in the future to set up a National Biotech Fund. These are entirely funded with SIDBI resources, but managed by an independent fund manager.
 - International Level:** Proposed US-based US\$ 50 million fund for cross border investments in knowledge based SMEs.
- **International Financial Institutions** Virtually all international development agencies invest in direct equity investment funds in emerging markets, to support economic development. International Finance Corporation (World Bank), European Bank for Reconstruction and Development, and the national development agencies of the United States, United Kingdom, Germany, Sweden, Norway, and Switzerland are among this group. Typically these organizations invest on the same terms as other investors in funds managed by independent managers.
- **Ireland** Enterprise Ireland has co-invested with private investors in funds, and with the European Union has established 16 private sector funds investing in seed and venture capital. In partnership with Bank of Ireland, an "Enterprise 2000" fund has been established to make small investments and loans to young companies.
- **Mexico** (See above)

[3] Loans/Guaranties to Funds

- **Germany** (See above)
- **Korea** The Korean Government will loan up to 20% of the capital of Start-up Promotion Funds, which have their capital from private investors and are managed by private fund managers. These funds are required to invest 40 to 50% of their assets in start-up companies, but are free to invest the remainder as they desire.

- **United States of America** The Small Business Investment Company (SBIC) program, administered by the U.S. Small Business Administration (SBA) is the largest and oldest government support program for venture capital in the world. In over 40 years of operation, SBICs have invested over \$21 billion in nearly 120,000 financings to U.S. small businesses, including such successes as Intel Corporation, Apple Computer, Federal Express, and America OnLine.

The basic objective of the program is to attract and supplement private capital for venture capital funds (SBICs), managed by private investment managers, that invest in small companies that would not otherwise be able to raise capital from purely private sources. Many require amounts of capital greater than that available from individuals, but less than the minimum required by private venture capital firms. In this program, SBA licenses, regulates, and agrees to provide two thirds of the total capital of an SBIC, with the remaining one third provided as equity by private investors such as insurance companies, foundations, endowments, wealthy individuals, and pension plans. The SBICs are organized and are operated just like private venture capital funds, with all investment decisions made by the private fund manager

SBICs agree to abide by SBA regulations, primarily to make only direct investments in companies small enough to meet required standards. Except for the exclusion of a few industries, investments are not targeted by SBA. Capital supplied by SBA requires a rate of return much lower than that expected by the fund as a whole. Any excess flows to the private investors and fund managers, increasing, or “leveraging” their returns.

SBA funds are provided either through 10-year loans (“debentures”) or preferred limited partnership equity investments (“participating securities”). Debentures require current payment of interest, and are used by SBICs that make loans with equity rights or features. Participating securities, which have no current cash payment obligation, are used by SBICs making equity investments in small companies. The rate and fees of the debentures to the SBIC are about 2% above the ten-year U.S. treasury rate. In addition to this basic cost, SBICs using participating securities must pay 10% of their profits to SBA.

Funds for the program are raised by SBA in the capital markets through the sale of debentures guaranteed by SBA and the U.S. government. In the U.S. budget system, the only required government appropriation is a “credit subsidy” or form of loss reserve. Based on the loss experience of the program the government has concluded that no loss reserve is required. For the current year, therefore, if approved by Congress, the SBIC program will be able to guarantee \$6 billion of financing to SBICs, at no cost to the U.S. taxpayer.

In addition to making 50% of the total number of equity financings made by venture capital firms to U.S. small business last year, with an average investment size well below that of private venture firms, the SBIC program assists new fund managers who are raising their first funds. The program is achieving its objectives and helping to build the venture capital industry of the future. (see www.sba.gov/inv for details).

[4] Leveraged Investment in Funds

- **Australia** In 1999, the Australian government started the Innovation Fund program, a variation of the U.S. SBIC program. Government capital is invested along with private capital in new venture investment funds managed by private fund managers, with 2/3 of the total coming from government. As cash distributions are made from the fund, after recovering its investment and a government interest rate of return, the government receives only 10% of further profits, with the remaining 90% of profits going to fund management and the private investors who have invested only 33% of the fund capital.
- **Israel** Israel has developed a technology-based SME segment of its economy that is the envy of the rest of the world. With a population of only 6 million, Israel has produced more companies currently listed on NASDAQ than any other, except for Canada and the U.S. itself. From one venture capital fund in 1992 it now has over 50 funds in operation, with over \$2 billion to invest, most of which is from foreign sources.

This success was based on the Yozma program, which started in 1991. Government invested \$8 million in each of 10 new venture capital funds, along with \$12 million in each from private investors. After 6 years, the private investors had the right to buy the government share for its cost plus a small return; virtually all the profits from the fund were allocated to the private investors. This gave them a motivation to invest. Funds were managed by private fund managers.

These first funds were very successful in enabling the formation of new enterprises and making money for their investors. With this record, the fund managers were able to raise money for later funds without government support.

- **Netherlands** The government will loan 25% of the capital of a venture capital fund that agrees to invest in small technology companies, and will convert the loan to a grant if the fund actually makes such investments.
- **United States of America** (See description of SBIC program above) The United States agency Overseas Private Investment Corporation (OPIC) makes ten-year loans to direct equity investment funds investing in emerging markets around the world. These loans are typically twice the amount of

private capital in the funds. Interest is not due until the loan is paid at maturity or prepaid. In addition to interest, OPIC receives a small annual fee (typically 1.5% of the loan balance) and a small participation in profit distributions (typically around 6% of profits).

[5] Loss Insurance

- **Finland** A program to guarantee up to half the losses on venture investments in small technology companies has mired in administrative detail, and little used. The government is now funding a portion of the capital of regional venture funds, but a shortage of private capital and professional management is inhibiting implementation.

[6] Tax Credits

- **Canada** Individual investors are encouraged to invest in LSVCCs by a 15% tax credit on investments up to \$3,500, which is often coupled with a tax credit from the provincial government.

[7] Tax Advantage

- **Israel** Tax incentives are offered to investors in companies that list on the Tel Aviv stock exchange.

[8] Discontinued Programs

- **Australia** The Management and Investment Company (MIC) program of 1983-91 offered tax incentives for long-term investments in open-end funds that would make investments in SMEs. The stock market crash of 1987 prompted investors to demand redemption of their shares, which forced the MICs to sell their holdings in young, unmarketable companies at very low prices, and severely reduced the ability of the MICs to make additional investments in successful investee companies that needed further capital for growth. Another plan the Pooled Development Funds of the 1990s provided tax incentives that could not be used by the institutional investors that were already exempt from taxation, and were so restrictive in their definition of allowable investments that they were unattractive to taxable investors.
- **Ireland** A tax incentive program called "Business Expansion Scheme" was misused by investors, who made low-risk loans rather than venture investments with funds received under the program. A 1994 program required pension funds to invest in venture capital funds: they invested only in specialty "venture" funds that invested in later-stage development, rather than in the earlier stage financing that was intended.

- **Netherlands** The government in 1995 discontinued a program that guaranteed up to 50% of losses on investments in eligible small concerns.
- **Sweden** Government support has now been withdrawn from expansion of a program to invest in venture funds, as they have become too conservative and risk-averse.
- **United Kingdom** A tax-incentive plan, the Business Expansion Scheme (BES) was widely misused for investments in low-risk, asset-based companies. The Venture Capital Trust (VCT) scheme allowed small investors to participate in venture capital, with tax incentives, but has also been criticized for failing to direct financing to small technology-based concerns.

LEGAL AND REGULATORY FRAMEWORK

As the government recognizes, the absence of supportive laws and regulations severely limits the availability of financing for SMEs, especially from non-governmental and foreign sources. From the past experiences of our legal team and the interviews we have had with domestic and foreign fund managers and investors, it is clear that the most serious barriers to investment in SMEs come from problems related to:

- Laws respecting the organization and operation of investment funds and credit guaranty organizations
- Corporate laws, including those dealing with the formation of corporations and issuance of different classes of stock
- Exit and Security legislation, especially with regard to transferability of shares held by founders and investors prior to public listing

The impact of these legal and regulatory barriers are dramatized in the two Case Studies that follow. These were prepared by the Jun He Law Offices in Beijing, based on actual experiences.

Following the two Case Studies are three memoranda, prepared by the Jun He firm, that discuss in detail the legal issues related to:

1. Financing Policies and Mechanisms for SMEs
2. China's Investment Funds, and
3. Credit Guarantee System for SMEs

Other issues related to credit guaranty organizations will be discussed under Task C below. Some of the major observations of these papers are summarized below:

With respect to debt financing, we found the following principal financing barriers for SMEs:

- Commercial Banking Law provides that a commercial bank can only charge a loan interest rate within a range set by the central bank. This differential is not enough to compensate the bank for the additional risk and cost of servicing smaller loans. We recommend that a commercial bank be given flexibility to set its loan interest rate, especially with regard to the costs and risks involved in lending to a SME
- Current law prohibits lending between enterprises; we suggest to that these be permitted, and regulate inter-company loans so as to make available new financing channels for SMEs

As to equity financing, our work to date suggest the principal legal and regulatory impediments include the following:

Investment Funds

- Company Law does not allow a company (other than those investment companies and holding companies allowed by the State Council) to invest over 50% of its net assets in the securities of other companies. This prevents the legal formation of corporate investment funds. Therefore, we recommend that this cap be abolished for corporate investment funds. Similarly, China's Limited Liability Company laws does not provide the protection against liability for investors that is found in most Western law.
- The national law does not currently permit the formation of limited partnerships, which is the form used most often by venture capital funds in countries with mature venture capital industries; we suggest to add a chapter on limited partnership to the partnership law, taking into consideration local regulations and practices (such as Beijing Limited Partnership Regulations)
- There is no relaxation of laws or regulations for the benefit of substantial and sophisticated investors, who are able to protect their own interests
- Investment funds must receive government approval before they commence operations and in the event of significant investment, including particularly investments by foreign entities
- Rules that set a maximum value for intangible assets (the PRC Company Law requires that maximum value of intangible assets be no more than 20% of the registered capital, while according to *Notice on Certain Policies of the MOFTEC Encouraging and Promoting the Development of Small and Medium Enterprises Redistributed by the State Council* issued on August 24, 2000, for certain kinds of SMEs the level can be raised to 35%) make it difficult to price technology companies, which have a high goodwill factor; we suggest that valuation of intangibles be determined by market forces. However, laws should provide greater protection of trade secrets.

- Investors who commit to invest in venture funds are required to put up the full amount of their commitment at inception of the fund. With so much excess cash, fund managers typically invest in open market securities, which is distinctly contrary to international best practice.

Corporations

- Minimum paid-up capitalization rules require a larger capitalization than is necessary for SMEs; we suggest the minimum level be lowered or eliminated.
- Current law limits capital contribution in the form of technology up to 35% of the registered capital of a company. Since so much of the value of technology-based companies is in their intellectual property, this prevents realistic valuations for investment. Similarly, we recommend that the law also permit capital contribution in other forms such as stocks and creditor's rights, to encourage investment.
- Corporations are limited to issuing only one class of stock; preferred shares may not be issued. This restricts the flexibility of investors in structuring venture financing; we suggest legislation to allow the issuance of preferred shares to attract risk-averse investors, and increased alternatives for investment structuring.
- Options and warrants are not allowed. This limits the potential use of quasi-debt securities (such as bonds convertible into shares or bonds that carry warrants to purchase shares). We recommend the right to issue management stock options to align the interests of management with that of the investors; further, we recommend, without governmental approval, the right of pre-authorization of shares for later issue, increase of share capital, repurchase or redemption of shares and holding of treasure shares
- Companies limited by shares and foreign-invested enterprises are subject to governmental approval for capital increase, share transfer and other corporate acts; we suggest changing the current governmental review procedure to a simple registration system
- MOFTEC regulations require that a foreign-invested enterprise must have three consecutive profitable years before conversion into a company limited by shares; we suggest this minimum profitable period be shortened, in order to enable more SMEs to convert to a form preferred by investors.
- Company Law requires a company to specify its scope of business in its articles of association; we suggest to require only "lawful business or purposes" (such as required under US Delaware General Corporation Law) so that a SME will have flexibility to conduct its affairs

- Company Law has not provided enough protection of minority shareholders (often investors in a SME); we suggest adding clauses on cumulative voting, a right to form a voting trust, right to approve related party transactions, right to bring derivative suit and permissible exit strategies (see below)

Exits

A venture capital or SME equity investment fund must have an ability to sell their holdings in portfolio companies ("exit") as they mature. The law imposes severe impediments to the most common ways of accomplishing this:

- Investors who are shareholders prior to an initial public offering (IPO) are required to hold their shares for an extended "lockup" period following the IPO, usually three years. This compares with international practice of generally less than six months. The extended lockup period has often been cited as such a serious problem that it forces investors to organize outside China.
- Company Law has not provided, and could be revised to provide, the following exit strategies (i.e., as generally recognized in the US) for investors: piggy-back right, demand registration right, tag-along right, drag-along right and tender offer right upon change of control
- It is difficult for shareholders to redeem their investment through repurchase of shares by the company under present PRC Company Law. Only under two situations can a company repurchase its shares: to cancel its registered capital, or to be incorporated with another company holding its shares.
- Lack of "second board" has denied this outlet for the sale of shares in small or new companies; in the absence of a second board in Shenzhen, we suggest liberalization of listing requirements of the Hong Kong Growth Enterprises Market so that more mainland SMEs can qualify for such second board

SME FINANCING IN THE PRC

Prepared by JUN HE Law Offices

As of September 26, 2001

Case Study (I):

I. Basic Information about the Case

A certain collective enterprise (Company A), established in 1996 with registered capital of ¥2,000,000 and 20 employees (3 senior managers (original investors) and 3 principal technicians and salespersons). The superior authority in charge of Company A invested ¥600,000 when Company A was established, ¥400,000 of which was recovered in the same year (1996), and collects “affiliation management fee” annually. At present, Company A operates well with total assets of ¥20,000,000 and net assets of ¥10,000,000. It is engaged in an area of business banning foreign investment before the China’s formal entry into the WTO. To expand its scope of operation to attract strategic investment, Company A hopes to:

1. turn the company into a company of limited liability with standard operation;
2. attract domestic and foreign investments;
3. obtain more bank loans; and
4. complete all the necessary preparations for the Company’s listing in the overseas market.

II. Major Legal Issues

1. Asset ownership determination of collective enterprises – prerequisite for the conversion into shares

1.1) How “investor owns” is reflected in the process of asset ownership determination

According to the relevant laws and regulations, the assets of the collective enterprise belong to all the staff and workers whose representative organ is the workers’ congress while the actual investors are just a few senior managers. Usually, individual senior managers have to give away part of the investor interest, free or at nominal cost, to get the support of other employees. The current laws do not fully protect the interest of the actual investors in Company A in the conversion process.

1.2) Can “affiliation management fee” offset the investment of the superior authority in charge of the Company

According to the current laws and regulations, whether the annual affiliation management fee to be turned into the superior authority in charge of Company A (affiliated organization) can offset the capital subscription from the superior authority is not considered in the asset ownership determination of the collective enterprise.

2. Financing and reorganization targeted at domestic investors

After the process of determination of asset ownership of the collective enterprise, Company A can be converted into a company of limited liability whose shareholders include historical investors and the superior authority in charge of the Company who holds approximately 10% of Company A ownership (state-owned stock). Afterwards, Company A can attract domestic investors, increase its capital and stock volume, and become a completely private company of limited liability after the transfer of the state-owned stock.

1. Subscription of capital

Company A needs to go through some capital subscription verification procedures during its conversion into a standard company of limited liability. According to the principle of “capital substantiation” of the current Chinese law applicable to non-foreign-invested enterprises, subscription of the full amount of the registered capital constitutes a necessary condition for the establishment of a company.

According to the relevant provisions of the *Company Law of the PRC*, Company A may be faced with the following problems when its shareholders subscribe their shares of the registered capital and such problems may impose some restraints on the composition of the investment into Company A:

- 1) subscription cannot be in the form of creditor’s rights;
- 2) subscription cannot be in the form of share rights;
- 3) ambiguity in the laws regarding the subscription by Company A’s original shareholders in the form of Company A’s net assets which include creditor’s rights, debt and/or share rights; and
- 4) restrictions on the subscription of capital in the form of intangible assets which usually is not to exceed 20% of the registered capital with the maximum allowed amount below 35% (although higher limit for investment in the form of intangible assets may be allowed in some local regulations).

2. Restriction on investment

According to Article 12 of the *Company Law of the PRC*, with the exception of the investment companies and holding companies stipulated by the State Council, the accumulated investment amount of a company into other companies of limited liability and companies limited by shares cannot not exceed 50% of its net assets, excluding the increased amount of capital converted from the profits of the invested companies after the

investment. Consequently, both the company of limited liability converted from Company A and other companies of limited liability investing in the company of limited liability from Company A shall be restrained by such provision in their investment activities.

3. Protection of the investors

Like many medium and small-sized private enterprises in China, original investors and principal technical personnel of Company A usually have a strong collective sense, sometimes even a sense of a family which creates some difficulty for the other investors to join in. Meanwhile, the *Company Law of the PRC* tends to be too general in the protection of the interests of minority shareholders and in corporate governance while the relative governmental industry and commerce organs are only accustomed to approving regulations with language similar to that of the *Company Law*. As a result, domestic investors investing in Company A are often frustrated by the following issues:

- 1) lack of norms in the management of venture capital in China;
- 2) preferred stock; According to international customs, if an investor only put in capital without being involved in the management of the company, such investment shall be in the form of preferred stock and enjoy certain preferential treatment in dividends, increase in capital and stock, bankruptcy, liquidation, and listing registration. Currently, there are no provisions for such preferred stock in Chinese law.
- 3) Protection of minority shareholders

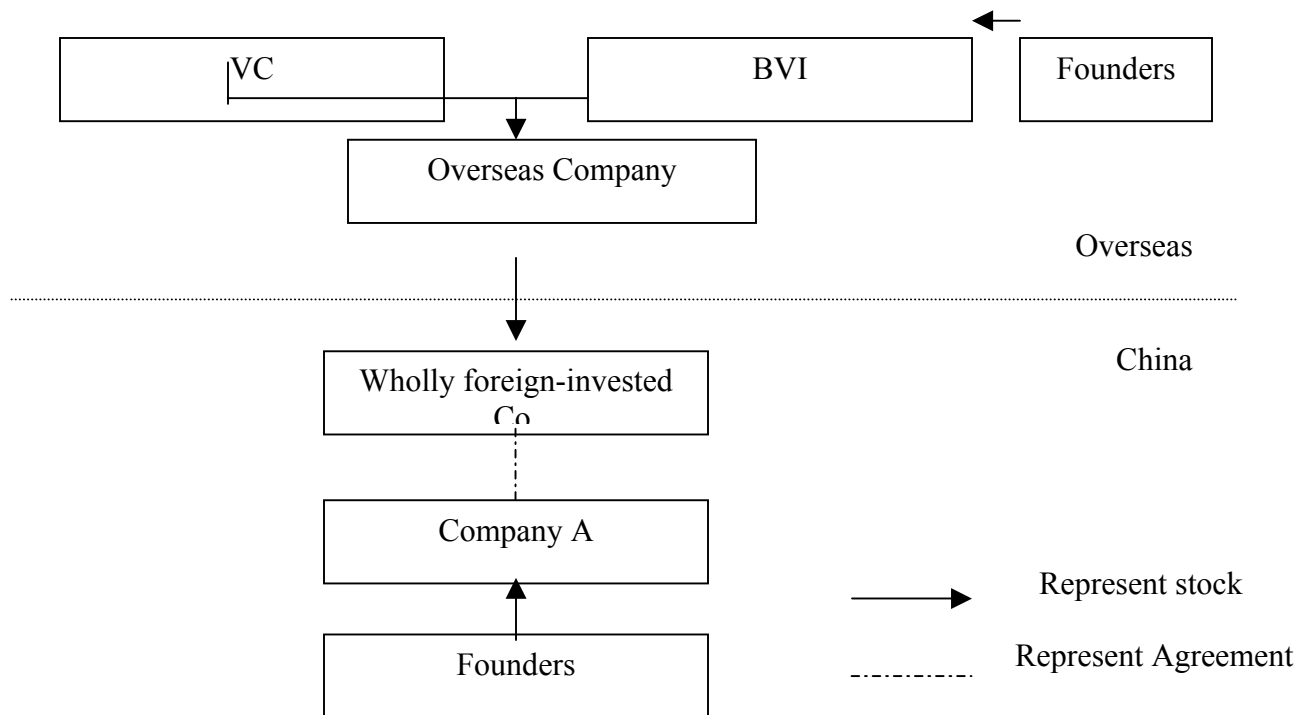
Currently, there are provisions in the *Company Law of the PRC* and the articles of association for companies of limited liability approved by governments and generally accepted regarding accumulative voting, connected party transaction, compensation system for shareholders and company management, and rules regarding the mutual guarantee by the shareholders and the company. As a result, the check and balances to protect shareholder interests in a Chinese company, especially the interests of minority shareholders, do not exist.

