

Appendix CC

The Legal Mechanisms for Small and Medium Sized Enterprise Financing in China

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for
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Financing
in
China

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Definition and Classification of SME's

• **Definition of SME's:**

Large enterprise: has over five hundred million yuan RMB (¥500,000,000) for the gross annual sales and the total capital respectively.

Medium enterprise: has over fifty hundred million yuan RMB (¥50,000,000) for the annual sales and the total capital respectively.

Small enterprises include all the rest.

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Definition and Classification of SME's

• **Classification of Enterprises:**

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: After 1993, the enterprises are classified by their organizational format and divided into corporation, partnership, individual proprietorships and cooperative stock enterprises as well as the three types of foreign funded enterprises

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**Legal Background of SME Financing
– Basic Company System**

• **Capital System**

(1) The minimum Registered Capital for a company is too high.

(2) Methods of Capital Subscription:

a. lack of stipulations on investment in the form of stocks or creditor's rights;

b. lack of clear laws governing the evaluation and verification of the intangible assets;

c. indefiniteness still exists in practice with regard to the ownership of intangible assets.

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**Legal Background of SME Financing
– Basic Company System**

• **Mechanism of Examination and Approval**

The incorporation, merger, division and issuance of new shares of a company limited by shares must be subject to the approval of a department authorized by the state council or of a people's government at the provincial level, which limits the financing channels of the SME companies limited by shares and increases financing cost.

Suggest to loosen the over-strict administration and create a more open environment for the SME's to give full play of their advantage of operation flexibility.

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**Legal Background of SME Financing
– Basic Company System**

• **Limits on Scope of Business**

Increase the costs of businesses and capital restructuring; restrict the financing efficiency; limit their flexibility in business activities; lower their risk resistance abilities.

Suggest to adopt more flexible administrative systems and loosen the restrictions on the scope of business, such as to adopt the business scope administration of "all businesses permissible unless special approvals required."

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Legal Background of SME Financing – Basic Company System

- Limits on outside investment ratio

The aggregate amount of such investments may not exceed 50 per cent of the investing company's net assets. Investments to SME's for the purpose of their capital and share expansion are restricted by the above provision.

Suggest to cancel or loosen the restrictions on outside investment ratio

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Legal Background of SME Financing – Basic Company System

- Taxation

The preferential tax treatments to SME's are not clear and specific enough; The preferential tax treatments made by the different local governments often conflicts with the state policies.

Suggest to legislate united, specific and clear laws and regulations applicable to SME's preferential tax treatments and tax collection and administration.

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SME Equity Financing

- Equity Financing by Private Placements

- (1) New Investors

Lack of sufficient protection for investors, especially the minority shareholders; PRC individuals are not qualified in their personal capacity to invest in foreign investment enterprises; Restrictive access barriers imposed by industry to foreign and domestic private investment.

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SME Equity Financing

- (2) Capital Withdrawal Mechanisms under Equity Financing

Share transfer (including merger); Bankruptcy and dissolution (withdraw by liquidation); Judicial Enforcement; Reduction of the registered capital.

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.

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SME Equity Financing

- Public Offering

- (1) Main Approaches

Listing of domestic investment shares inside China (i.e. A shares); Listing of foreign investment shares inside China (i.e. B shares); Issuance of shares for capital increase by "shell purchase"; Listing outside China; Listing outside China with domestic interest.

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SME Equity Financing

The threshold to issue A shares or B shares is too high to be reached by SME's. Moreover, in terms of financing in the security market, the private enterprises, as the main force of SME's, have not received the equal treatment as the state owned enterprises.

Since an enterprise listing 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).

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SME Equity Financing

- (2) Hong Kong GEM, Contemplated Domestic "GEM", and SME Public Offerings

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 in solely relying on Hong Kong and Bermuda companies.

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

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SME Equity Financing

- (3) Domestic Financing for Foreign Investment Companies Limited by Shares

According to the *Several Opinions on the Listed Company Involving Foreign Investment* jointly issued by Ministry of Foreign Trade and Economic Commission and China Securities Regulatory Commission in November, 2001, foreign investment company limited by shares is allowed to apply to be listed and issue A shares or B shares.

Currently the domestic financing for foreign investment companies limited by shares is still in the trial period.

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SME Debt Financing

- Loan of Domestic Bank

- (1) Impediments From Banks

SME's are small and usually without good credit. Lack of small and medium sized banks particularly serving SME's; The incentive provided by the state for the banks to give loans to SME's is insufficient.

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SME Debt Financing

- (2) Credit System of SME's

Lack of corresponding files for enterprises and entrepreneurs; The information collection and establishment of credit evaluation system are still in their infancy.

Suggest to promote the the development of non-government credit evaluation institutions.

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SME Debt Financing

- (3) Credit Guarantee System of SME's

A series of laws and regulations have been promulgated to establish credit security system for SME's and made some progress.

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SME Debt Financing

- International Commercial Loan

Strict qualification requirements and approval procedures shall be applied to the organizations in China borrowing international commercial loans or providing security to foreign entities, which means that it is very difficult for SME's to get loans from foreign entities.

Suggest to 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 SME's may get international commercial loans

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SME Debt Financing

- Loans between Enterprises

Chinese laws currently prohibit direct loans between enterprises. SME cannot borrow directly from the enterprises that have spare capital. It affects the flow of capital and its effective utilization to some extent.

Suggest to properly regulate inter-enterprises loans and improve relevant laws.

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SME Debt Financing

- Trust Loan

Currently, there are many legal disputes in China over trust loans, and domestic trust and investment institutions are unwilling to deal in such business.

Suggest to further strengthen the standardization of the trust loan business conducted by trust and investment institutions and specify the punishment rules for malpractice of trust and investment institutions.

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SME Debt Financing

- Bond Financing

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: Subjects of bond issuance are mainly limited to big-sized state owned enterprises, and SME's in practice have no access to such financial instrument.

Suggest to Consummate relevant legislations, expand financing channels of SME's.

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Conclusion

The key for the consummation of SME's financing legal system includes:

1. Reduce unnecessary governmental intervention so as to give the SME's financing a free and favorable environment, and bring SME's' advantage of flexibility to full play.

2. Consummate relevant legislations, guarantee the continuity, standardization and stability of the policies in support of SME's, and enhance the efficiency and force of such support.

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