- 4) The supervisory organ of the company organization - - board of supervisors

According to our understanding, the boards of supervisors for most small and medium-sized companies of limited liability in China do not function.

3. Financing and reorganization targeted at foreign investors

At present, the following module is often adopted for overseas financing in the areas restrictive to foreign capital:



The steps constituting the above module are as follows:

- 1) Chinese citizens set up a foreign company abroad;
- 2) The foreign company sets up wholly foreign-invested company (WFOE) in China;
- 3) The WFOE purchases the part of business where foreign invested is allowed and the related assets from Company A; and
- 4) The WFOE and Company sign an agreement through which the WFOE can receive profits from the business area of Company A where foreign investment is restricted or prohibited.

The module above is the overseas financing structure adopted to avoid restrictions on the entry of certain business areas and there are no clear laws or regulations prohibiting such practice and the relevant government agencies in charge have not yet banned such practice. However, since the above structure only allows the investor to control the interest by way of agreement instead of by stock ownership, the structure has some unstable elements in term of law and may result in disputes between the investor and Company due to their different interests such as the SINA Wang Zhidong incident. In addition, the following legal issues may also be involved:

- 1) Chinese citizens invest abroad

At present, the only official document governing the overseas investment by the residents in China is the *Provisional Management Regulations on the Foreign Exchange Owned by Residents in China* (the “Provisional Regulations”) issued by the State Administration of Foreign Exchange on September 15, 1998. According to Article 22 of the Provisional Regulations, residents in China need to submit the “Approval for Overseas Investment Issued by the State Agency in Charge of Overseas Investment” to the government agency in charge of foreign exchange and to the bank for wiring foreign exchange out of China to invest. According to the explanations of the relevant government agency, the Provisional Regulations only apply to the wiring of foreign exchange out of China to invest by Chinese residents and does not apply to the residents’ act of depositing foreign exchange abroad or taking cash of foreign currency out of China to invest. Therefore, there are no clear laws governing the depositing foreign exchange abroad or taking cash of foreign currency out of China to invest.

In addition, other current laws regarding overseas investment (mainly including the *Regulations on the Examination, Approval, and Management of Non-Trading Enterprises Abroad* issued by the MOFTEC on March 23, 1992 and the *Regulations on the Approval of the Establishment of Organizations in Hong Kong and Macao* issued by the MOFTEC, the People’s Bank of China, and the Hong Kong, Macao, and Taiwan Affairs Office of the State Council) only apply to businesses and government-sponsored institutions, not individual residents in China. The MOFTEC has so far not issued any formal rules of law regarding overseas investment by individual residents and does not accept any applications for overseas investment by individual residents. Nor has the MOFTEC approved any project for individual’s overseas investment. However, the MOFTEC is inclined to endorse the legality of individual’s overseas investment with their legal foreign exchange income.

In summary, the Chinese law does not ban the Chinese citizen to be engaged in overseas investment. Chinese citizens to invest overseas through wiring foreign exchange out of China must get approval from the government agency in charge of overseas investment (according to the *Provisional Regulations on the Management of Foreign Exchange Owned by Chinese Residents* issued by the State Foreign Exchange Management Bureau). As for the Chinese citizen investing overseas with foreign exchange from abroad, there is no clear law allowing or banning such activity.

2) Capital transfer

At present, the normal module for Company to list in foreign market with domestic interests is: the Chinese citizen first sets up a foreign company abroad, and then achieve the goal of listing overseas with domestic interests through the foreign company’s purchasing Company A’s assets or stock. The main regulation dealing with such listing is the *Notice by the State Council on the Strengthening of Management of Issuing Stock and Listing Overseas* (the “Red Chip Guide”) issued

by the State Council on June 20, 1997. According to the Red Chip Guide, for any transfer of the assets of the domestic enterprises through purchase, stock swapping, allocation, or any other methods to overseas non-listing company or to foreign listing company controlled by the Chinese capital, or for the overseas listing through first transferring the domestic assets to overseas non-listing company and then to foreign company controlled by the Chinese capital, the owner of the domestic enterprise or the Chinese holding shareholder should first obtain the approval of the people's government at the provincial level or the agency of the State Council in charge as well as the approval of the China Securities Regulatory Commission (CSRC).

Several points remain unclear in the above provisions:

- 1) There is no clear legal definition on "Chinese capital." According to the current legal practice, the legal overseas income of a Chinese should not be "Chinese capital" while the Chinese resident's income legally obtained from sources within China should be "Chinese capital."
- 2) What income is "from sources within China": there are currently no clear legal provisions as to whether, in the process of financing, the difference between the appraisal value of the assets to be purchased within China and the evaluation value of overseas share based on such assets in their conversion to share rights shall be regarded as the interests and rights formed overseas by the Chinese capital. In practice, the CSRC tends to have the opinion that such interests and rights are not Chinese capital. However, such opinion purely depends on the examination and approval of the CSRC without any clear legal provisions.
- 3) Individual's foreign exchange (loans from sources outside China)

There are no clear provisions in Chinese law prohibiting Chinese individuals from using international commercial loans. According to the *Provisional Management Regulations on the Foreign Exchange Owned by Residents in China (Revised)* (the "Revised Provisional Regulations"), if an individual Chinese resident pulls some foreign exchange income generated from the overseas capital project into China and then needs to pay foreign currency, exchange into foreign currency, or wire the foreign exchange in the capital abroad, approval from the relevant foreign exchange management agency is needed. Since the laws and regulations regarding individuals' borrowing overseas (such as how to register such foreign debts) are unclear, it is rather difficult in practice for an individual to be approved to borrow abroad to be used or exchanged into foreign exchange to pay for the interest and principal in China.

- 4) Joint capital by individuals

The current laws of enterprises with foreign investment do not allow the investment by individual Chinese citizens to set up Sino-foreign joint ventures or cooperative enterprises. Such laws are detrimental to the development of small and

medium-sized high-tech enterprises, especially those relying on individual investment and technical support.

If an individual in China intends to set up a Sino-foreign joint venture or cooperative enterprise, the individual must first set up a company. However, Article 12 of the Company Law of PRC stipulates that the total amount of outward investment of the company cannot exceed 50% of its net assets, therefore, causing waste of individual funds and assets and idle capital as a result.

5) Option

According to the *Resolution of the State Council on Strengthening Technical Renovation and the Development of High-Tech to Realize Industrialization* issued on August 20, 1999 by the State Council, private high-tech enterprises are allowed to use stock options and other methods to mobilize the initiatives of the management and technical personnel. However, no laws or regulations on options have been issued so far.

Issues related to Chinese citizens holding options of overseas companies: according to the provisions of the Chinese law, the holding options of overseas companies by Chinese citizens is the individuals' private investment action in nature. The current law does not specifically prohibit overseas investment by Chinese citizens if such investment does not involve domestic foreign exchange. For the individuals' investment involving domestic foreign exchange, please refer to the sections of "Chinese citizens invest abroad" and "Individual's foreign exchange."

6) Trust

The Chinese *Trust Law* was issued by the National People's Congress in April of 2001 and will be implemented on October 1, 2001. According to the *Trust Law*, Chinese citizens can set trusts in China to achieve legal purposes.

At present, there are no clear provisions about the applicability of the *Trust Law* on foreign enterprises' engaging Chinese citizens by way of trust to invest in China. However, trusts aiming at entering areas restrictive to foreign investment may be voided for violating the law.

7) Conflicts between local laws and laws from the central government

According to the Regulations on the Filing of Laws and Regulations issued by the State Council on February 18, 1990, all local laws, regulations issued by the departments of the State Council and regulations by local people's government should all be filed with the State Council. The State Council is responsible for checking for any conflicts between local laws, regulations and national laws, administrative regulations and between local laws and local regulations. In case of

any conflicts, the State Council can repeal, change, or remand to change. To our knowledge, there has been no precedence of repeal in practice.

At present, it is not clear whether the local laws and regulations conflicting with the state law is automatically invalid. According to our understanding, the above-mentioned conflicting local laws and regulations still have legal power before they are specifically repealed. Therefore, China has not found a solution to the conflicts between and among its laws and regulations.

4. Obtaining bank loans

1) Conditions of the loan

General Rules for Loans and other Chinese laws and internal bank regulations impose rather strict conditions on loan application by various kinds of enterprises. Since small or medium-sized enterprises are usually smaller and not as credit-worthy as that of large enterprises, it is more difficult for such enterprises, especially private small and medium-sized enterprises, to get loans. The *Opinions on the Further Improvement of Financial Services to Small and Medium-Sized Enterprises* issued by the People's Bank of China provides some guiding regulations for the commercial banks in China to improve loan services to small and medium-sized enterprises but fails to provide a clear and stable preferential and encouraging policies. As a result, the incentive for the commercial banks to provide loans to small and medium-sized enterprises is very limited.

2) Loan guarantee

According to our understanding, financial institutions usually require the borrowing enterprises to provide corresponding guarantee before granting the loan and it is rather difficult for small and medium-sized enterprises to get such loan guarantee. The *Guiding Opinions on the Establishment of Experimental Credit and Guarantee System for Small and Medium-Sized Enterprises* issued by the MOFTEC stipulates on the establishment and operation of the credit and guarantee organizations for small and medium-sized enterprises on the municipal, provincial, and national levels. However, due to limited coverage of such guarantee system and complexity of the application process, it is a rare occurrence for a small or medium-sized enterprise to get a loan with the help of such guarantee system.

3) Loans between enterprises

Financing between enterprises is prohibited by the relevant financial laws and regulations in China. According to the legal interpretation by the Supreme People's Court, loan agreements between enterprises violate relevant financial laws and regulation are void. In addition to the return of the principle, the interest income already received or to be received by the creditor according to the agreement should be confiscated and a penalty equivalent to the amount of the bank interest should be imposed on the debtor. The court shall also collect the interest from the payment

date of the loan to the date decided by the court for the debtor to repay the principal at the rate agreed on by the parties. If the parties did not agree on the interest of the loan, the interest rate for bank loans for the same time period will be applied.

4) Loan by mandate

According to relevant laws, an enterprise can loan to another enterprise through a trust and investment organization by way of loan by mandate, namely, Party A provides funds which a trust and investment organization (the mandatory) loans to Party B on A's behalf and according to the loan criteria confirmed by Party A such as the target, use, term, and interest of the loan, supervises the use of the loan by the borrower, and assists Party A in recovering the loan. Party A shall pay the mandatory certain amount of processing fee but the mandatory does not assume the obligation of ensuring the repayment of the loan by Party B or provide guarantee for the repayment of the loan. According to our understanding, there are so many legal disputes over loans by mandate that Chinese trust and investment organizations are reluctant to take such business. The main reasons for such disputes are that the trust and investment organizations are too flexible in the arrangements of loan by mandate, lack of clear definition of mutual rights and obligations, inappropriate promises or promises violating regulations such as guarantee of the repayment of the loan made by some trust and investment organizations to the lenders in order to attract deposits.

5) Movement of funds

Though the relevant finance laws prohibit financing between enterprises, it is inevitable that the enterprises will have the relationship of creditor claim and debt in their business dealings. Chinese enterprises makes use of the accounting principle that funds deposited in the borrowing enterprise's account for less than one year are regarded as the normal movement of the funds. In the name of joint development, joint research and advance payment for investment between the lending enterprise and borrowing enterprise, the lending enterprise remits funds as capital needed for joint development to the account of the borrowing enterprise. Currently, there are no effective supervisory methods in Chinese law for such activities.

6) Loan arrangement between individual and enterprise

The lending enterprise lends funds to its employee who in turn lends the funds to the borrowing enterprise. According to the relevant laws and the interpretation of the Supreme People's Court, the loan arrangement between an individual and an enterprise falls under the category of private loan and is valid as long as the parties involved truly intend such a transaction. In such an arrangement, the lending enterprise shall assume the credit and moral risks of the borrowing employee.

5. Listing

After a period of continued operation, Company A shall seek to issue and list its stock.

- 1) Listing of A/B shares (including planned GEM in China).
- 2) Conditions for the listing of H shares (including the list of GEM).
(basically the same as that of the listing of A/B shares)
- 3) Listing of the overseas interests in overseas market.
(see the analysis before)

SME FINANCING IN THE PRC

Prepared by JUN HE Law Offices

As of September 26, 2001

Case Study (II)

Convert a State-Owned Holding Company Limited into a Company Limited by Shares
List the Company in China

I. Basic Scenario

X Company Limited is a company of limited liability established before the implementation of the *Company Law of the PRC* with its 3 shareholders of A, B, and C. A used to be a state-owned enterprise under the local light industry bureau, and now has invested all its operative assets, personnel, and debts into X Company Limited. B and C are both state-own enterprises and both have invested in X Company Limited with cash. X has gone through standardization in accordance with the Company Law and set up the employee shareholding association. The local Administration of State Assets has approved the transfer of some of A's shares to the employee shareholding association of X. X has set up 4 sino-foreign joint ventures to attract financing, 3 of which are doing well and one is no long in operation. There are relatively many connected transactions between the four joint ventures and there are many mutual loans and guarantees between and for each other. After its investment into X, A only keeps a small amount of non-operative assets (including overseas investment) without any personnel or business operation activities.

II. Legal Issues Related to the Establishment of a Company of Limited Liability on the Basis of a State-Owned Enterprise

1. Forms of capital subscription and the related problems

In many situations, a state-owned enterprise is converted into a company of limited liability as a whole and the first condition for the state-owned enterprise to absorb investment is to digest the debts of the original enterprise. As a consequence, different forms of capital subscription result in the establishment of the company of limited liability.

- A. All the assets and debts of the state-owned enterprise are included in the capital subscription and the amount of such capital subscription is based on the net assets of the appraisal with the corresponding debts transferred to the company of limited liability. The old enterprise just remains a shell. Such a scheme is relatively fair to other investors and can protect the interests of the original creditors of the old enterprise. The drawback of such a scheme is that the old enterprise only has relatively small ownership in the new company of limited liability and such drawback prevents this scheme from being widely adopted.
- B. All the assets and debts of the state-owned enterprise are included in the capital subscription but the calculation of the capital subscription amount is based on the assets only while the debts being regarded as the capital subscription still unmade. The parties shall agree on the schedule to use the dividends of the state-owned enterprise to gradually pay off the unpaid balance in the capital subscription amount after the establishment of the company of limited liability. Such a scheme is more favorable to the state enterprise since the state enterprise will have relatively bigger ownership of the new company while the interests of the original creditors still being protected since all the debts are transferred to the new company of limited liability. The drawbacks of such a scheme are that it is more risky for new investors and unfair to the new investors in terms of investment proportion since the new investors usually put in cash. The above characteristics of the scheme lead to the wider adoption of the scheme. However, such a scheme has relatively major legal problems including:
- a. The form of capital subscription with future dividends of the new company violates the system of actual capital subscription as established in the current *Company Law*, especially the principle of capital substantiation;
 - b. Since the state-owned enterprise shall be faced with the pressure of making up the unpaid balance in its capital subscription, it often raises funds from employees, hence leading to the formation of the employee shareholding association. However, the legal status of the employee shareholding association is, to a large degree, indefinite and under debate (please see “Legal issues involved with the employee shareholding association” for more discussion).
- C. The state-owned enterprise makes its capital subscription with its operative assets and keeps its debts in the old enterprise. Such a scheme imposes relatively smaller burden on the new company of limited liability and is relatively fair to other investors. The drawbacks of such a scheme are that it does not provide sufficient protection to the creditors of the old enterprise and, as a result, will have more resistance in the establishment of the new enterprise.

In all 3 schemes discussed above, the old enterprise does not keep its substantive operative assets and personnel and, in reality, no longer meets the requirements of an independent legal person. In practice, however, the Administration of Industry and

Commerce will not cancel such an enterprise for failing to pass the annual review since the enterprise still has income from its investment in the new company of limited liability. As the investor of the old enterprise, the Administration of State Assets recovers its investment through transferring its ownership in the new company after its establishment.

2. Recurrent problems related to the assets of the capital subscription of the old enterprise

A. Land use right, buildings and construction in progress

Most state-owned enterprises obtained their land use right including buildings and construction in progress through allocation and the state-owned enterprises must, if in strict compliance with the law, first complete the procedures needed for the assignment of such land use right before they can use it in their capital subscription. Since the processing of such assignment incurs a large amount of assignment fee, majority of the state-owned enterprises fail to complete the necessary assignment procedures according the relevant regulations and, as a result, this portion of the capital subscription will be more problematic. Since the Administration of Urban Real Property Law provides that assignment of buildings cannot be separated from the land use right of the land to which the buildings are attached, such capital subscription problems is particularly prevalent in capital subscription in the form of buildings.

Solution: make up the assignment fee. However, there are no particularly favorable policies regarding the state-owned enterprises' making up of the assignment fee and the practices of local government in different regions vary in solving this historical problem.

B. Implementation of asset transfer of third-party right

C. Non-assignable exclusive operation right obtained under special permission

The non-assignable exclusive operation right obtained under special permission necessary for the new enterprise is often carried on under the name of the old enterprise with the income so generated belongs to the new enterprise. The law does not address the legality of such income.

D. The capital subscribed by the wholly-owned subsidiaries of the old enterprise (e.g. "third-industry" enterprises not incorporated under the *Company Law*, school-sponsored enterprises and other licensed enterprises with or without legal person status).

Sine the old enterprise has full ownership, it can therefore invest all the assets and liability of the old enterprises into the new company of limited liability. However, the law does not stipulate whether the old enterprise must issue public notice according to the dissolution procedures of the *Company Law*.

III. Legal Issues Related to the Conversion of a Company of Limited Liability into a Company Limited by Shares and Listing and Financing of the New Company

1. Employees holding shares

- A. The causes for the existence of the employee shareholding association
 - a. Financing type
Variation of financing when the enterprise is in urgent need of capital.
 - b. Risk type
Used to improve efficiency of the enterprise and increase employee participation in the management of the enterprise and the unity of the enterprise.
 - c. Welfare type
Used as a means to increase employee income when the enterprise is doing well.

- B. Legal problems with the employee shareholding association
 - a. Variation of financing
Different from private loan, this variation of financing violates relevant provisions of the *General Principles of Loan*.
 - b. Conflict with the relevant provisions on the management of state assets
Holding of shares by employees is often realized through employees' purchasing of the state-owned shares. According to the provisions on the management of state assets, transfer of state assets must undergo the process of evaluation and the transfer price cannot be lower than 90% of the valued price. In practice, the transfer of such state assets is often accomplished without undergoing the evaluation process and creates major impediments to the legality of such transaction.
 - c. The nature and legal status of the employee shareholding association
The employee shareholding association as a unique investment body is registered as an association. Usually, an association is not profit seeking in nature and the *Company Law* has strict qualification restrictions on the establishment of an investment company. An employee shareholding association is a typical investment organization without any business operation, thus highlighting the conflicts between the *Company Law* and other laws.

- C. Treatment of the employee shareholding association
The *Notice on Stopping Issuance of Share Certificates of Internal Staff and Workers* (November 25, 1998) provides that all companies limited by shares no longer issue share certificates of internal staff and workers. The CSRC is negative towards the listing of the companies limited by shares still having employee shareholding associations. As a result, before the establishment of the company limited by shares, the situation of share holding by employees of the old company must be taken care of as follows:

- a. Stock transfer
- b. Revocation by the Administration of State Assets' original approving the establishment of and share holding by such employee shareholding association
Resulting issues: How to compensate the employees.

D. Implementation of the employee shareholding association and option

Incentive arrangement of employee share holding and stock options of the listing company share some common characteristics and are faced with similar legal barriers such as capital substantiation. Since the company does not adopt authorized capital system, it cannot issue shares to employees (or senior management) and employees must get shares through stock transfer or capital increase. As a result, it becomes more difficult to set up options.

2. Avoiding major capital restructuring

The Guiding Opinions on the Restructuring and Reorganization of Companies Intending to List issued by the CSRC (draft for comments) requires:

- A. The company of limited liability to be converted as a whole into a company limited by shares for listing must enter the company to be listed as a whole with the old company's business, assets and debts without separating the business and assets from the old company. The following conditions must be satisfied:
 - a. Use the audited net asset value as the basis to be converted to stock. If asset evaluation was conducted before the conversion and company books were adjusted based on the evaluation, no double count of the achievements of the old enterprise;
 - b. There should be reasonable basis for the premium multiplier of the new investment for the increase of capital or shareholders one year before the initial public offering.
- B. Without special permission, establishment of two or more listing companies of identical or similar business in the same enterprise group is not allowed.
- C. If major asset (including stock) purchase and replacement, acquisition (including merger), or sale or increase or decrease of capital by the company to be listed took place in the past 3 years (if the new company is less than three years old, include such information of the old enterprise), especially if the above activities led to any change in the majority shareholder or in 1/3 of the senior management of the company to be listed, the company should at least independently operate for one full accounting year after the changes mentioned above before submitting its application for listing.

- D. If the volume of assets (stock) purchase and replacement, acquisition or sale, or increase or decrease of capital exceeds 70% of the total volume of the company to be listed and the major business of the company has changed, the company should at least independently operate for 3 full accounting years after the changes mentioned above before submitting its application for listing.

The regulations above greatly increase the difficulty for small and medium-sized enterprises to list and finance through restructuring and reorganization in terms of the subjects qualified for such listing and financing.

3. Independent operation of the investing company and joint venture companies

X Company Limited and all its joint venture companies share the same business premises. X Company Limited controls the production and sales and, to cut costs and expenses, X Company Limited share one set of management system and supporting facilities including water, electricity, security, food services, etc. with other joint venture companies

Solution: Sign a related-party transaction agreement and agreement to ensure supporting services and clearly divide costs and expenses.

4. Requirements for the main business of the company of intended listing

X Company Limited set up 4 joint venture companies through investment to enjoy the preferential policies on the import of raw materials and taxation with majority of its production moved to the joint venture companies. As a result, X Company cannot meet the requirements of “prominent main business, stable income sources, and competitive core business” etc. required by the CSRC in the *Guiding Opinions on the Restructuring and Reorganization of Companies Intending to List* (draft for comments).

Solution: Purchase all the shares held by foreign investors in a certain joint venture company and convert the joint venture company into a subsidiary of X Company Limited.

5. Issues related to the qualifications of the founding members

Before a company of limited liability can be converted into a company limited by shares, it must make the adjustment to have at least over five founding members.

The old shareholders (now just a shell) have legal problems regarding the restriction that their investment in other companies cannot exceed 50% of their net assets.

6. Issues related to the legality of business operation

Legal consequences of exceeding the business scope. How to correct the situation of operation exceeding the business scope? How to determine the nature of the experimental operation exceeding the business scope before the expansion of the business scope?

How to interpret Article 12 of the Company Law in the case of investment of over 50% in other companies? How to deal with the consolidated statements of an enterprise group?

(The end)

Report on Development of Financing Policies and Mechanisms
for
Small and Medium-sized Enterprises
(Legal)

Prepared by JUN HE Law Offices

As of September 26, 2001

Definition and Classification of Small and Medium-sized Enterprises (SMEs) and Scope of this Report and Study

1. Classification of Small-and-medium Enterprises

Classification Standards on Big, Middle and Small Industry Enterprises (the “Classification Standards”) issued by the ex State Economic and Trade Committee is the current standards for classifying the scales of enterprises. The Classification Standards is currently under revision. It is reported that the revised Classification Standards will base the classification on the gross annual sales and the total capital of an enterprise. A large enterprise will have over five hundred million yuan RMB (¥500,000,000) for the gross annual sales and the total capital respectively. Enterprises with the annual sales and the total capital ranging from RMB 50,000,000 yuan to RMB 500,000,000 yuan fall under medium enterprises. Small enterprises include all the rest.

This report is not limited by the above classification and, instead, focuses on the SMEs with annual sales under RMB 10,000,000 yuan or RMB 20,000,000 yuan, relatively small in size and insignificant for a certain trade or region.

2. Classification of Small and Medium Enterprises

China has undergone two phases in the classification of SMEs. Before the promulgation of the Company Law in 1993, China classified enterprises according to the forms of ownership and divided enterprises into state enterprises, collective enterprises, private enterprises and three types of foreign funded enterprises (i.e. equity joint ventures, contractual joint ventures and solely foreign funded enterprises). With the promulgation of the *Company Law of the People’s Republic of China* (“PRC”)(the “Company Law”) as the division line, China began to classify enterprises on the basis of their organization format. China now has established its enterprise law system with the *Company Law of the People’s Republic of China* (“PRC”)(the “Company Law”), the *Partnership Enterprise Law of PRC* (the “Partnership Law”) and *Law of PRC on Individual Sole Investment Enterprises* (the “Sole Investment Law”) as the core.

Enterprises are classified into corporations, partnerships, individual proprietorships and cooperative stock enterprises as well as the three types of foreign funded enterprises governed by the special company law, i.e. the *Law of Foreign-Invested Enterprises*.

3. Scope of the Report

This report analyses the critical legal issues in the financing practice of different kinds of SMEs from the perspectives of basic systems of Chinese Company Law and financing through issuance of stocks and bonds. The report also makes some legislation recommendations for the reference of the related authorities.

Legal Background SME Financing – Basic Company System

I. Capital System

1. Minimum Registered Capital

(1) Legal Requirements

According to Article 23 of the Company Law, “The registered capital of a limited liability company shall be the amount of the paid-up capital contribution of all its shareholders as registered with the Company Registration Authority.” “The registered capital of a limited liability company shall be no less than the following minima: a. RMB 500,000 yuan for a company engaged mainly in production and operation; b. RMB 500,000 yuan for a company engaged mainly in commodity wholesale; c. RMB 300,000 yuan for a company engaged mainly in commercial retail; and d. RMB 100,000 yuan for a company engaged in science and technology development, consultancy or services.”

According to Article 78 of the Company Law, “The registered capital of a joint stock limited company shall be the total amount of paid-up share capital as registered with the Company Registration Authority.”

According to Article 152 of the Company Law, a joint stock limited company applying to have its shares listed and traded must have the total amount of the company’s share capital of no less than RMB 50,000,000 yuan

(2) Impediments:

- a. The minimum required registered capital is too high which imposes a high threshold for the establishment of SMEs detrimental to fully mobilizing nongovernmental capital and to attracting foreign investment.
- b. Since only SMEs with RMB50,000,000 or more registered capital are qualified to have its stocks listed and traded, a considerable number of SMEs with relatively satisfactory achievements cannot meet such requirements for the establishment of a listed company. As a result, inefficient mergers and

acquisitions and restructuring are conducted to make up the legally required minimum registered capital, resulting in the decline of capital quality and profit per share.

(3) Legislation Recommendations:

Lower the threshold of registered capital to lower the threshold of establishing SMEs.

2. Methods of Capital Subscription

(1) Legal Requirements

- a. According to Article 24 of the Company Law, “A shareholder may make its capital contributions to a company in currency or by contributing material objects, industrial property rights, non-patented technology and land-use rights at their appraised value.”
- b. Article 24 of the Company Law also states “The investment in the form of industrial property rights and non-patented technology at their appraised value shall not exceed twenty percent of the registered capital of a limited liability company, except where special State regulations in respect of the application of high and new technological achievement provide otherwise.”
- c. According to the *Notice on Certain Policies of the State Economic and Trade Commission Encouraging and Promoting the Development of Small and Medium Enterprises Redistributed by the State Council* issued on August 24, 2000, “in order to encourage various investors to invest in the establishment of small and medium enterprises in the form of technology and other production elements, the appraised value of such investment can reach thirty-five percent of the total registered capital (except otherwise stipulated).”

(2) Impediments

- a. Lack of stipulations on investment in the form of stocks or creditor’s rights.
- b. Indefiniteness exists in practice with regard to the ownership of intangible assets and imposes impediments to the future SME financing.
- c. There are no clear laws governing the evaluation and verification of the intangible assets investment. There exist in practice unsubstantiated registered capitals.
- d. In practice, the protection for the trade secrets and other intellectual property of SMEs is insufficient which leads to insufficient protection of the investor interest.

(3) Legislation Recommendations

- a. Clearly define the scope and classification of the intangible assets used in investment
- b. Improve the regulations upon the ownership and evaluation system;
- c. Improve the legal rules penalizing fraud, forgery, and other deceptive activities in the process of capital subscription.
- d. Improve legislation to strengthen the protection of trade secrets and other intellectual property.

II. System of Examination and Approval

1. The system of examination and approval mainly concerns companies limited by shares incorporated under the Company Law and foreign invested enterprises incorporated under the Law of *Foreign Invested Enterprises*.

(1) Legal Requirements

Article 77 of the Company Law provides that “The establishment of a company limited by shares shall be subject to the approval of a department authorized by the State Council or of a People’s Government at the provincial level.”

Article 183 of the Company Law provides that “The merger or division of a company shall be subject to the approval of a department authorized by the State Council or of the People’s Government at the provincial level.”

Article 139 of the Company Law provides that “After a resolution to issue new shares has been adopted by the shareholders’ general meeting, the board of directors must apply for approval to a department at the provincial level.”

Article 6 of the *PRC Wholly Foreign-owned Enterprises Law* provides that “An application for establishment of wholly foreign-owned enterprises shall be submitted for examination and approval by the State Council department in charge of foreign economic relations and trade or an organization authorized by the State Council.”

Article 3 of the *PRC Sino-foreign Equity Joint Venture Law* provides that “Joint venture agreements, contracts and articles of association concluded by the parties to a joint venture shall be reported to the state foreign economic relations and trade administrative department for examination and approval.”

Article 5 of the *PRC Sino-foreign Co-operative Joint Venture Law* provides that “Applications for the establishment of co-operative ventures shall be made by submitting for approval to the responsible foreign economic relations and trade departments of the State Council or departments authorized by the State Council and regional governments such documents as agreements, contracts and articles of association entered by the Chinese and foreign venturers.”

(2) Impediments

- a. According to current regulations, the establishment, division, merger, and new shares issuance of the company limited by shares shall be approved by the examining and approving authorities. The strict administration limits the

financing channels of the SME companies limited by shares and increases financing cost.

- b. The establishment, capital expansion, shares transfer and other changes of foreign invested enterprises shall be approved by the examining and approving authority, therefore, increase the financing cost of middle-and-small foreign invested company.

(3) Legislation Recommendations

- a. Simplify the investment procedures to establish companies, and consider to gradually implement the system of review and examination by registration, for instance, first adopt such system to the encouraged investment fields.
- b. Strengthen supervision over companies by independent agencies and the society. Create a more open environment for the SMEs to give full play to their advantage of their operation flexibility.

2. Scope of Business

(1) Legal Requirements

Article 11 of the Company Law provides that “The scope of business of a company shall be specified in its articles of association and shall be registered according to law. Items within the scope of business of a company that are subject to restriction under laws or administrative regulations shall be approved according to law. Companies shall engage in business activities within their registered scope of business. A company that amends its articles of association in accordance with statutory procedures, may change its scope of business following change of registration by the company registry.”

Article 71 of the *PRC Administration of Company Registration Regulations* provides that “If a company engages in business activities out of its approved scope of business, the registry shall order it to make corrections and may impose on it punishment from RMB 10,000 yuan to 100,000 yuan; if its breaches are serious, the registry shall revoke the company’s business license.”

(2) Impediments

- a. The above provisions increase the costs of businesses and capital restructuring of SMEs and restrict the financing efficiency.
- b. The above provisions limit the flexibility in business activities of SMEs and lower their risk resistance abilities.

(3) Legislation Recommendations

- a. Adopt more flexible administrative systems and loosen the restrictions on the scope of business.
- b. Adopt the business scope administration of “all businesses permissible unless special approvals required.”

3. Outside Investment Ratio

(1) Legal Requirements

Article 12 of the Company Law provides that “If a company, other than an investment company or holding company as specified by the State Council, invests in other limited liability companies or companies limited by shares, the aggregate amount of such investments may not exceed 50 per cent of the investing company’s net assets. After an investment had been made, the increase therein resulting from capitalization of the profit derived from the company invested in shall not be included.”

(2) Impediments

Investments to SMEs for the purpose of their capital and share expansion are restricted by the above provision.

(3) Legislation Recommendations

Cancel or loosen the restrictions on outside investment ratio according to the international practices.

4. Taxation

(1) Legal Requirements

Currently, China already has some policy documents providing tax preferential treatment to SMEs, for example, the *Several Policy Opinions on Encouragement and Promotion of Development of Small-and-Medium Enterprises* (the “Policy Opinions”) issued by the State Economic and Trade Commission on July 6, 2000. Article 9 of the Policy Opinions provides “All domestic investment by middle-and-small enterprises invested in the technological reform projects which meet the requirement of state industry policy may enjoy the treatment that the investment can offset the enterprise income tax according to the regulations. Specific measures shall be implemented according to the unified state regulations. Laid-off workers from state-owned enterprises who establish middle-and-small enterprises may enjoy tax reduction or exemption treatment. In order to encourage the development of the SMEs, research should be accelerated to lessen small-scale taxpayers’ burden of industry and enterprise value-added tax. To the non-profit credit guarantee and re-guarantee institutions in the national pilot range whose purposes are to serve SMEs enterprises, their income from business of security may be exempt from business tax for three years with the confirmation of local governments.”

(2) Impediments

- a. The preferential tax treatments to SMEs are not clear and specific enough.
- b. Tax policies at different places are not consistent. As required by the *Notice on Prohibition against Enterprise Income Tax Reduction and Exemption Beyond Authority* by the Ministry of Finance and State Administration of Taxation in 1998 and the *Notice on State Council’s Correction of Local Governments’ Policy of Tax Collection First and Refund Later* by the State Council in 2000, the tax policies shall be consistent, and it is not allowed for local governments at all levels to exempt and/or reduce tax beyond their authorities.

(3) Legislation Recommendations

- a. Unify local preferential tax treatments.
- b. Legislate specific and clear laws and regulations applicable to SMEs preferential tax treatments and tax collection and administration.

SME Equity Financing

This part mainly summarizes and analyzes the practical hurdles of SME equity financing, and tries to provide legislation recommendations.

I. Equity Financing by Private Placements

1. New Investors

(1) Impediments

- a. Limitation upon the proportion of a company's outside investment by the Company Law.
- b. Lack of sufficient protection for investors: in practice, the founding investors and core technicians of a SME, specially of a private SME, usually tend to be a close group which tend to create some difficulties for participation of new investors. At the same time, the stipulations of the Company Law concerning the protection of minority shareholders and the structure of corporate governance tend to be too general to give sufficient protection to new investors. Besides, the approach of agreement protection is also insufficient, for the Administrations for Industry and Commerce are normally inclined to approve the articles of associations that have similar contents and words to those stipulated in the Company Law.
- c. Lack of sufficient protection of minority shareholders: currently, both Company Law and regularly approved articles of associations, lack any specific stipulations on cumulative voting, connected transactions, and the indemnification by shareholders and by the management of a company. As a result, the power balance and protection mechanisms for the shareholders, especially minority shareholders, are very weak.
- d. PRC individuals are not qualified in their personal capacity to invest in foreign-investment enterprises (the "FIEs").
- e. Restrictive access barriers imposed by industry to foreign and domestic private investment.
- f. Currently, there are no regulations on classified shares (e.g. the preferred shares).

(2) Legislation Recommendations

- a. Add relevant stipulations to the Company Law or in separate SME regulations for the protection of investors and especially minority shareholders.
- b. Permit to issue the classified shares (e.g. preferred shares) to attract risk-averse investors.
- c. Loosen the limitations on PRC individuals' investing in FIEs.
- d. Simplify the procedures required for SMEs' capital or equity modifications, and reduce the costs of such modifications.

3. Capital Withdrawal Mechanisms under Equity Financing

(1) Approaches

- a. share transfer;
- a. reduction of the registered capital;
- b. judicial enforcement; and
- c. bankruptcy and liquidation; etc.

(2) Impediments

The current Company Law and the relevant laws and regulations do not provide specific requirements and procedures for registered capital reduction. In practice, it is not very likely for an investor to withdraw investment by capital deduction due to the hurdles such as administrative approval.

(3) Suggestions

- a. Add specific requirements and procedures of the reduction of registered capital in Company Law and the relevant laws and regulations;
- b. Broaden approaches of investment withdrawal;
- c. Decrease the barriers imposed by administrative approval and increase opportunities for SME financing.

(4) Investment Fund

According to the investment target, China's current investment funds mainly include securities investment fund, industry investment fund and venture capital fund. The securities investment fund refers to an collective investment approach of benefit and risk sharing. The industry investment fund refers to an investment approach that provides direct financial assistance to unlisted enterprises with involvement in capital operation and supervision and ultimately realizes high returns through share transfer transactions. The venture capital fund refers to a special risk investment to small and medium technological enterprises with a goal to foster their development. The

investment funds can be raised in two forms: public offering and private placement. The investment funds shall be managed by fund managers.

II. Public Offerings

1. Main Approaches

a) Listing of domestic investment shares inside China (i.e. A Shares):

According to the Company Law, to apply for approval to list its shares, a company limited by shares must satisfy the following conditions: the total share capital of the company is no less than RMB 50,000,000 yuan with more than three years or more in business operation and profitable for the past three years.

b) Listing of foreign investment shares inside China (i.e. B Shares)

According to the State Council, Listing of Foreign Investment Shares inside China by a Company Limited by Shares Provisions¹, when applying for approval to issue foreign investment shares listed inside China for the establishment of a company by means of a share offer, the total amount of the sponsors' capital contributions shall be not less than RMB 150,000,000 in addition to other requirements provided in the PRC Company Law; where a company applies for approval to issue foreign investment shares inside China in order to increase its capital, it shall also comply with the requirements such as the company's total net asset value is no less than RMB 150,000,000.

c) Issuance of shares for capital increase by “shell purchase”

A company can acquire the equity of a listed company, and raise capital for newly injected business through issuing shares.

d) Listing outside China;

Article 155 of the Company Law provides “Upon approval by the State Council’s department for the administration of securities, a company may be listed outside the PRC. The specific measures shall be provided for by the State Council in special regulations.”

Article 29 of PRC Securities Law provides that, “Where a domestic enterprise wishes to issue securities directly or indirectly outside China, or wishes for its securities to be listed and traded outside China, this must be ratified by the securities supervision and administration body of the State Council.”

Other important regulations concerning listing outside the PRC are:

¹ Passed by the State Council on 2 November 1995, promulgated on and effective as of 25 December 1995.

*State Council, Further Strengthening Administration of the Issue and Listing of Shares Outside China Circular*² (i.e. the “Guidance of Red Chip”); and

*Further Standardizing Operations and Intensifying Reform of companies listed Outside China Opinion*³.

Moreover, a company listed on various securities markets shall also comply with the different requirements of these markets respectively. The shares and securities markets for listing outside China include, H Shares, Hong Kong Growth Enterprises Market (the “GEM”), and N Shares, etc.

e) Listing outside China with domestic interest;

Article 29 of the PRC Securities Law provides that, “Where a domestic enterprise wishes to issue securities directly or indirectly outside China, or wishes for its securities to be listed and traded outside China, such transaction must be ratified by the securities supervision and administration body of the State Council.” Since the “indirect issue” is not given a specific definition, CSRC therefore has liberal discretion to give its opinions upon this issue.

According to Articles 2 and 3 of the Guidance of Red Chip, if Chinese-funded, non-listed companies registered outside China and Chinese-funded-controlled-Listed Companies Registered Outside China apply for the issue and listing of shares outside China by using assets that they own outside China and those assets inside China which are formed from the investment of their assets outside China and which they have actually owned for not less than three years, the matter shall be handled in accordance with local law; however, the domestic work units that hold the share rights in the above-mentioned companies shall obtain the prior consent of the State Council, according to its subordinate relationship. Those of such companies’ assets inside China which they have actually owned for less than three years may not be included in the application for issue and listing of shares outside China, unless there is a special need to do so, in which case the matter shall be examined by the China Securities Regulatory Commission and subsequently examined and approved by the State Council Securities Commission. Following the completion of the listing activity, the domestic work units that hold the share rights in the Chinese-funded controlling shareholder shall report the relevant information to the CSRC for the record.

In any case where assets of an enterprise in China are to be transferred to a Chinese-funded, non-listed company registered outside China or a Chinese-

² Promulgated by the State Council on, and effective as of, 20 June 1997.

³ Issued by the State Economic and Trade Commission and the China Securities Regulatory Commission on 29 March 1999.

fund-controlled Listed Company Registered Outside China by means of acquisition, exchange of shares, allocation or any other means for the purpose of listing outside China, or where assets inside China are first to be transferred to a Chinese-funded controlling shareholder shall obtain the prior consent of the provincial-level People's Government or the relevant competent authority of the State Council, according to its subordinate relationship, whereupon the matter shall be examined by the State Council Securities Regulatory Commission and subsequently examined and approved by the State Council Securities Commission according to the industrial policies of the State, the relevant regulations of the State Council and the total annual quota.

Since there is no specific definition of "Chinese-fund", it is not clear whether the "domestic work units that hold the share rights" include individuals. Additionally, in practice, there are no specific approval procedures at provincial-level people's governments for individual's application of listing outside China, and there are no laws or regulations for listing outside China by private enterprises or individuals who has PRC nationality. Due to the above circumstances, CSRC issued the *Issue and listing of Shares Outside China by Oversea Companies Related with Domestic Interest Circular* on June 9, 2000 to clarify its approval authority. In practice, CSRC will issue a "no dissent" approval where it has no dissenting opinion upon a case of listing outside China.

2. Hong Kong GEM, Contemplated Domestic "GEM", and SME Public Offerings

(1) Introduction

The name of the domestic "GEM" has experienced a series of modifications from "Hi-tech enterprises market", "second exchange system" and finally to "GEM." These modifications indicate the trend of enlarging eligible scope of enterprises listing on this market and of reducing the administrative intervention with the market.

(2) Impediments to the establishment of the domestic "GEM"

- a. Amendment of Company Law is the precondition of establishing domestic "GEM."
- b. Besides the conflict of regional interests, the essential reasons for the delay of establishing domestic "GEM" are the immaturity of domestic capital market and lack of fund. Moreover, the current low tide of NASDAQ and Hong Kong GEM also affected the establishment of the domestic "GEM".

(3) Suggestions: Combining the domestic and Hong Kong GEM

The domestic "GEM" will definitely constitute competition with the Hong Kong GEM after its establishment. While domestic market is confronted with a lack of fund, Hong Kong GEM has also experienced difficulties resulting from solely relying on Hong Kong and Bermuda companies. Therefore, we suggest

combining the domestic and Hong Kong GEM and loosening the listing requirements for the domestic enterprises.

3. Limitation on listing outside China (including Hong Kong) by domestic enterprises
Since an enterprise listed outside China will consequentially turn into a FIE, it therefore has to comply with the *Guidance Catalog of Foreign Investment Industries*, which means it will not be allowed to conduct certain businesses, such as the telecommunications value-added business (e.g. ISP and ICP).

(4) Domestic public offerings of Foreign Investment Companies Limited by Shares

a) Legal Requirements

According to Article 2 of the *Relevant Questions on the Foreign Investment Companies Limited by Shares Circular* issued by Ministry of Foreign Trade and Economic Commission (“MOFTEC”) in 2001, when an existing foreign investment company limited by shares applies to issue A shares or B shares, it shall obtain a written consent of MOFTEC and shall meet the following requirements:

- a. The company shall comply with the requirements of current foreign investment policy prior to and after the listing.
- b. The company must be incorporated in accordance with due procedures.
- c. The non-listed equity of the company shall be no less than 20% of the total share capital after listing.
- d. The company shall also comply with other relevant requirements provided by the relevant laws and regulations.

b)

According to the Company Law, a company applies for listing must be a company limited by shares. Therefore, a limited liability company must change into a company limited by shares before it can be listed.

According to the Company Law and relevant regulations of CSRC, when a limited liability company changes into a company limited by shares, it shall satisfy the following requirements:

- a. The business, assets, claims and debts of the original company shall be wholly inherited by the company limited by shares, and it is not permitted to peel off the business and assets of the original company.
- b. The company shall convert shares at a ratio of 1:1 based on its audited net assets.
- c. The company cannot adjust its accounting based on the evaluation value of assets. Otherwise it cannot cumulatively calculate the profits of the original limited liability company.

(2) Impediments

According to Article 15 of the *MOFTEC, Certain Questions on the Establishment of Foreign Investment Companies Limited by Shares Tentative Provisions*⁴, if an established FIE wished to apply for conversion into a company limited by shares, it shall have a record of profitability for the last consecutive three years. Legislation Recommendations

The above-mentioned legal requirements are very stringent, and they actually constitute a relatively high threshold for foreign investment and Hi-tech SMEs. We suggest shortening the minimum profitable period for a FIE to convert into a company limited by shares.

Debt Financing

This part mainly summarizes and analyzes the practical hurdles of SME debt financing, and tries to provide corresponding legislation recommendations.

I. Loan of Domestic Bank

1. Loan of Domestic Bank

(1) Legal Requirements

Both current *People's Bank of China, General Loan Provisions* and bylaws of domestic banks provide strict requirements for applying loans by various enterprises. SMEs have to overcome many practical hurdles to obtain loans from domestic banks.

(2) Impediments

- a. Traditionally, the state-owned commercial banks loan money and provide other services to only big and medium state-owned enterprises. These banks think that they may have to take relatively high risks to develop the financing service market for SMEs because most SMEs are small and without good credit. On the other hand, due to the strict risk management system of the banks, the staff in charge of loans has to bear substantial responsibility for the loans they grant. Therefore, the staff in charge of lending is only willing to loan the money to big enterprises with good credit record. Therefore, the SMEs can hardly obtain loans from domestic banks.
- b. Lack of small and medium banks mainly serving SMEs.
- c. In order to improve bank service for SMEs, the People's Bank of China issued *Further Improving Financing Service for SMEs Opinion* in 1998, and *Guidance on Further Strengthening and Improving Financing Service for SMEs Opinion* in 1999. In these opinions, the People's Bank provided general guidance for improving SMEs financing service. However, since there was still no specific and stable policy support to benefit SMEs, the incentive is still not enough.

⁴ Promulgated by the Ministry of Foreign Trade and Economic Co-operation on, and effective as of, 10 January 1995.

(3) Suggestions

Uniform, definite, and steady preferential fostering policies regarding loan to SMEs should be stipulated in related laws and regulations so as to give commercial banks incentives to loan SMEs.

2. Credit System of SMEs

(1) Legal Requirements

In April 2001, ten ministries and commissions including the State Economic and Trade Commission (“SETC”) promulgated *Strengthening Credit Management of SMEs Several Opinions* (the “Several Opinions”). The Several Opinions points out that a united information collection and credit evaluation system shall be established among all levels of administration of economy and trade, finance, financial institutions, tax, industry and commerce, supervision of quality and technology, customs, foreign exchange, public security and so on. This is intended to make the query and communication of SMEs credit materials widely available to the society.

(2) Impediments

Currently, there are no well-established credit system and corresponding files for enterprises and entrepreneurs. Consequently, it is difficult for banks to conduct comprehensive investigations on credit conditions of SMEs. The information collection and establishment of credit evaluation system are still in their infancy.

(3) Legislation Recommendations

Establish credit evaluation system based on the shared resources pools of all related administrations and encourage the development of non-government credit evaluation institutions.

3. Credit Guarantee System of SMEs

In order to reduce loan risks, banks generally require debtor to provide mortgage or reliable guarantee for the loan. SMEs, of small scale and limited assets for mortgage, can hardly find qualified guarantors as required by banks. A series of laws and regulations have been promulgated to establish credit security system for SMEs. Though some progress has been made, the credit security system is still haunted by insufficient funds and restricted by complex examination and approval procedures. Therefore, in practice, there are few cases that SMEs got loans through such security.

Please "Report on Credit Guarantee System for Small and Medium-sized Chinese Enterprises" in this memorandum.

II. International Commercial Loan

1. Legal Requirements

- a. According to the *Administration Procedures of Taking Out of International Commercial Loans by Organizations in China* and other relevant laws, the strict qualification requirements and approval procedures shall be applied to the organizations in China borrowing international commercial loans;
- b. In addition, the *Administration Procedures of the Provision of Security to Foreign Entities by Domestic Institutions* strictly limits the conditions and qualifications for the domestic entities providing security to foreign entities.

2. Impediments

The above legal requirements make it difficult for SMEs to get loans from foreign entities. In reality, it is very hard for SMEs to obtain foreign capitals in the form of loans.

3. Legislation Recommendations

Relax the requirements for the registration of foreign loans, the control upon the quotas and the security to the foreign entities so that the competent SMEs may get international commercial loans.

III. Loans between Enterprises

1. Direct Loans Between Enterprises

(1) Legal Requirements

Chinese laws currently prohibit direct loans between enterprises. According to the judicial interpretation of the Supreme Court of the P.R.C., the borrowing or lending contract between enterprises violates the relevant financing regulations and is void. In addition to the return of the principal, the interests gained or agreed to be gained by the lender shall be confiscated and a fine of the amount equal to the amount calculated by the bank interest rate shall be imposed on the borrower.. The court shall collect the interest for the period between the original due date of the loan to the date set by the court for the borrower to return the principal. Such interests shall be calculated based on the interest rate originally agreed upon in the loan contract by the lender and the borrower. Otherwise, the interest rate of the loan shall be calculated based on the interest rate of the bank loan during the same period if the lender and the borrower have not agreed upon such interest rate.

(2) Impediments

The above requirements make it impossible for SMEs to get loan from big enterprise and, to some degree, affect the flow of capital and its effective utilization.

(3) Legislation Recommendations

Properly regulate inter-enterprises loans and improve relevant laws.

2. Trust Loan

(1) Legal Requirements

In accordance with the related laws, an enterprise may provide loans to other enterprises through a trust and investment company in the manner of trust loan. Namely, the enterprise provides the fund to the trust and investment company (the trustee) which gives the loan to another enterprise according to the target, use, sum, term, interest rate of the loan specified by the fund provider. The trust and investment company is responsible for supervision of the loan use by the debtor and provide assistance in reclaiming the loan. The fund provider shall give the trustee some procedure fees. But the trustee shall not assume any payment and relevant security obligations for the loan.

(2) Impediments

To our knowledge, there are many legal disputes in China over trust loans so that domestic trust and investment institutions are unwilling to deal in such business. The main reasons for such disputes and unwillingness are as follows: the arrangement of the trust loan by enterprises and the trust and investment institutions is too flexible and the rights and obligations involved are vague. In order to attract deposit, some trust and investment institutions even give the fund providers improper promises such as security of payment of loans.

(4) Legislation Recommendations

- a. Further strengthen the standardization of the trust loan business conducted by trust and investment institutions.
- b. Specify the punishment rules for malpractice of trust and investment institutions.

IV. Bond Financing

Legal Requirements

Due to the occurrence of illegal money collection, the currently applicable *Administration rules of Enterprise Debenture* adopts strict quota control and stipulates examination and approval systems regarding enterprise bonds

2. Impediments

- a. The threshold for the issuance of enterprise bonds is too high;
- b. Bond issuance is subject to administration of the State Economic Plan Commission, People's Bank and CSRC, and the procedures of application for issuance are very complicated.
- c. Subjects of bond issuance are mainly limited to big-sized state owned enterprises, and SMEs have no access to such financial instrument.

2. Legislation Recommendations

Consummate relevant legislations, expand financing channels of SMEs.

V. Government Financial Support

Legal Requirements

In May 1999, Ministry of Science and Technology, Ministry of Finance promulgated *MST, MOF, Science and Technology SMEs Innovation Fund Tentative Rules* which stipulates the establishment of the special governmental fund for science and technology innovation projects conducted by SMEs of science and technology in nature. This fund consists of central governmental appropriation and the interests derived thereof. The eligible enterprise may get discount interest loans or grants.

3. Impediments

The government fund is focused on science and technology SMEs. The government support for traditional SMEs is lacking.

4. Legislation Recommendations

Consummate legislation on governmental fund and strengthen the governmental fund support to the traditional SMEs with great potentials.

Conclusion The key to the consummation of the SMEs financing legal system includes:

1. Reduce unnecessary governmental intervention so as to give the SMEs financing a free and favorable environment, and bring SMEs' advantage of flexibility to full play.
2. Consummate relevant legislations to clarify and specify the support policies of SMEs financing, and change the unpredictability, fluctuation and human interference of policies, and guarantee the continuity, standardization and stability of the policies in support of SMEs and enhance the efficiency and force of such support.

In summary, the fundamental requirement for the consummation of SMEs financing legal system is to build clear, favorable and fair legal environment.

Report on China's Investment Funds

Prepared by JUN HE Law Offices

As of September 26, 2001

1. Definition of Investment Funds

Generally speaking, a fund means a capital item reserved for the purpose to start, maintain or develop an undertaking. In a legal sense, the definition of "fund" is relatively complicated. The following introduces funds from the the perspectives of their origins, managing organizations and uses.

1.1. Foundation

According to the *Administrative Rules on Foundations* issued by the State Council implemented on September 27, 1988, a foundation means a nongovernmental non-profit organization in the form of a mass organization as legal person, whose purpose is to manage the funds donated by foreign and domestic social organizations, and other organizations and individuals. The goal of a foundation is to foster the development of scientific research, cultural education, social welfare and public interest undertakings. A foundation may deposit the funds in a financial institution for interests, or purchase securities such as bonds and stocks, with the restriction that the stocks of an enterprise purchased by the foundation shall not exceed 20% of the total stocks of the enterprise. A foundation shall not run an enterprise.

1.2. Foundation and other project-specific fund management organizations established through state funds

The *Administrative Rules on Foundations* shall not apply to foundations and other project-specific fund management organizations established through state funds, such as the agricultural development fund. According to the *Administrative Rules on Agricultural Development*, the fund sources of the agricultural development fund mostly come from various taxes, for instance, cultivated land occupation tax, major portion of the actual increase in the township enterprise taxes over that of the preceding year, major portion of the taxes on special local products of agriculture, forestry and aquatic products industry, etc. The allocation of the agricultural development fund is controlled by the management team of state land construction fund. On the local level, the allocation of the agricultural development fund is controlled by the agricultural development management teams. For the local areas without management teams, the allocation of the fund shall be arranged by related authorities under Ministry of Finance. The arrangements shall be filed with the governments at the same level for approval.

The agricultural development fund is administrated by project. The *Administrative Rules on Development Projects of Agricultural Development Fund* by the State Council (implemented on September 12, 1989) states that free economic aids shall be, in principle, given to non-business projects exclusively of social and ecological benefits. As for manufacturing and operational projects with direct economic benefits, compensated supports are generally provided and which will be paid back at a fixed date; and for projects with both of the above characteristics, the percentages of the free portion and compensated portion of the aid are determined on the basis of the economic yields of the project.

According to introduction made at the *Seminar on Development of Financing Policies and Mechanisms for Small and Medium-Sized Enterprises*, we think that the proposed Development Fund for Small and Medium Enterprises is similar to the agricultural development fund.

1.3. Investment Fund

According to the investment target, China's current investment funds mainly include securities investment fund, industry investment fund and venture capital fund. The securities investment fund refers to a collective investment approach of benefit and risk sharing. The industry investment fund refers to an investment approach that provides direct financial assistance to unlisted enterprises and engages in capital operation and supervision and ultimately realizes high returns through share transfer transactions. The venture capital fund refers to a special risk investment to small and medium technological enterprises with a goal to foster their development. The investment funds can be raised in two forms: public offering and private placement. The investment funds shall be managed by fund managers.

With the goal to enhance SME financing, we will focus our research on the investment fund.

2. Present Situation of China's Investment Fund

The China's investment fund industry came into being in the early 90's of the last century. Its appearance adapted to the reform of the investment system at that time. It raised funds for some locally invested projects and undertook some securities investment. The initial funds are all established through public offerings. Regulatory authorities did not impose strict limitations on the investment objects. There are many private placement funds in China now, but there are no corresponding laws and regulations to govern such funds. In terms of investment objects, China's current investment funds are only limited to securities investments. In terms of organization, the funds provided in law and actually existing nowadays are all contractual funds, not corporate funds.

2.1. Current status of China's investment fund laws

There is some legislation on investment funds in China now, which is far from perfect. Currently, lots of investment fund legislation is either being drafted or under deliberation. There are two ways of thinking in the investment fund legislation: one is to have separate legislation for securities investment fund, industry investment fund, and risk investment fund according to the investment objects; the other is to differentiate legislation for public offering funds and private placement funds according to fundraising methods.

Legislation, as for most of the existing laws and regulations and the laws and regulations currently being drafted, seems to have adopted the approach of classification by investment objects. The following is an introduction of each such legislation activity.

2.1.1. Securities investment fund

The State Council Securities Commission issued the *Tentative Rules on Securities Investment Fund Regulation* (the “Tentative Rules”) regarding the securities investment fund. The Tentative Rules regulates the fund establishment, fund raising and transaction; fund trustees and fund managers; rights and obligations of fund holders; investment operations and supervisions; and punishment, etc. The following highlights the main points.

- (1) Principal fund sponsors shall be securities companies, trust investment companies, and fund management companies incorporated under Chinese laws; each sponsor’s paid-up capital shall be no less than RMB 300,000,000;
- (2) When a fund sponsor applies for the establishment of a fund, he/she shall submit a fund contract and a trust agreement to CSRC;
- (3) A sponsor may apply for the establishment of either an open fund or a closed fund;
- (4) The term for a closed fund shall not be shorter than five years with the minimum amount of raised fund of no less than RMB 200,000,000;
- (5) After the establishment of a closed fund, its fund manager and/or fund trustee may apply to CSRC and a securities exchange for public trade of the fund;
- (6) A fund trustee must be a commercial bank examined and approved by CSRC and the People’s Bank of China;
- (7) Sponsors of fund management companies shall be securities companies, trust investment companies incorporated under Chinese laws; each sponsor’s paid-up capital shall be no less than RMB 300,000,000; the minimum paid-up capital of the proposed fund management company shall be RMB 10,000,000;
- (8) Fund holders have the right to attend or designate representatives to attend meetings of fund holders; to acquire information on fund yields and supervise the fund operation;
- (9) When a fund manager manages several funds, its total holding of securities issued by one company shall not exceed 10% of such securities; the ratio of a fund’s investment in state bonds shall not be lower than 20% of the net value of the fund;

- (10) Any placement of mortgage, guaranty, short-term loan, or loan on fund assets is prohibited.

According to the *Tentative Rules*, CSRC issued the *Pilot Measures on Open Securities Investment Funds*, which states in detail the establishment of open securities investment funds, responsibilities of fund managers, purchase and repurchase. The following are the main points.

- (1) Open funds shall be established by fund managers;
- (2) A fund may be established if its net sales value exceeds RMB 200,000,000 and its minimum number of subscribers reaches 100; the term of fundraising shall not exceed three months;
- (3) At the beginning of the establishment of an open fund, the fund contract and prospectus can stipulate that only purchase transactions are accepted, and not redemption during the stipulated term, but the term shall be no longer than three months;
- (4) An open fund may state its expected fund scale in its fund contract and prospectus and stop accepting purchasing applications when the expected fund scale is reached.
- (5) The amount of open fund units purchased and the price for redemption shall be calculated according to net unit asset value of fund as of the date of purchase and/or redemption plus or less relevant expenses.

2.1.2. Industry investment fund

According to the relevant sources of information, the legislation of China's industry investment fund has made great progress. The fifth draft of the *Tentative Measures on Industry Investment Fund Administration* (the "Measures") is pending for approval of State Council Office of Legal System. To our knowledge, the Measures, supplementary to the *Investment Fund Law* that will soon be approved, will regulate in detail the establishment, management, trust, investment operation, surveillance, termination, liquidation etc. of the industry investment funds.

2.1.3. Venture capital fund

Currently, there isn't any complete statute on venture capital funds. The State Council issued in 1999 a *Notice on Several Opinions Regarding Establishment of Risk Investment Mechanism Forwarded to Ministry of Science and Technology and Other Authorities by General Office of State Council*, which mentions that relevant authorities under State Council will set up detailed implementation measures on the establishment of venture capital companies and the application, examination and approval, administration of venture capital funds. Therefore, much needs to be done about venture capital funds such as deciding a basic mode of China's venture capital fund, enacting and consummating related statutes, creating a good policy environment, standardizing the activities of the main

subjects of venture capital investment, developing a mature multilevel stock trade market, and regulating mergers and acquisitions and the operations of agencies.

The Standing Committee of China's National People's Congress is drafting the *Investment Fund Law*. Issues concerning private placement fund and risk investment fund under close public attention are hopefully solved through the *Investment Fund Law*. It will, however, be a long-term process because many related legal issues are involved in the *Investment Fund Law* and the relevant contents in the *Company Law* and *Partnership Enterprise Law* need to be amended and consummated.

2.2. Major legal hindrances to the development of China's investment funds and proposed resolutions

It is already a common understanding that legislation should precede the development of China's investment funds. There are several legal issues awaiting solutions:

2.2.1. Forms of funds

China's current investment funds are all contractual funds. China's applicable laws and regulations have provided for neither corporate funds nor limited partnership funds.

(1) Corporate funds

Corporate funds are in the form of corporation; and raise capital by way of issuing shares. Ordinary investors subscribe shares of the corporation in order to purchase the fund, and thus become the shareholders of the corporation, enjoy the investment returns according to the shares held. The capital of the corporate fund is the assets of the corporate legal person. According to the articles of association of fund companies, the meeting of directors will entrust a special financial advisor or fund management company to operate and manage the fund. As proved in practice, the supervision of fund holders' meeting and trustees on fund managers is relatively weak in contractual funds. Corporate funds are comparatively stronger in supervising fund managers, protecting fund holders' rights, and stimulating healthy operation of the funds.

(2) Limited partnership funds

Partners of limited partnership consist of limited partners and unlimited partners. The limited partners shall be responsible for the liabilities of the partnership within their respective capital contributions. The limited partnerships are usually run by the unlimited partners. This form of partnership has its advantage in risk investment by combining unity of people with unity of capitals. It can attract the investment of those who are not good at corporate operation and are not willing to take unlimited responsibilities. Partners with unlimited responsibilities are

usually engaging in daily operation and will, as a result, pay close attention to the performance of the corporation. This form will support risk investors and technical personnel in the participation in business establishment.

To our knowledge, *Investment Fund Law (Draft)* will provide that investment funds may adopt the form of contractual, corporate and limited partnership funds.

2.2.2. Protection for rights of fund holders

The protection for fund holders' rights is the concern of investors, especially those minority investors. The current legislation on protection for minor investors is insufficient. The *Investment Fund Law (Draft)* will place such protection in the first place. It states that, in the fund operation, if an investor's right is harmed by the untrue disclosure of information, by operation violating relevant rules and by other related acts, the investor may claim for such damages. Therefore fund trustees, fund managers and agencies can be sued. Some scholars and professionals point out that the function of compensation mechanism shall be conditional upon the solution of other matters, such as the clarification of responsibility nature, burden of proof, clarification of litigation parties, and trial skills.

2.2.3. Standardization of private placement funds

Standardization of private placement funds is also under close public attention. To our knowledge, the legislative team of the *Investment Fund Law* has reached the following understanding about private placement funds:

- (1) Private placement funds shall be initiated and established by institutions; if individuals desire to establish funds, they shall incorporate companies as a precondition;
- (2) In the scope of private placement fundraising, the minimum of individual capital shall be RMB 200,000; institutional capital is RMB 1,000,000; the number of investors shall range from 2 to 200;
- (3) Advertising is prohibited for private placement funds fundraising. However, signs can be made at the gate of the company and introduction can be made at the company's website;
- (4) The forms of private placement funds shall be classified as contractual, corporate and limited partnership funds;
- (5) Relationships between funds and investors shall be defined in contracts or articles of association; supervisory authorities shall strictly examine such contracts or articles of association;
- (6) Two points of private placement funds shall be examined and approved: one is the establishment of the fund companies, the other is the establishment of the funds;
- (7) Capital of private placement fund invested in investment targets designated in the fund names (including three categories: securities fund,

industry fund and venture capital fund) shall not be lower than 80% of its total amount of capital;

- (8) Private placement funds shall periodically disclose information to their investors;
- (9) Private placement funds shall protect the interests of their investors.

The solutions of many issues in private placement funds await further discussion about the *Investment Fund Law (Draft)* among institutions participated in the legislation.

2.2.4. Relationship between the *Trust Law* and investment fund

The trust law is regarded as a law closely related to investment fund in any country. It is the legislative basis of other related laws and regulations including trust industry law and investment fund law. The *Trust Law* formulated by Standing Committee of National People's Congress came into force on October 1, 2001. The promulgation of the *Trust Law* will generate some positive effect on the legislation on investment funds. The *Trust Law* sets up a foundation for the legislation of the *Administrative Measures on Trust Investment Companies*. The *Trust Law* does not, however, function so directly on investment funds. Comparing with general trust contractual relationships, investment fund contractual relationship has its special attributes. According to the current practice in China, the difference between fund contractual relationship and trust contractual relationship is reflected in the following three aspects:

- (1) In terms of contractual parties, the parties of a fund contract are the fund holder, fund manager and fund trustee. The party who manages and uses the fund is the fund managing company, acting as the fund manager. The parties of a trust contract are the entrusting party, the trustee, and the beneficiary. In a capital trust, the trustee who is also the manager and user of the capital is the trust investment company.
- (2) The trust investment company, as the practical manager and user of the capital, manages or disposes the trust property in its own name for beneficiary's benefits or special purposes. The fund manager, however, cannot manage or dispose the fund in its own name; all the operations have to be conducted in the name of the fund.
- (3) The stipulation of rights and obligations of the parties in the fund contract or articles of association of the fund are the same to every fund holder; however, such stipulation in the trust contract is respectively made in detail with each entrusting party. The return of fund is equally allocated among all the fund holders according to the fund unit or other methods. The return of trust property is allocated among the entrusting parties according to the specific trust contract entered into with each entrusting party.

In addition, at the point of supervisory authority, the investment fund is respectively supervised by CSRC or industry investment authorities according to the business of the investment fund; and the trust industry is supervised by the People's Bank.

Therefore, it seems necessary to enact laws to regulate the investment fund contractual relationship or to make the adjustment range of the *Trust Law* applicable to the current fund contractual relationship.

Report on Credit Guarantee System
for
Small and Medium-sized Chinese Enterprises

Prepared by JUN HE Law Offices

As of September 26, 2001

I. Legal Structure regarding Current Credit Guarantee for Small and Medium-sized Chinese Enterprises

1. Laws, regulations, judicial interpretations and departmental rules containing general provisions on security
 - (1) Along with the strengthening of economic and trade contacts between China and the rest of the world, securities to domestic and foreign entities are used more frequently, from which more problems are arising gradually. Under such circumstances, China firstly strengthened its administration of security to foreign entities. The provision of security to a foreign entity by a domestic institute and the relevant administration of foreign exchange in connection therewith are stipulated in, and the competent examination and approval system has been established by, the *Interim Rules of the People's Republic of China on Administration of Foreign Exchange*, the *Interim Administrative Measures on Foreign Exchange Security*, the *Administrative Measures on Provision of Foreign Exchange Security by Domestic Institutes to Foreign Organizations* and other relevant local regulations.
 - (2) The *Security Law of the People's Republic of China* effective as of October 1, 1995 (the "Security Law") and the *Interpretations of the Supreme People's Court on Several Issues concerning Implementation of the Security Law of the People's Republic of China* effective as of December 8, 2000 (the "Judicial Interpretations") contain legal provisions on the general legal issues regarding security.
 - (3) Based on the foregoing legal provisions, security may be provided currently in China in the following five forms: guarantee, pledge, mortgage, lien and deposit. A property or a right of the property nature may be provided as a security, including without limitation, movable property, real estates and rights to or on a property.
2. Departmental rules on the credit guarantee system for small and medium-sized enterprises

The State Economic and Trade Commission established the Department of Small and Medium-sized Enterprises after the restructuring of the State Council in 1998. In the same year, the State Council decided to set up the leading committee of promotion of development of small and medium-sized enterprises throughout China and held the first meeting of such committee at which it was decided that the government would begin to support the development of small and medium-sized enterprises by first overcoming their difficulties in fundraising and obtaining security for loans. At the Nationwide Economic and Trade Convention held at the end of 1998, it was decided to organize and commence a pilot program for the establishment of the credit guarantee system for small and medium-sized

enterprises throughout China. The State Economic and Trade Commission, as well as other relevant departments of the State Council, issued a stream of departmental rules thereafter for the purpose of setting up, supporting and administering the credit guarantee system for small and medium-sized enterprises, mainly including:

- (1) *Guidance Opinions on the Pilot Program for Setting up the Credit Guarantee System for Small and Medium-sized Enterprises* issued by the State Economic and Trade Commission in 1999 (the “Guidance Opinions”)

The Guidance Opinions contains legal provisions on the establishment of the credit guarantee system for small and medium-sized enterprises in all aspects. The credit guarantee system for small and medium-sized enterprises is composed of institutes at municipal, provincial and national levels. The funds of a guarantee institute may be raised from such resources as the government budget, social collection, membership fees and share subscription. The guarantee shall be provided for small and medium-sized enterprises which have the development potential or which will contribute to increase of employment rate. The guarantee may be provided for bank loans, financial lease or other economic contracts. The procedures for providing guarantee include application by the debtor, evaluation of the credit of the debtor and the guarantee examination, etc.

- (2) *Opinions on Several Policies to Encourage and Promote the Development of Small and Medium-sized Enterprises* issued by the State Economic and Trade Commission in 2000 (the “Policy Opinions”)

The Policy Opinions is a guidance document for encouraging the development of small and medium-sized enterprises and contains principle provisions on speeding up the establishment of the credit guarantee system for small and medium-sized enterprises throughout China. The Policy Opinions requires the acceleration of the establishment of the credit guarantee system at the levels of central government, province and region (municipality) which mainly provides guarantee for small and medium-sized enterprises, those engaging in scientific and technological businesses, as well as establishing and improving the rules of entry, fundraising system, credit evaluation and risk control system and trade coordination and self-control systems applicable to the institutes providing guarantees. In order to promote the development of inter-enterprise guarantee and commercial guarantee business, the Policy Opinions requires the implementation of the pilot programs for providing guarantees and re-guarantees, explores the establishment of institutes providing credit re-guarantee for small and medium-sized enterprises in China, and provides re-guarantee service for the institute providing guarantee for small and medium-sized enterprises. The Policy Opinions also states that the income obtained by a non-profitable institute providing guarantee or re-guarantee for small and medium-sized enterprises from its guarantee business which has been included in the national pilot program shall be exempted from business tax for three years.

- (3) *Notice on Relevant Issues concerning Establishment of the Credit Guarantee System for Small and Medium-sized Enterprises throughout China* issued by the State Economic and Trade Commission in 2001

The notice was issued in order to accelerate the establishment of the credit guarantee system for small and medium-sized enterprises and stipulates the requirements of an institute to be covered by the credit guarantee system for small and medium-sized enterprises throughout China. After the issuance of the notice, the State Economic and Trade Commission issued the *Notice on the (First) List of Guarantee Institutes Covered*

by the Pilot Program for the Credit Guarantee System of Small and Medium-sized Enterprises Throughout China ([2001] No. 406) and listed 104 guarantee institutes in China in the pilot program for the credit guarantee system for small and medium-sized enterprises throughout China.

- (4) *Notice of the State Taxation Administration on Exemption of Excise Tax for Institutes Providing Credit Guarantee and Reguarantee for Small and Medium-sized Enterprises* issued by the State Taxation Administration in 2001

The notice stipulates the tax preferential treatment applicable to the guarantee institutes covered by the credit guarantee system for small and medium-sized enterprises throughout China. Subject to the examination and approval of the State Economic and Trade Commission, a unit which has been covered by the credit guarantee system for small and medium-sized enterprises in China and which collects income from its guarantee business according to the standards set forth by the people's government above the level of municipality may be exempted from the excise tax for three years.

- (5) *Interim Measures on Administration of Risks of Institutes providing Guarantee for Loans by Small and Medium-sized Enterprises* issued by the Ministry of Finance in 2001 (the "Interim Measures")

The Interim Measures was issued to regulate and strengthen the administration of financing guarantee institutes for small and medium-sized enterprises and to prevent and control the guarantee risks. As provided for in the Interim Measures, the fee rate of the guarantee is usually limited to 50% or less of the interest rate of bank loans for the same period. The maximum amount of the guarantee deposit for any single enterprise shall not exceed 10% of the capital actually raised by the guarantee institute. The guarantee institute may provide guarantee on different financing arrangements such as loans from financial institutes, payment of drafts and financing leasing. The Interim Measures also stipulates the coordination relationship between a guarantee institute and a loan financial institute, the guarantee evaluation system and the examination system of the performance of a guarantee institute.

In addition to the departmental rules issued by various departments and commissions of the State Council, many provinces and municipalities issued local regulations regarding the establishment and operation of the credit guarantee system for small and medium-sized enterprises such as the *Interim Measures of Henan Province on Administration of Credit Guarantee for Small and Medium-sized Enterprises* (1999), the *Provisions on Administration of Loan Credit Guarantee for Small Enterprises* of Shanghai Municipality (1999) and the *Interim Measures on Supervision and Administration of Credit Guarantee for Small and Medium-sized Enterprises* of Beijing Municipality (2001).

- (6) The Standing Committee of the Ninth National People's Congress included the *Law on Promotion of Small and Medium-sized Enterprises* in its legislation agenda. The legislation will be under the responsibility of the Finance Committee of the National People's Congress and the draft team of the *Law on Promotion of Small and Medium-sized Enterprises* was set up in April 1999. Currently, the law has been drafted and will be submitted to the National People's Congress for examination in December. The draft law insists on protecting the legal interests of small and medium-sized enterprises, actively supports the establishment and development of small and medium-sized enterprises, emphasizes the improvement of the external surroundings of small and medium-sized enterprises, and makes small and medium-

sized enterprises function in creating more employment opportunities, strengthen the creativeness and encourage social investments. One of the core contents of the draft law is to adapt to the public financial budget system and establish the subject of and a special fund for development of small and medium-sized enterprises in the financial budget of the Central Government, in order to create a fair market environment for small and medium-sized enterprises. In addition, the draft law also contains provisions on the construction of the management structure, credit guarantee and social service system of small and medium-sized enterprises.

II. Basic Structure of the proposed Credit Guarantee System for Small and Medium-sized Chinese enterprises

According to the basic requirements in the Policy Opinions issued by the General Office of the State Council, the basic structure of the Chinese credit guarantee system for small and medium-sized enterprises set up based on the Policy Opinions is as follows:

1. Nature

The nature of various guarantee institutes is as follows:

- an institute providing credit guarantee for small and medium-sized enterprises shall be a non-financial institute which is a policy supporting institute used by the government to indirectly support the development of small and medium-sized enterprises and which shall not engage in the finance business and financial credit business and which is not targeted to gain profits;

- a guarantee institute for inter-enterprise guarantee for small and medium-sized enterprises shall be a guarantee institute which is set up voluntarily by small and medium-sized enterprises mainly by funds raised from member enterprises and which is targeted to the member enterprises and which is a non-financial institute and shall not engage in the finance business or be targeted to gain profits;

- a commercial guarantee institute for small and medium-sized enterprises is a guarantee institute which is set up by social investments and which is targeted to gain profits.

A guarantee institute for small and medium-sized enterprises may be set up as an enterprise legal entity, institutional legal entity or society legal entity which is held by the state or a portion of the shares of which is held by the state. An inter-enterprise guarantee institute may be set up as a societal legal entity or enterprise legal entity, and a commercial guarantee institute may be set up as an enterprise legal entity or a private or partnership enterprise.

2. Principles and Purposes

Principles: to coordinate between the support of development and prevention of risks, governmental support and market operation, and provision of guarantee and increase of credit.

Purposes: to gradually develop the credit guarantee system for small and medium-sized enterprises into a social credit system mainly focusing on small and medium-sized enterprises and to encourage credit guarantee institutes for small and medium-sized enterprises to gradually develop into social credit centers incorporating credit records, credit evaluation and credit guarantee.

3. Structure of the System

The credit guarantee system for small and medium-sized enterprises will be composed of one body and two wings. The “one body” refers to the credit guarantee system for small and medium-sized enterprises set up at the three levels of city, province and state, under which the national credit re-guarantee system for small and medium-sized enterprises will provide re-guarantee service to credit guarantee institutes for small and medium-sized enterprises at the level of province, the credit guarantee system for small and medium-sized enterprises at province level will provide re-guarantee service to credit guarantee institutes for small and medium-sized enterprises at the city level, and the credit guarantee system for small and medium-sized enterprises at the city level will provide re-guarantee service to community inter-enterprise guarantee institutes and commercial guarantee institutes as well as engage in the 3rd party guarantee business. The “two wings” refer to inter-enterprise guarantee institutes and commercial guarantee institutes located in urban communities which will provide guarantee service to small and medium-sized enterprises. The wings are the foundation of the credit guarantee system for small and medium-sized enterprises and engage in the direct guarantee business for small and medium-sized enterprises. Commercial guarantee institutes and inter-enterprise guarantee institutes shall enjoy the re-guarantee services and risk sharing provided by credit guarantee institutes for small and medium-sized enterprises in accordance with the national provisions and agreements.

4. Sources of Funds

The sources of funds for credit guarantee system for small and medium-sized enterprises include: allocation of the government budget, allocation of the state-owned land and assets, social investments and collection, share subscription by members or risk deposit, and donations from within and outside China, among which credit guarantee institutes for small and medium-sized enterprises will raise funds from allocation of the government budget, allocation of state-owned land and assets and social investments and collection as well as from the government credit guarantee fund, re-guarantee deposits, membership risk deposits and donations from within and outside China, inter-enterprise guarantee institutes for small and medium-sized enterprises will raise funds from share subscription by members and other social investments as well as the membership risk deposits and donations from within and outside China, and commercial guarantee institutes for small and medium-sized enterprises will raise funds from social investments as well as from the risk deposits paid by the guaranteed enterprise(s) and donations from within and outside China. The credit guarantee fund for small and medium-sized enterprises will be established by allocation of the government budget and limited to use for purpose of the guarantee and 3rd party guarantee business for small and medium-sized enterprises, and will be operated on the commission basis by the credit guarantee institutes for small and medium-sized enterprises at the levels of state, province and city respectively according to the different sources of the fund budget as supervised by the supervision and administration committee of credit guarantee for small and medium-sized enterprises at the levels of state, province and city respectively (i.e. economic and trade commissions, people’s banks and financial departments at various levels).

5. Function of Institutes and Targets of Service

The major function of the credit guarantee system for small and medium-sized enterprises is to operate its own capital and the government credit guarantee fund, to engage in the re-guarantee and 3rd party guarantee business, and to be solely responsible

for such credit management work as collection of credit records, credit evaluation and credit information of those small and medium-sized enterprises covered by the service provided by the credit guarantee system for small and medium-sized enterprises. The major function of inter-enterprise guarantee institutes for small and medium-sized enterprises is to operate its capital contributed by investments of member enterprises and other nongovernmental investments, to engage in the direct guarantee business for its member enterprises, and to provide such credit services as collection of credit records, credit evaluation and credit investigation of its member enterprises. The major function of commercial guarantee institutes for small and medium-sized enterprises is to operate its capital contributed by investments of its shareholders, to engage in the direct guarantee business as allowed by the laws and policies, and to provide such credit services as credit evaluation and credit investigation of the guaranteed enterprise(s). The 3rd party guarantee business for small and medium-sized enterprises will cover the loan guarantee, establishment investment guarantee and risk investment buyback financing guarantee for various small and medium-sized enterprises in compliance with the national industrial policy. The credit re-guarantee service for small and medium-sized enterprises will be provided to inter-enterprise guarantee institutes and commercial guarantee institutes, providing them with the re-guarantee service to share direct guarantee risks. The direct guarantee business for small and medium-sized enterprises will cover guarantee services for all economic activities allowed by the law.

6. Cooperative Banks and Guarantee Deposit

There are two types of cooperative banks. One type is the cooperative banks engaging in the direct loan guarantee business which will normally be selected by inter-enterprise guarantee institutes and commercial guarantee institutes from banks with high credibility and initiatives, especially those small and medium-sized financial institutes and with which guarantee institutes will determine such cooperation issues as guarantee responsibility, proportion of responsibility share, amplifying times and credit evaluation by entering into contracts. The guarantee deposit will normally be deposited into a special account of the cooperative bank or used to purchase national bonds. The other type is the cooperative banks engaging in the 3rd party guarantee business. Under normal circumstances, a bank will submit an application to a credit guarantee institute for small and medium-sized enterprises and such credit guarantee institute will then apply for approval of the supervision and administration committee of credit guarantee for small and medium-sized enterprises at the same level, after which the credit guarantee institute will enter into a contract with the cooperative bank setting forth such cooperation issues as the authorized amount, loss rate of loan, compensation rate and share of responsibility. The guarantee deposit for the direct guarantee business and 3rd party guarantee business will be managed separately. Inter-enterprise guarantee institutes and commercial guarantee institutes will deposit the guarantee deposit into the cooperative bank or a bank designated by the supervision and administration committee of credit guarantee for small and medium-sized enterprises and the people's bank at the same level, based on a certain proportion of the result of the guarantee amplifying times multiplied by the compensation rate (e.g. 50%) as determined by the cooperative bank. Credit guarantee institutes for small and medium-sized enterprises will deposit its own guarantee deposit (in monetary form) and the government credit guarantee fund for small and medium-sized enterprises trusted thereto into the cooperative bank which engages in the 3rd party guarantee business or a bank designated by the supervision and administration committee of credit guarantee for small and medium-sized enterprises and

the people's bank at the same level, based on a certain proportion of the result of the guarantee amplifying times multiplied by the determined compensation rate (e.g. 80%).

7. Risk Control and Responsibility Share

Risks will be controlled by agreed amplifying times, credit evaluation, membership, counter guarantee by enterprises and operators, determination of compensation rate, implementation of compulsory re-guarantee and claim for compensation in accordance with the law. Risks will be shared by setting forth the responsibility proportion between the guarantor and the creditor, the guarantor and the re-guarantor, and the guarantor and the guaranteed. Inter-enterprise guarantee institutes and commercial guarantee institutes for small and medium-sized enterprises will set up the guarantee risk deposit according to a certain proportion of its income from the guarantee business (e.g. 20%).

8. Business Self-disciplinary and Government Supervision

The business union of guarantee institutes for small and medium-sized enterprises will be set up and all guarantee institutes of various types engaging in the guarantee business for small and medium-sized enterprises must become a member of such a business union in its locality. Such government authorities in charge of economic and trade, finance, banks and industry and commerce will establish the supervision and administration committee of credit guarantee for small and medium-sized enterprises at the province and city levels. (Under such circumstances, the person-in-charge of the governmental department administering small and medium-sized enterprises in a provincial or municipal government will normally hold the position of the director of such committee concurrently.) The government authorities in charge of finance and auditing as well as other investors will establish the boards of supervisors of guarantee institutes. (Under such circumstances, the biggest shareholder or the person of the financial authority will normally hold the position of the chairman of such board of supervisors concurrently.) All guarantee institutes engaging in the direct guarantee business for small and medium-sized enterprises must participate in the compulsory re-guarantee program for credit guarantee institutes for small and medium-sized enterprises in the city where they are located, and may, based upon negotiation, participate in the voluntary re-guarantee. All urban credit guarantee institutes for small and medium-sized enterprises must participate in the compulsory re-guarantee program for credit guarantee institutes for small and medium-sized enterprises in the province, autonomous region or municipality directly under the central government where they are located. All credit guarantee institutes for small and medium-sized enterprises of a province, autonomous region or municipality directly under the central government must participate in the compulsory re-guarantee program for national credit re-guarantee institutes for small and medium-sized enterprises in the city where they are located.

9. Trade Entry and Supporting Policies

The trade entry system into the guarantee business must be strictly implemented in order to control guarantee risks. Establishment of an inter-enterprise guarantee institute or commercial guarantee institute for small and medium-sized enterprises must be examined and approved by the people's government at the region or city level and must be registered at the administrative department of industry and commerce at the same level. Establishment of a provincial or municipal credit guarantee institute for small and medium-sized enterprises must be examined and approved by the people's government at the province level and must be registered at the administrative department of industry

and commerce at the same level. In the policy published by the General Office of the State Council that “as may be decided by the local government, the income obtained by a non-profitable credit guarantee or re-guarantee institute for small and medium-sized enterprises which has been covered by the national pilot program from its guarantee business may be exempted from the business tax for a period of three years,” the guarantee institutes covered by the national pilot program refer to the national, provincial and municipal credit guarantee institutes for small and medium-sized enterprises as well as the inter-enterprise guarantee institutes and commercial guarantee institutes for small and medium-sized enterprises which have participated in the compulsory guarantee programs. The income on which the business tax may be exempted shall refer to the income obtained by the national, provincial and municipal credit guarantee institutes for small and medium-sized enterprises from their guarantee business; the part of the income obtained from engaging in the direct guarantee business by inter-enterprise guarantee institutes and commercial guarantee institutes for small and medium-sized enterprises which has been repaid for re-guarantee purpose; and the part of the income obtained from engaging in the guarantee business by inter-enterprise guarantee institutes and commercial guarantee institutes for small and medium-sized enterprises which has been used to establish the guarantee risk deposit according to the ratio determined in accordance with the regulations.

III. Impediments for Secured Financing of SMEs

The credit guarantee system for SMEs is not completely established yet. Therefore, the main forms of security for SMEs are asset mortgage, pledge, right pledge, and 3rd party guarantee. Meanwhile, the security for SMEs is subject to *General Rules of Loan*, which prohibits the loans between enterprises and sets strict limitations and complicated procedures for obtaining overseas loans. As a result, financing of SMEs is limited to bank loans. Besides, the risk control and responsibility system imposed by the banks to a large extent further limit the financing of SMEs. The specific issues are as follows:

1. The authorized 3rd party guarantee system and the credit evaluation in the credit and loan management of banks are mainly designed for big and medium-sized state owned enterprises, therefore strengthen the tendency for credit funds to be oriented to big and medium-sized state owned enterprises. At present, pilot credit evaluation systems of credit quality have been planned and being built in Beijing, Shanghai, Guangzhou and some other places, but the task to unify the currently isolated and secluded credit systems of different locations into a national credit system has not yet started.
2. The low credit rating, unstable business operation, limited assets for mortgage and little accesses to guarantee provided by entities with high credit ratings, all of which impose relatively significant risks to banks. Besides, due to the characters of SME loans such as small loan amount, high frequency and urgency, the management cost for loans to SMEs is comparatively high. As a result, banks are very prudent in providing loans to SMEs which in turn affects the development of SMEs and eventually leads to a vicious cycle.

3. The registration system of general assets, especially intangible assets, has not been completely established. In addition, the forms of security for property preservation required by banks and pilot guarantee institutions as well as the people's courts emphasize assets with relatively complete registration system, such as land and buildings. Therefore, the scope of assets of SMEs available for security is limited to a great degree.

IV. Limitations on Security for SMEs Imposed by Current Legal System to Establishment of Secured Financing and Credit Guarantee Systems for SMEs

Since administrative regulations and department regulations regarding credit guarantee systems for SMEs are largely at the stage of pilot or solicitation of opinions regarding the policies, the matters in credit guarantee system shall still be governed by *Security Law*, the Judicial Explanations and the other related laws.

1. Limitations on Security for SMEs imposed by the Security Law and Judicial Interpretations

1.1 Pledge of rights

The Security Law provides for pledge of rights. Article 75 of the Security Law lists the rights which can be pledged such as promissory notes, bills of exchange, checks, bonds, certificates of deposits, etc.; shares and share certificates that are transferable according to law; use right of trademarks transferable according to law, patents, property rights among copyrights that are transferable according to law and other rights that are transferable according to law. Obviously, the laws allow property rights to be the objects of a pledge but, in practice, only limited number of property rights are used or accepted as the objects of a pledge such as stock rights, deposits, rights and interests in an investment, insurance rights and interests, rights and interest of an account, etc. On the other hand, exclusive use rights for trademarks, patents, copyrights, rights from special permission for operation, lease rights, rights for cooperation and development and other rights are seldom used as the objects of a pledge and lack corresponding governing laws.

1.2 Creditor's rights with both guarantee and property

According to Article 28 of the Security Law, if an obligation is secured by both a guarantee and property, guarantor shall be liable for the part of the obligation not secured by the property. If the creditor waives the obligation secured by the property, the guarantor's obligation for the waived part is also waived. According to Article 38 of the Judicial Explanations, in the case the same creditor's right is secured with both a guarantee and property from a third party, the creditor can request the guarantor or the provider of property to assume security responsibility. The two articles above conflict to some extent.

Article 28 of the Security Law stipulates the priority of security by property and the creditor cannot make a choice in enforcing his security rights, i.e. the creditor can only

enforce the security right from the property first and then the security right from the guarantee. The above arrangement is not very reasonable since it deprives the creditor of his right to choose how to enforce his security right. In addition, since the realization of the security right from security by property is usually lengthy and costly, requiring the creditor to first enforce his security right from collateral security is detrimental to the protection of his interests.

1.3 Offset debts directly with pledged property

According to Article 66 of the Security Law, “pledgors and pledgees may not agree in contracts on the transfer of the ownership of pledged property to the pledges when the pledgee has not received fulfillment of the obligation at the expiration of the term for performance of the obligation.” At the same time Section 2 of Article 71 of the Security Law states if the pledgee does not receive payment at the expiration of the term for performance of the obligation, he may agree with the pledgor to convert the pledged property into value. There is no clear legal rule on how to differentiate between converting the pledged property into value and offsetting debts directly with pledged property and further discussion is needed.

1.4 Registration system

The current registration system complementing the Security is far from satisfactory, specifically:

- 1) There is no corresponding registration system for the pledge of certain rights;
- 2) The commerce and industry administration agencies generally do not register the stock right of domestically funded enterprises;
- 3) Since three types of foreign investment enterprises (i.e. contractual joint ventures, equity joint ventures, and wholly owned foreign enterprises) do not have rosters of shareholders, registration cannot be accomplished according to law; and
- 4) Insurance rights and interests and account rights and interests cannot be registered.

1.5 Security to foreign entities

The Security Law does not have special provisions for the qualification of the subject of security. However, our security to foreign entities and foreign exchange administration are closely related. According to Section 2, Article 5 of the *Procedures for the Security by Domestic Entities to Foreign Entities* (the “Procedures”), the maximum amount of security to foreign entities provided by non-finance enterprise legal persons cannot exceed 50% of the net assets of such enterprises, nor can such amount exceed the foreign exchange income of the enterprise for the last year. In other words, if the non-finance enterprise legal person did not have any foreign exchange income last year, it is not qualified to provide security to foreign entities. Article 6 of the Procedures states that domestically funded enterprises can only provide security for its directly affiliated subsidiaries or the joint ventures it has invested in to foreign enterprises to cover foreign debts in the amount not exceeding the amount of the investment by the

Chinese parties. Under these provisions, individuals cannot provide security to foreign enterprises. In reality, small and medium-sized enterprises can hardly meet such requirements and have to entrust financial organizations to provide security for their foreign debts to foreign entities. As a result, it is extremely difficult for small and medium-sized entities to get foreign financing.

2. Legal Status of Credit Guarantee Institutions Is not Clear.

2.1 Legal Forms of Credit Guarantee Institutions for SMEs

Based on the conditions of local pilots, the forms of established credit guarantee institutions for SMEs fall into three categories: (a) not-for-profit legal person (35%), generally named as provincial or municipal credit guarantee centers for SMEs, financed by local governments. These credit guarantee centers are run as enterprises and market-orientated, and adopt the membership approach; (b) enterprise legal person (50%), generally named as provincial or municipal credit guarantee corporations for SMEs, financed by local governments as well as funds from other channels. These credit guarantee corporations are run in accordance with the *Company Law*; and (c) legal persons of associations, generally named as provincial or municipal credit guarantee associations.

2.2 Legal Status of Credit Guarantee Institutions

As mentioned before, the various projected credit guarantee institutions, by their nature, are: (a) indirect policy support institutions for the development of SMEs, which are not financial institutions, and therefore, shall not deal in financial business and financial credit and shall not be mainly profit seeking; (b) credit guarantee institutions voluntarily formed by SMEs, which are financed by the contribution of member enterprises, and intended to serve them, and shall not deal in financial business, and shall be nonprofit; (c) commercial credit guarantee institutions for SMEs, which are financed by non-governmental entities and profit-orientated.

Credit guarantee institutions for SMEs may be enterprises, legal persons held by the state or in which the state participates, non-governmental legal persons, and legal persons of an association. Mutual aid credit guarantee institutions for SMEs may be established in the form of legal person of an association or enterprise legal person. Commercial credit guarantee institutions for SMEs may be enterprise legal person or single-investor enterprise or joint venture.

As to the above description, certain problems and conflicts remain to be resolved:

- (1) Credit guarantee institutions may take the form of a corporation, which is profit-orientated, and differ dramatically from non-profit legal persons and legal persons in governing laws. As a result of the application of different taxation systems, social welfare systems, administration systems and so on, the cost of operation and model of management in various credit guarantee institutions will differ considerably.

- (2) If credit guarantee institutions are not defined as financial institutions, currently applicable regulations regarding the manner of operation of financial institutions, such as risk management, share of responsibility, rate of capital sufficiency, limitation of financing rate for a single entity and so on, will not apply to credit guarantee institutions. However, the operational processes of credit guarantee institutions and financial institutions have some in common. Therefore separate detailed regulations should be formulated for credit guarantee institutions.
- (3) Considering that the sources of funds (including appropriate funds, donation, membership contribution, etc.) for credit guarantee institutions are diverse, new provisions regarding both rights and obligations in relation to investors and means of contribution shall be formulated. Such potential provisions are subject to various systems such as state-owned asset management, which should first be coordinated with the credit guarantee program.

STRATEGY FOR IMPROVING SMEs ACCESS TO CAPITAL

China's pending SME Promotion Law calls for the State to widen its efforts to expand direct financing of SMEs. The principal purpose of a State-sponsored program to support equity investments in SMEs (the "SME Equity Program" or the "Program") is to attract investment capital to SMEs from investors who would otherwise be unlikely to target investment at the SME level.

The experience of the United States, Israel, Australia, and other countries has demonstrated that government support programs can be enormously effective in attracting major amounts of non-governmental investment in SMEs and venture capital investments. This section sets out the fundamental features of such a program and provides options for further consideration of how the Program might be structured.

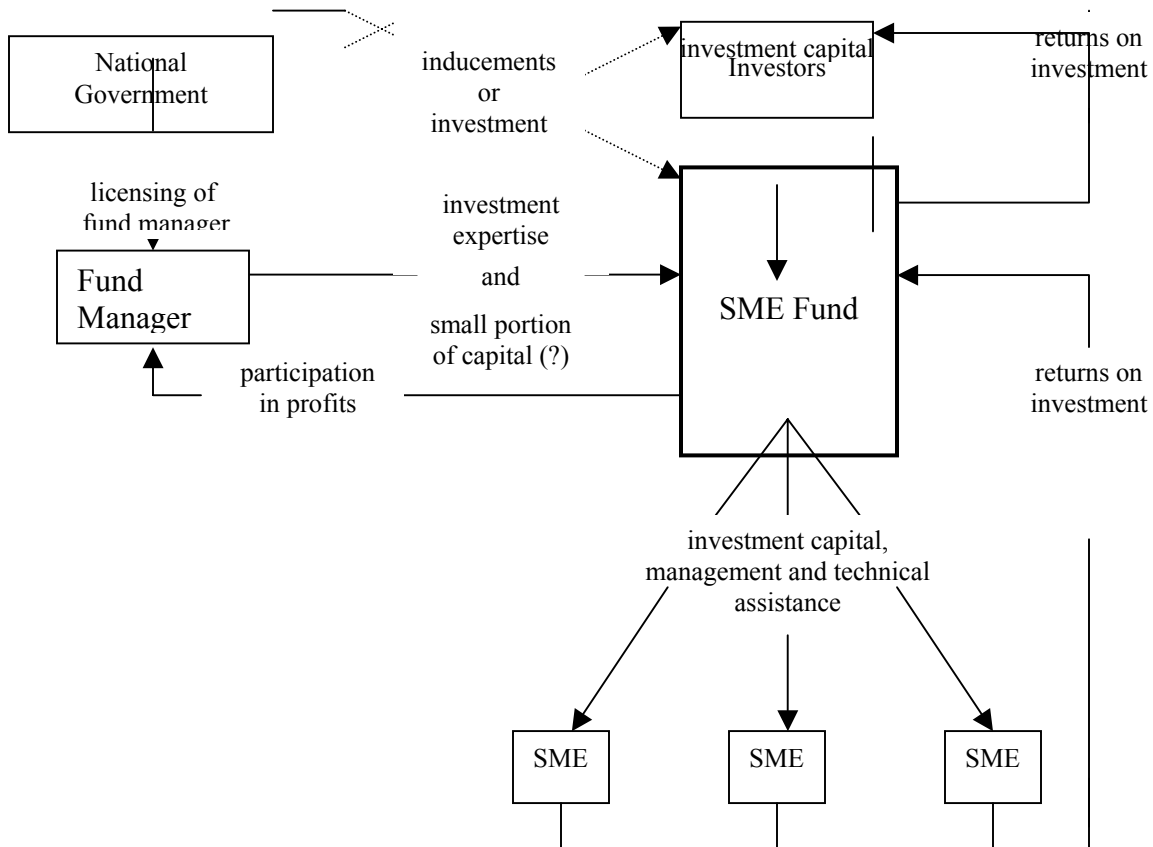
Overview of the SME Fund Structure

Experience shows overwhelmingly that equity investment in SMEs is best accomplished through professionally managed investment vehicles focused exclusively on SME investment (for this report, the "SME Funds"). It is assumed, therefore, that any state-sponsored program to expand direct investment in SMEs will also be, in essence, a program to support the creation and capitalization of SME Funds which, by policy, must invest in SMEs. It is also assumed that, while the underlying principals of venture capital investment are essentially the same for all venture capital funds, regardless of their investment targets, the skills, strategies, orientation, and internal economics of SME Funds will vary from those funds having more typical investment policies and targeting larger or later-stage companies.

The earlier section, International Practices of Investment Support by Government, describes ways in which national and regional governments around the world have provided inducements to investors in venture capital funds targeting smaller, early stage companies or new companies in higher risk industries. The shared basis for these various programs is that the state government is willing to invest in the program, through either financial or fiscal means, in a manner favoring the financial returns to the other investors over those to the State. By doing so, the state increases the likelihood that the other investors will receive a return from their investment in the fund which is superior to the return received by the State. Therefore, the returns to the other investors will also exceed the overall rate of return achieved by the fund's portfolio of investments.

For a highly simplified example, let us assume a fund whose portfolio companies achieve an aggregate 15% internal rate of return (IRR) for the fund, net of the fund's management costs and other expenses. If the government provides 50% of the capital invested by the fund and limits the government's return to only 5%, then the other investors in the fund will receive, in addition to the 15% return produced by the portfolio, that portion of the returns which the government has been willing to forego. In this case, the other investors will receive, indeed, approximately a 21% return on their investment,

a commercially attractive return more in line with other classes of assets having similar risk profiles. While the figures used in this example are only illustrative, the relationships among them are central to the economics of the SME Equity under consideration.



In the above chart, investors in the SME Fund (the “Investors”) contribute cash for ordinary shares in the SME Fund (also, the “Fund”). Investors may also make loans to the Fund. The Fund is organized in the most appropriate corporate form under Chinese law at the time of its incorporation, most probably a limited liability company. The share capital and borrowings of the Fund are then managed by a team of investment professionals engaged by the Fund (the “Fund Manager”).

While the investment team of the SME Fund may be directly employed by the fund, we recommend that the Fund Manager be organized as a separate company, most probably a limited liability company also. The engagement of a separate Fund Manager should help to minimize liability on the part of the Investors and will facilitate both the structuring of the most appropriate financial incentivisation of the Fund manger and the termination of the Fund Manager in the case of poor performance or breaches of law or contractual obligations. The obligations and compensation of the Fund Manger are normally detailed in a contractual agreement between the Fund and the Fund Manager (the “Fund Management Agreement”).

The Fund Manager's primary activities include:

- ❑ identification of potential SME investees;
- ❑ screening and selection of investment candidates;
- ❑ financial analysis and due diligence review of potential investees;
- ❑ business and strategic planning assistance to investees;
- ❑ negotiation, structuring and closing of investments;
- ❑ direct provision of, and/or arrangement for, on-going technical assistance and business support to investees;
- ❑ monitoring of investments;
- ❑ assistance to investees in procuring additional investment or loans; and
- ❑ determination and implementation of investment exit strategies.

It is invariably considered best practice in mature venture capital markets that the Fund Manager's key investment officers be compensated in a manner which provides a strong incentive to both remain with the team managing the Fund and to achieve maximum returns on the Fund's investments, within the investment policies of the Fund. The most successful compensation scenarios include salaries, annual performance bonuses, and a participation in the profits of the Fund. This last key element of compensation is generally known as a "carried interest". Under this arrangement, the Fund (the Investors) agrees that after the Fund has received a certain minimal return on the share capital of the Fund, profits of the Fund are then shared by the Investors and the Fund Manager. Normally, the Fund Manager's share of such profit distributions will be from 15% to 25% of profits.

Sometimes, Fund Managers for the SME Funds will be required to provide at least some small portion of the capital of the Fund from their own resources, typically 1% to 3%. By putting their own money at risk, the Fund Managers will have additional incentive, beyond current compensation and the carried interest, to make the Fund a success.

Achieving Financial and Developmental Objectives of the SME Equity Program:

The most fundamental principle of venture capital is that the objectives of the investors, fund managers and investee companies must be strictly aligned through out every phase and aspect of the investment process. For venture capital funds whose objectives are purely financial, this alignment is principally achieved by each party's goal of attaining maximum financial yield. Further alignment among the three principal constituents is then achieved by agreement as to such factors as the timing of distributions, the degree of acceptable risk, and the types of investments to be made.

In the case of the SME Equity Program, the interests of all three parties must be similarly aligned. Each must be focused on maximum financial yield. However, given that the State has the additional developmental objective of assisting the SME sector, the financial objectives of the Fund Manager and other Investors must be pursued *subject to the investment policy of the SME Fund*. In other words, the developmental objectives of

the Fund should be clearly established in the Fund Management Agreement and other founding documents of the Fund. Once these have been agreed and set forth, the Fund Manager should seek maximum returns from investments in the Fund's portfolio, just as the SME entrepreneur should be pursuing maximum profitability for his or her company.

In our discussions with managers of existing Chinese venture capital funds, particularly those capitalized principally by provincial governments, we found that return objectives and expectations often were not clearly established. We cannot overstate the importance of agreement between the Investors, the State, and the Fund Manager as to the specific rate of return being sought.

Investment Policy of the SME Funds under the SME Equity Program:

If we assume that the interests of all parties are aligned and that return expectations have been clearly established, it then becomes incumbent upon the SME Equity Program to establish unambiguous developmental objectives of the Program. Again, these objectives drive must be expressed in terms of the investment policy set forth in the Fund Management Agreement and other founding documents.

Paramount among the items of the investment policy imposed upon Funds under the Program must be a clear definition of an SME. Our finding thus far is that, while official definitions of small and medium have been established for individual sectors, these official definitions are suited only to an economy dominated by very large, primarily state-owned enterprises. They are likely to define SME at a larger size level than would be found anywhere else in the world. Most importantly, they do not take into consideration China's need for the creation of great numbers of new, more entrepreneurial enterprises, nor the current presence throughout China of many thousands of smaller, growth-oriented businesses in need of special measures to support their growth. Indeed, we believe that the lack of generally acceptable definition for SMEs poses a significant obstacle to SME development programs.

In our discussions with government officials, private sector investors, venture fund managers, entrepreneurs and other parties in China, we found that the term "SME" often referred not to a particular size range of enterprise, but to enterprise engaged in "traditional" sectors. This generally appeared to mean sector outside information technology (IT), biotechnology, new materials development, and other "high-tech" areas generally involving new proprietary technologies and highly valued intellectual property. We also found that many people in China think of SME as synonymous with "private". In this case, private usually meant that management control is not in the hands of the State and that the managers of the enterprise also own shares of the company. (No one assumed that an enterprise is not private solely because a portion of the shares of the business are owned by the government or a state-owned enterprise, or "SOE".) This latter aspect of the current usage of SME likely reflects the great size disparity between SOE and private Chinese businesses, which are primarily smaller businesses. We found almost no one for whom the current official, sector-specific definitions of small and medium were meaningful.

It is our hope that the definition of SME may yet be established in the SME Promotion Law to facilitate the appropriate channeling of resources to SMEs and the identification and implementation of appropriate SME support programs.

Certainly, in order to avoid abuse of the SME Equity Program and to achieve its developmental objectives, Fund managers must be given a precise definition of SME. Consistent with the needs we have seen for financing entrepreneurial activity in China and the current bias of venture capital investment toward larger and/or “high-tech” investments, we wish to suggest that the following parameters be established for investments to be eligible for financing under the SME Equity Program:

- businesses with no more than 250 employees in the manufacturing sector or no more than 100 employees outside the manufacturing sector,
- businesses less than three years old (in their pre-investment form).

These criteria are intended to further the important development objective of providing risk capital financing for new entrepreneurial activities while not conflicting with other government policy being pursued through the establishment of venture capital funds focused on technology sectors.

Eligibility Criteria for Fund Managers

Again, the basis for the SME Equity Program is the willingness of the State to subordinate its financial return to the other Investors in order to induce them to invest in an SME Fund. Given that the prospective Fund Manager has the opportunity to earn the highest rate of return among all Investors in the Fund by virtue of its carried interest, then the State is essentially subsidizing a portion of the Fund Manager’s return in order to induce the Fund Manager to successfully raise, establish, and operate an SME Fund. For this reason, it should most often be the Fund Manager who undertakes to raise the capital of the Fund and the State must apply strict criteria to eligibility of a prospective Fund Manager to be able to take advantage of this subsidy on the part of the State.

Minimally, any Fund Manager applying to the SME Equity Program (the “Applicant”) must accomplish the following in applying for preliminary consideration for the Program:

- Determine the geographic market and business sectors in which it intends to invest.
- Verify provisional commitments of capital from other sources in an amount not less than RMB 50 million.
- Prepare a well-structured business plan, detailing plans for investing in SMEs. This plan should include information on the proposed types of investments, the types of industries in which the Applicant plans to invest, the developmental stages of these businesses, their geographic locations, the range of values of investment (total RMB

to be invested), and investment strategy, including investment instruments to be used and intended mechanisms for exiting investments.

- Describe the governance structure of the SME Fund, providing the names and resumes of members of the proposed Board of Directors.
- Describe the qualifications of management personnel for the SME Fund. This should include detailed resumes of the key managers as well as an organizational chart and the hiring criteria for positions below key management.
- Demonstrate through letters of reference and other means, that the sponsors and Fund Managers are reputed to have high standards of integrity and forthrightness in their past business dealings.
- Demonstrate, on the basis of personal and professional history as well as personal testimony of the Applicant, that they have a keen interest in development at the SME level and significant past exposure to SMEs

Given that it is unlikely that many key managers of Applicants will have had professional venture capital experience, the Applicant must demonstrate *the degree to which* key managers meet the following criteria:

- *Ability to generate deal flow:* The Applicant must demonstrate that the key managers and the proposed directors of the SME fund have the industry-related networks and other contacts necessary to identify a substantial number of potential investments from which to select successful portfolio companies.
- *Ability to perform effective due diligence and analysis.* The Applicant must demonstrate sufficient experience among its management in operational analysis, financial modeling, and business appraisal. Combinations of high-level management experience in both industry and financial organizations may be necessary to qualify a fund management team in the absence of direct equity investment experience.
- *Familiarity with investment structures.* The Applicant must demonstrate experience related to corporate formation, capital structuring, merging and/or acquiring of companies, and the structuring of shareholder agreements, particularly as it relates to the protection of shareholder rights in the decision making processes of a company and in the sale or liquidation of its shares. Access to outside legal counsel, alone, is insufficient in this regard and the Applicant must demonstrate an internal capacity in the proposed SME Fund to both understand and negotiate terms of investment.
- *Ability to monitor and add non-financial value.* The Applicant must demonstrate significant experience in the overall management and supervision of the operations of a business enterprise. The proposed team of key managers must

have, in the aggregate, relevant business experience in all key areas of business including marketing and sales, business and financial planning, human resource management, accounting and financial controls, production processes, and procurement of technology and raw materials. Of particular importance in this regard is the demonstrated experience of having made meaningful contributions to the progress of companies in which key management may have served operationally, governed, or, ideally, invested. Additionally, there should be experience within the management team of having contributed significantly to the positive transformation or liquidation of a failing enterprise (commonly known as “turn-around” and “workout”).

- *Ability to achieve liquidity – “exiting”*. The Applicant must demonstrate that its key managers have experience related to the sale or transfer of ownership of an enterprise. Principal factors in this regard include direct participation in achieving one or more such exits; breadth of industry contacts among firms, both domestic and international, capable of making strategic acquisitions of young businesses, and preparation of an enterprise for listing on a stock exchange.

Again, in establishing eligibility criteria for Applicants to the Program, one must take into consideration the brevity of the history of venture capital and private equity investment in China, the relatively limited activity in the sale and acquisition of companies through financial intermediaries, and the virtual absence to-date of smaller, private company listings on the existing stock exchanges.

Direct private equity and venture capital experience in China remains rare and those resident Chinese professionals who possess such experience will naturally gravitate toward larger funds, particularly those investing in technology-related companies. Therefore, the SME Fund Program will need to admit fund managers whose business experience provides the maximum of exposure to relevant activities, the development of related applicable skills, and the establishment of a verifiable track record of success in past endeavors.

Also, given the present rarity of experience in venture capital investing, we recommend that the State consider the establishment a formal program for the training of fund management professionals to augment the experience required by the eligibility criteria for the SME Fund Program. Our discussions to-date with venture capital managers from various provinces in China clearly show both an urgent need and a strong desire for training in venture capital practices on behalf of funds investing at all levels. Furthermore, given that the existing funds in China may have absorbed the vast majority of current venture capital expertise in China and that SME investment requires additional emphasis on certain skills, the need for training for prospective SME Fund Managers is likely to be even greater than for Chinese venture capitalists as a whole.

EQUITY SUPPORT SCHEMES

As noted above, China has relied on public financing (principally by municipalities and cities) to provide funding for venture capital financing. Virtually all of this financing has been targeted at technology-based ventures, rather than SMEs that are active in more traditional sectors of industry or service.

The reasons for this are understandable: government at all levels wants to encourage development of businesses in the knowledge-based economy of the future; these often offer outstanding opportunities for growth; and the capital markets of China value the earnings of technology-based companies at a much higher multiple than traditional industries. Consequentially, businesses in these traditional fields must rely on the financial resources of entrepreneurs and informal sources of debt and equity financing, a requirement that often slows their potential rate of growth.

Without a combination of encouragement and financial support from the Central Government, we would not expect that investment funds would be active outside the technology-based industries. Yet the importance of SMEs to an economy is well known and well established, as summarized earlier in this report. SMEs create most new jobs in China, and produce half of its GDP. The same is true in the European Union, the United States, and many other nations.

While recognizing the importance of SMEs to an economy, it is crucial to bear in mind that the vast majority of SMEs in highly-developed economies operate outside high-technology areas.

The Importance Of Financing Younger Companies in Traditional Industries

The SME Promotion Law currently in draft stage recognizes not only the importance of SMEs to China, but also the wide variety of support mechanisms necessary to bring China's SMEs into their proper productive role in the economy. Among the actions called for in the draft law is to "widen channels for SME direct financing". New direct financing has already begun for larger, technology oriented companies, through nearly 200 venture capital funds in China. However, there remains a great need for risk capital financing focused on newer and smaller SMEs in more traditional sectors. Furthermore, we believe such risk capital investment for SMEs should be made formal and replicable throughout China in order to maximize the benefits of other areas of SME support such as training, technical assistance, and loan guarantees.

While it is important for China to exploit its advantages in high-technology areas, particularly in new materials and software development, China must also recognize that traditional areas of industry offer promising opportunities, not only for entrepreneurs to build fast-growing businesses but also for investors to build profitable portfolios of equity investments. In the U.S. and Europe, traditional areas of business such as food processing, light manufacture of consumer goods, retailing, and consumer services still

comprise a substantial portion of the high-growth stocks on both the NASDAQ and New York exchanges.

A recent article in Business Week magazine, for example, selected a top 100 “hot growth companies” from among 10,000 listed companies. Of the top 20 of these growth companies, most growing at a rate exceeding 100% per year, fully 50% were businesses whose activities were entirely unrelated to technology. Only about a 25% involved proprietary technology. In Europe, in 1999, growth in technology companies reached its highest historical level. Yet, in 1999, technology investments accounted for only 26% of European venture capital and private equity investment.

A recent survey of venture capital firms in China conducted by VCChina, found that while there are almost 200 venture capital companies in China, only a little less than half of the are actively investing. Of those firms, about 60% are capitalized entirely by sources within Mainland China. According to the responses to VCChina’s surveys of those Chinese VC firms, 54% of their investments to date have been in information technology companies, 21% in bio-technology, and 11% in new materials. Only 14% of investment has been made in enterprises operating outside these areas.

Furthermore, responses to the VCChina survey showed that only 6.1% of the Chinese VC firms had invested in seed stage enterprises, while over 90% of them had invested in development – or growth stage -- companies.

In addition to the current neglect in China of start-up, early stage investments in traditional products and services outside high-technology, it appears that financing in smaller amounts for smaller and younger companies is very rare, if available at all. While we have not yet found data providing the average size of investments of Chinese venture capital firms, our meetings with firms and the documents they provided to us indicate that Chinese VC firms generally do not invest at a level below RMB 10 million and that investments typically are in the range of RMB 10 – 100 million. By comparison, in the U.S., where the scale of investment will normally be higher due to higher cost of labor, marketing, and other elements of business, the *average* investment of the nearly 400 Small Business Investment Companies in 1999 was less than RMB 7.5 million.

Given the present bias in China’s nascent venture capital industry toward larger, later stage, and high-technology investments, we believe there is a strong and immediate need for risk capital investment for younger, smaller and more traditional SMEs.

The Power of Venture Capital to Accelerate Growth

A brief discussion of the value of venture capital in growing companies is equally appropriate for the Task B section of this Report as for the present Task A section. However, given that the effect of venture capital within the SME sector will be of an equally positive nature to that in the larger, technology-oriented areas, it is worthwhile to look at the economic benefits of venture capital in various parts of the world before describing more specifically its role in SME development.

The European Venture Capital Association conducted in recent years a survey of venture capital firms in the EU and compared the behavior of VC-backed firms with the 500 largest private firms in Europe. While one would certainly expect that venture capital-backed firms would grow at a faster pace than larger, older, and more established companies, the comparison is nonetheless an impressive indication of the value of venture capital in growing enterprises. According to the EVCA survey, during the period 1990 through 1995, in companies backed by venture capital:

- sales rose an average of 73% annually, twice the rate of the top 500 companies;
- employment increased an average of 15% per year as compared with only 2% for the top 500;
- expenditures in research and development averaged 8.6% of sales as compared with 1.3% for the top 500; and
- 81% of surveyed managers of VC-backed firms stated that their companies either would not have existed or would have grown more slowly had they not been financed by venture capitalists.

A similar study by Coopers & Lybrand in Australia showed that during the period 1993 through 1996, VC-backed Australian companies:

- increased in employment by 20% annually as opposed to only 2% in the largest 100 Australian firms,
- sales increased by 42% annually as opposed to 6% in the largest firms,
- profits rose by 59% annually as opposed to 7% for the top 100, and
- export sales rose by 27% annually.

In United States, Coopers & Lybrand conducted a survey similar to their study in Australia. In a comparison between VC-backed American companies and the Fortune 500 largest firms during 1991 - 1995, they found that VC-backed companies:

- created new jobs at an average annual rate of 34% as compared with 4.5% for the Fortune 500,
- achieved annual sales growth of 38% as opposed to 3.5% for the top 500, and
- increased their annual R&D expenditures a three times the rate of the largest firms.

While VC-backed firms still represent only a small portion of existing firms in the U.S., Europe, Australia, and other economies where venture capital has developed into a

mature industry, these firms are disproportionately more success in virtually every aspect of their contributions to the economy. Furthermore, it is interesting to note that in the U.S., only an estimated 1 in 100 business plans presented to venture capitalists actually receives venture capital investment.

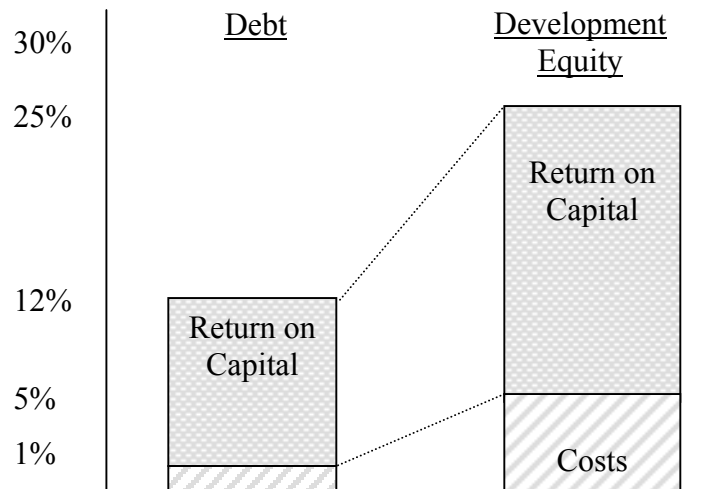
Many of the rejected entrepreneurs, however, go on to identify and receive financing from other sources and build successful businesses based on their original plans. It would be difficult to calculate how many entrepreneurs have been persuaded to venture forth into new enterprises based primarily on their faith in an active venture capital market. However, it would logical to assume that without the very visible presence of VC in the U.S., many successful ventures would never have been undertaken.

A similar logic would strongly suggest that the presence of venture capital dedicated to new and smaller businesses, businesses bringing innovation to more traditional industries, will engender significant new business creation and growth which would otherwise not have taken place.

The Benefits of Risk Capital for Growth-oriented SMEs

In discussing the value of equity investment for SMEs, it is important to understand that equity is not an alternative debt financing so much as a complement to it. Anyone familiar with business and a balance sheet should understand that both debt and equity are generally necessary in order to grow enterprises. It would be a pointless debate to argue that either bank lending or equity investment should be the exclusive financing tool in assisting small business development.

Given that the argument in favor of equity financing for SMEs is not an argument against lending, it is still important to look at the reality of a young, entrepreneurial business in a disadvantageous environment and to compare debt and equity within the context of that business. However, it is also necessary to compare the two from the point of view of the financial intermediary. Later in this section, the point will be made that SME entrepreneurs needs “hand-holding”, that is to say, on-going technical and managerial assistance from the steady hand of an outside investor, ideally an investor who is more experienced in the successful business practice. It must be understood from the outset, in comparing loans with equity financing, that such intensive assistance is not provided without significant costs to the investor. The diagram below compares the fundamental economics of bank lending with those of a relatively labor-intensive model of equity investing.



In this comparison, the costs of the lender at 1% are substantially less than those of the equity investor at 5%. However, 12% is the absolute ceiling for the lender's return. Should the lender see a significant problem or opportunity in the borrower's business, the lender is relatively helpless in addressing the situation. No matter how significant the issue, each time the lender commits time and resources to the borrower, the lender is cutting into the 12% return. For the equity investor, by contrast, each successful intervention in the operations of the investee potentially raises the return of the investor through the increased dividends and capital growth in which the investor has a pro rata share. While many would argue that the 5% cost of the labor-intensive investor is too high, it is unarguable that if a 25% annualized rate of return minus a 5% annualized rate of expense provides a 20% net return and a 12% annual interest rate minus a 1% annual cost provides only a 11% return, before cost of capital, the potential for high returns is greater with equity investing.

Considering this scenario within the context of a risk-adjusted return, the probability of obtaining an 11% return on debt obligation must be compared with the probability of realizing a 20% return on an equity investment. If we assume a 90% probability of realizing an 11% return on the loan, then 9.9% is the risk-adjusted return expectation. If, on the other hand, we reasonably project a 75% probability of obtaining a 20% return on the equity investment, then the expected return is 15%, still significantly higher than that of the loan.

Having considered the potential benefit of equity to the investor, it is of even greater importance to the work of Task A that we consider the benefits to the SME of have both equity investment and a professional equity partner. Consider the following hypothetical situation of two young companies in a very traditional industry:

A Tale of Two Printers

Imagine two printing businesses. Each depends on an antiquated two-color press for the bulk of its business. The city in which they operate is growing in both population and sophistication. New businesses, requiring a higher quality of printing and a faster turn-around time, have begun to look to out-of-town printers for more and more of their print work. Both local printers determine they need new four-color presses to keep up with the needs of the local market and recapture lost business from out of town. Each is looking at equipment costing RMB 5 million. One takes RMB 1.5 million out of cash flows and then borrows RMB 3.5 million from the local bank at 12% interest. The other printer, however, has found an outside equity partner to invest RMB 5 million for a significant minority share of the business.

Each business goes out to the market to promote its new capacity. The first business, however, finds its cash flow under pressure from its new debt obligations and finds it difficult to increase paper and ink inventories to accompany its increased production capacity and new orders. The second business, richer in cash and free from interest obligations, is not only able to purchase greater inventory at better, volume-based, prices, but also to hire a new marketing manager, working partially on commission. Furthermore, the second business's new equity partner, experienced in building businesses from an early stage, immediately does research to better match the right piece of equipment to the business's intended market, thereby saving RMB 250,000 on the purchase of the press. The equity partner also helps the entrepreneur to better understand his/her costs and how to manage cash to greater benefit. Based on experience and contacts, the equity investor puts together a marketing strategy with the entrepreneur, not only intended to reach new clients in the surrounding towns, but also to develop a competitive specialty in printing for academic institutions, including those in the larger cities.

Three years later, the borrowing business is still trying to make ends meet. Its owner is looking for assistance, but cannot afford a consultant. The bank, unable to offer technical and managerial help to the business, is beginning to look at its collateral with a more interested eye. The business with equity financing, by contrast, has seen a four-fold increase in its revenues. While the borrowing entrepreneur is still looking at sales as cash coming in to meet next week's payroll and make the next quarter's interest payments, the second printer has been looking at earnings as contributing to capital growth in the business. The equity investor and the entrepreneur are now beginning to look at a strategic sale of the business to a pre-press and printing firm purchasing smaller companies in order to establish a regional dominance in the business. The parties are discussing a purchase price at three times the equity partner's original investment.

In the above hypothetical scenario, it is clear that the presence of the equity investor has made the essential difference between a failing enterprise and a highly successful company.

In summary, there are three principal reasons for which equity investment is desirable or even essential for young SMEs:

- 1) Lack of access to bank financing.*

A number of studies we consulted, as well as anecdotal information we received, make it clear that most young, entrepreneurial companies in China lack sufficient collateral and track record to obtain bank financing. Moreover, the reputation of non-governmental businesses, while it is improving, remains poor and private SMEs are generally thought to be too risky to lend to under any circumstances. This frequently forces the SME entrepreneur to finance his businesses in the seed and early stages by relying on his own limited resources and those of family and friends. Once the business has been established, without additional financing from institutional sources, it will more often than not be dependent on retained earnings to grow. The enterprise is therefore condemned to grow slowly, if at all. Such financing through cash flows significantly limits the business's ability to take advantage of new market opportunities, access new technology, and capitalize on the improved internal capacity and external reputation it may have earned. Unlike most lending institutions in China, an equity investor will finance a young business out of faith in the entrepreneur and the opportunity the business has in the market, allowing the external financing of the business to fit its natural growth pattern.

2) Inability to service debt in the seed and early stages.

Even when an SME may be able to obtain debt financing from a lending institution, the drain of interest payments on cash flow will often prevent the business from having sufficient working capital to meet current demands or to grow. Excessive debt obligations are likely the most common reason for SME business failure in any environment. This is particularly true in the case of businesses borrowing from informal sources whose terms are generally far more expensive than those of formal banking institutions. This type of informal debt financing has been quite common in the Chinese SMRE sector. For Chinese SMEs which are able to obtain debt financing, from whatever source, the insufficiency of equity financing through personal savings, family, and friends often forces the entrepreneur to take on more debt than its ability to generate early-stage cash flow will permit. Therefore, while the ability of promising SMEs to access bank financing is improving, there is still an urgent need to make available more equity financing through formal sources.

3) Need for an outside, professional partner.

In order to grow, SMEs need both appropriate financing and essential business assistance. SME entrepreneurs in China, as in most environments, will generally be inadequately trained and skilled in the techniques of business management. Even when some management assistance is made available through business development centers, training programs, and other resources, useful business assistance will generally require additional financing for its implementation. Indeed, it is almost invariable in the SME sector that to provide financing without assistance or assistance without complementary financing is to diminish or jeopardize the value of one in the absence of the other. The value of a professional equity investor to a young enterprise, therefore, is to bring appropriate financial *and* non-financial value to the investee.

While certain technical issues of an investee business will require outside consultants, the professional staff of an investing SME Fund should be able to provide essential advice in areas such as planning, financial controls, general marketing strategy, client relations and organizational development. Many business issues related to these and other areas are matters of common sense rather than specific technical knowledge. As objective observers of the entrepreneur's activities, the SME Fund's officers are normally in a favorable position to identify such common-sense issues and work through them with the entrepreneur. In many cases, it may be even more crucial for the investor simply to supply *discipline*, often the most important missing ingredient in an otherwise capable entrepreneur.

An equity investor has a number of ways not generally available to a lender to induce or encourage management to seek technical advice and implement it. These include provisions in a shareholders agreement to approve major business decisions, major expenditures, and the level of management's compensation. Moreover, given that the equity fund's investment is largely unsecured by collateral pledges and dependent upon growth for the majority of its return, the SME Fund is highly motivated to supply the most appropriate, effective, and affordable non-financial value it is able to provide.

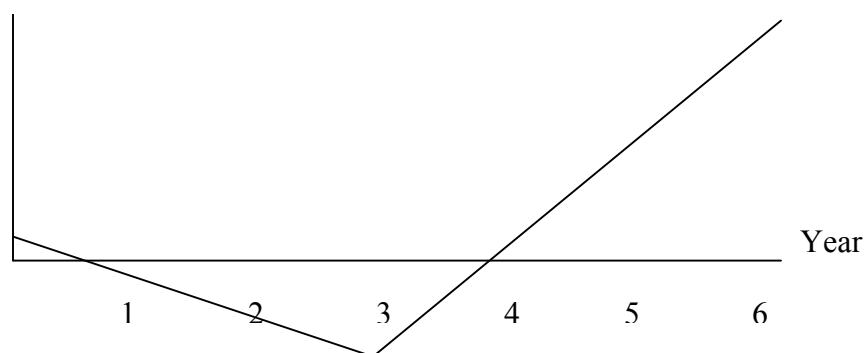
Conclusions

The discussion of the structure of an SME Fund under (iii) above leaves unresolved the manner in which the State would provide inducements to Investors to invest in SME Funds. (In the diagram, note broken lines going from the National Government to the Investors and the SME Fund) While we have gathered much information on current investment practices in China and on China's growing SME sector, we feel that it would be premature at this point to prescribe a final strategy for the SME Equity Program.

Therefore, based upon lessons drawn from the various programs described above in "International Best Practices" and the degree to which they contain elements appropriate to China, we would like to consider jointly with SETC three possible options, based on the structure illustrated and described above. It is important to bear in mind while considering these options that the cash flows of a fund principally engaged in equity investment are subject to what is often called the "J-Curve", as illustrated below:

“J-Curve” in Net Income to the Fund

Net Income from Investments



The above graph illustrates how the expenses of a fund will exceed income from investments in the early years. This is the result of the normal case in which a Fund investing primarily in equity participations will generally not attempt to receive dividends on its investment in a given company until after the completion of the second year of investment. Often, fund managers will forgo the distributions of dividends for even longer periods in order to reinvest earnings for the purpose of growing the company and its share value. While some current income may be received through interest payments on shareholder loans and fees in the early years, total annual revenues are unlikely to exceed management fees and other expenses of the fund until the third year or later.

It is generally impermissible under law for investors to seek dividend distributions from a Fund prior to that point at which the Fund has achieved positive retained earnings, that is to say, before the cumulative expenses of the Fund have been exceeded by the cumulative revenues of the Fund. Similarly, in the case of a loan to the Fund, it is economically unwise for the lender to seek interest and/or principal payments prior to the point at which the Fund has achieved positive retained earnings. To do so would simply serve to reduce the total amount of capital available to invest in portfolio companies.

Based on the foregoing, therefore, any option taken by the State in the SME Equity Program will have to assume that the State should not expect to receive either distributions or interest and dividend payments from an SME Fund until the fifth or sixth year of the Fund's operations.

After further discussion with SETC and industry participants, we will recommend a specific support program. The following approaches are indicative of the alternatives we are considering:

- a. Central Government loans to SME Funds or guarantees of bank loans to these funds. Government or the banks would expect only a conventional bank interest rate on their loans, so any excess profit would flow to the investors in the fund, including the provincial and local sources of capital. To avoid the pressure of current interest payments by the funds, these loans could be made as discount notes. Such a program would be very similar to the SBIC Debenture program, and the regulations for that program could provide a model.
- b. Direct investment in the funds by the Central Government. These could be made with the understanding that the fund could repurchase the government's share at cost plus a modest rate of return during the first five years of the fund's life (the Israel Yozma Fund model) or with the understanding that government would receive only a small percent of the fund's profits after it had recovered its investment and a modest rate of return from fund distributions (the U.S. SBIC Participating Securities model or the Australian Innovation Investment Fund model). Time-tested regulations are available for these programs.

A government-supported program would not only increase the amount of capital available, but would provide an opportunity for the Central Government to establish important standards for funds receiving such support. We recommend that the following be minimum requirements for funds that receive support:

- Fund managers must demonstrate they have had relevant experience and training for this role.
- Fund managers must be motivated by a compensation system that allows significant sharing of profits of the fund when investments are liquidated and cash is returned to investors.
- Funds must be limited to investing directly into companies that meet specific size limitations, and no investments may be made in open market securities. As a beginning pilot program, the size limitations should be quite small, and coupled with a requirement that the companies should not be more than three years old.
- Funds must agree to avoid investments in real estate and socially undesirable sectors.

PROPOSAL FOR A PILOT EQUITY SUPPORT SCHEME

Virtually every major government in the world has some kind of a support program to encourage direct investment in young SMEs. These are needed because, with the exception of popular high-tech companies, investors are generally unwilling to invest in SMEs. They believe the potential return on their investment is not high enough to justify the risk of loss and the length of time required before they can sell their

investment at a profit. The government support programs are designed either to increase the potential profit to the investors, or to reduce their risk of loss.

With the exception of one development-oriented fund in Sichuan Province, there are no organized investment funds operating in China that have a significant interest in investing in SMEs operating in traditional industries. Considering the perceived risk/reward potential of such investments, we do not believe there will be any in the future, unless they are supported by the government. We believe such support is warranted, to accelerate the inception and development of job-creating SMEs.

As a basis for recommending a specific support program, we have reviewed the support programs of many countries, in order to determine international best practice. All of the most successful programs are based on government support for funds that have the following characteristics:

1. They also have non-governmental co-investors.
2. They are managed by independent fund managers that are motivated by receiving a portion of the ultimate profit from the investments of the fund.
3. Government increases the potential rate of return to the other investors by limiting the profit it will take on the Government investment or loan to the fund.
4. Government satisfies its economic development objectives by limiting the right of the fund to invest in businesses that are smaller or younger than prescribed limits.

It is our understanding that the drafters of legislation are providing for a Development Fund, which can be used by SETC to invest in both credit guaranty companies that enable bank loans to SMEs, and to finance a new support program for investment funds that will provide equity financing for these companies. We strongly support this proposal, and believe it can have a major impact on the availability of financing for SMEs. We therefore recommend a pilot program, to be administered by SETC, in which at least five new funds would be formed.

These funds would be managed by independent managers: neither SETC nor the Development Fund would participate in investment decisions. However, by agreement with SETC the funds would be allowed to invest only in companies meeting the criteria set up by SETC. These would be:

1. Direct investments (or loans with equity rights)
2. Companies less than three years old, and smaller than a specified maximum size. For simplicity, we recommend the size restriction be a maximum of 250 employees for manufacturing companies, or 100 employees for non-manufacturing companies. SETC would have the right to allow investments in SMEs based on other criteria if requested by the fund manager.
3. Companies in any industry with the exception of real estate and socially undesirable fields such as alcohol, tobacco, armaments, and the like.

Hopefully, the proposed investment funds law will soon be enacted, and will allow drawdowns against commitments by investors and the Development Fund, so the individual funds will not have significant levels of excess cash at any time. No trading or investment in open market securities should be allowed, as this inevitably diverts management from its primary mission of direct investing in SMEs. Investment funds in other countries never allow investment of excess cash in anything except bank deposits or short-term debt of governments or very large companies.

We considered programs that are successful in other countries as possible models for a pilot program of government support for direct equity investment funds that would invest in both traditional and technology-based companies. The pilot would be managed by SETC. All of the models we considered are designed to attract non-governmental sources of investment, with three of the four limiting the profit to be taken by government, and allocating a higher share of profits to the non-governmental investors. Characteristics of individual support programs of other countries are described in the body of the Report. The following four models seemed most relevant for consideration by China:

1. Co-investment with local and provincial governments in new direct equity investment funds managed by independent managers. This would be the quickest way to launch these funds, but it would not encourage the participation of non-governmental sources. And since all investors have economic development as a principal objective, all-government funds risk having insufficient emphasis on profitability of investments and the ultimate sale. Consequently, the funds might not be self-sustaining.
2. The Israel Yozma fund model, which introduced venture capital to Israel in the early 1990s, with spectacular results. Government provided 40% of the investment capital for each of a series of funds, with private investors providing the remaining 60%. For a period of five years, the private investors had the right to purchase the government's share at its cost, plus a small interest rate. For a successful fund, therefore, the private investors received virtually all the profits, but risked only 60% of the investment. If the funds lost money, all investors, including the government, shared proportionately in the loss. The program is simple to administer, but subjects government to considerable risk, and requires the other investors to add to their investment later, possibly before it is clear that the fund will be profitable.
3. The Australian Innovation Investment Fund Program model, based on government investing two-thirds of the total investment capital of the fund, with non-governmental investors responsible for the remainder. If the fund is successful, all investors receive distributions in proportion to their investment, until government has

received back its investment plus interest, calculated at a government bond interest rate. Thereafter, government receives only 10% of distributions, with the other investors receiving 90%, even though they had invested only one-third of the fund total. Government has the same risk of loss as the investors, but a significantly lower profit potential.

4. The U.S. Small Business Investment Company (SBIC) model, the oldest and largest in the world, having operated since 1959. In its original form, the government loans two-thirds of the total investment capital of licensed funds, at a low government-based interest rate. By using discount notes, the program can be modified to eliminate the need for the fund to make cash payments of interest as its investments mature. All profits in excess of the interest on the government loans are paid to the investors who put up the remaining one-third of the fund. This is a powerful incentive for investment by non-governmental sources. At the same time, if there is a loss, government has priority on payments from the fund, and shares in the loss only if the private investors have lost everything. This greatly reduces the risk for government.

In our opinion, the program described in paragraph 4 above provides the best balance of incentive to non-governmental investors and risk of loss to the government. Consequently, we recommend that SETC be authorized to use a portion of the Development Fund to support at least five new investment funds. SETC would make discount loans to these funds, in a ratio of 1:1 for investment capital provided by government sources, and 2:1 for non-governmental sources. Experience of most countries with similar support programs suggests that a 2:1 ratio is required in order to increase the potential rate of return to a level that makes participation attractive to non-governmental sources.

Experience of other countries has confirmed that the most important determinant of success of any investment fund is the quality of its management. Moreover, it is important that management be allowed to operate independent of pressures from investors or government, and that it be motivated by a share of the eventual profits from the investment program. The fund managers should be selected by competitive tender, and be held responsible for arranging the investment capital of the fund. The manager will be motivated to seek as much non-governmental money as possible, since SETC would loan twice the amount of this capital, compared with only 1:1 loans against capital coming from governmental sources.

A full set of Guidelines for the operation of the pilot funds is included as Appendix A. Papers by domestic consultants discussing equity financing of both traditional and high-tech SMEs are included as Appendix B.

In order to increase the number and quality of managers for these funds and for existing venture capital funds, we believe the development and implementation of training programs is of critical importance. Consequently, we recommend that ADB and other development agencies support this effort by tendering for proposals from training organizations and universities. The training program should be based on the case method of instruction, to give the students the most practical knowledge, and should be coupled with internships or other opportunities for the students to participate directly with successful investment funds.