

Appendix W

The Legal Mechanisms for **Small and Medium-sized Enterprises** **Financing in China**

Definition and Classification of Small and Medium-sized Enterprises (SME's) and Scope of this Report and Study

1. Definition 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 SME's 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 SME's. 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. contractual joint ventures, equity 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 SME's from the perspectives of basic systems of Chinese Company Law, equity financing and debt financing. The report also makes some legislation recommendations for the reference of the related authorities.

Legal Background of SME Financing – Basic Company System

I. Capital System

1. Minimum Registered Capital

(1) Legal Requirements:

According to the Company Law, the required minimum registered capitals to establish a limited liability company are varied among the different types of business the company is engaged in. The least amount of registered capital to incorporate a company is RMB 100,000 yuan, which is for the kind of company engaged in science and technology development, consultancy or other services.

The registered capital of a company limited by shares, according to the Company law, shall be no less than RMB 10,000,000 yuan. And a company limited by shares applying to have its shares listed and traded publicly must have the total amount of the company's share capital of no less than RMB 50,000,000 yuan.

(2) Impediments:

- a. The required minimum registered capital is too high which imposes a high threshold for the establishment of SME's detrimental to fully mobilizing nongovernmental capital and to attracting foreign investment.
- b. Since only SME's with RMB50,000,000 or more registered capital are qualified to have its stocks listed and traded, a considerable number of SME's 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 SME's.

2. Methods of Capital Subscription

(1) Legal Requirements:

- a. According to 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. 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); according to the *Notice on Certain Policies of the MOFTEC Encouraging and Promoting the Development of Small and Medium Enterprises Redistributed by the State Council* issued by State Council 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. There are no clear laws governing the evaluation and verification of the intangible assets investment. There exist in practice unsubstantiated registered capitals.

(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;

II. System of Examination and Approval

1. Legal Requirements:

According to the Company Law, the incorporation, merger, division and issuance of new shares 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.

2. Impediments:

The administration to a company limited by shares is over-strict, which limits the financing channels of the SME companies limited by shares and increases financing cost.

3. Legislation Recommendations:

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

III. Scope of Business

1. Legal Requirements:

According to the Company Law, companies shall engage in business activities within their registered scope of business.

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 authority shall order it to make corrections and may impose punishment on it."

2. Impediments:

- a. Increase the costs of businesses and capital restructuring of SME's and restrict the financing efficiency.
- b. Limit the flexibility in business activities of SME's and lower their risk resistance abilities.

3. Legislation Recommendations

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 are required."

IV. Outside Investment Ratio

1. Legal Requirements

According to the Company Law, "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."

2. Impediments

Investments to SME's 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.

V. Taxation

1. Legal Requirements

Currently, China already has some policy documents providing tax preferential treatment to SME's. For example, according to the *Several Policy Opinions on Encouragement and Promotion of Development of Small-and-Medium Enterprises* issued by the State Economic and Trade Commission, "To the non-profit credit guarantee and re-guarantee institutions in the national pilot range whose purposes are to serve SME's 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 SME's are not clear and specific enough.
- b. The preferential tax treatments made by the different local governments, such as tax first and return some portion next, tax rate reduction, and so on, are conflict with the State policies. There existed a lot of such situations.

3. Legislation Recommendations

Legislate united, specific and clear laws and regulations applicable to SME's 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. 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.
- b. PRC individuals are not qualified in their personal capacity to invest in foreign investment enterprises (the “FIEs”).
- c. Restrictive access barriers imposed by industry to foreign and domestic private investment. The revised *Industrial Guiding Catalogue for Foreign-Invested Enterprises*, implemented from April 1st, 2002, has made a further movement to lessen the restriction to the industrial access. Moreover, the *Several Opinions of the State Development Planning Commission on Promotion and Guidance of Private Investment* issued by the State Development Planning Commission in December of 2001 has stated that expect the area that is treated by the special rules and regulations by the State, the private investment is encouraged in the same area as where foreign investment is also allowed and encouraged. The above policies will benefit the development of SME’s. However, in practice it is still lack of specific implementing procedures.

(2) Legislation Recommendations

- a. Add relevant stipulations to the Company Law or in separate SME regulations for the protection of investors and minority shareholders.
- b. Loosen the limitations on PRC individuals' investing in FIEs.

2. Capital Withdrawal Mechanisms under Equity Financing

(1) Approaches

- a. Share transfer (Including merger), the founders of the company having its shares listed and traded are not allowed to transfer their shares three years after incorporation;
- b. Bankruptcy and dissolution, withdraw by liquidation;
- c. Equity in pledge: the pledgee can only use the method of putting the equity up for auction to realized the right of pledge;
- d. Judicial Enforcement, not limited by the three-year limitation upon the corporate founders;
- e. Reduction of the registered capital

(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) Legislation Recommendation

- 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.

II. Public Offerings

1. Main Approaches

(1) The current main approaches for the domestic enterprises:

- a. Listing of domestic investment shares inside China (i.e. A Shares);
- b. Listing of foreign investment shares inside China (i.e. B Shares);

- 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: 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: Chinese-funded, non-listed companies registered outside China and Chinese-funded Listed Companies Registered Outside China shall 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 in China of their assets outside China and which they have actually owned for not less than three years.

(2) Impediments

- a. 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 in practice, as the main force of SME’s, have not received the equal treatment as the State Owned Enterprises. The *Notice of Sending Out Several Opinions of the State Development Planning Commission on Promotion and Guidance of Private Investment* requires the security supervision department to provide equal opportunities to the SME’s project financing, on the basis of the improved and perfect ratifying mechanism;
- b. 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).

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 in 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. 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 (“MOFTEC”) and China Securities Regulatory Commission in November, 2001, foreign funded company limited by shares is allowed to apply to be listed and issue A shares or B shares.

Currently, financing in the domestic stock market for foreign funded companies limited by shares is still in the trial period.

SME Debt Financing

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

I. Loan of Domestic Bank

1. Impediments from the Bank

(1) Impediment

- a. The banks think that they may have to take relatively high risks to develop the financing service market for SME's because most SME's 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 loan prefer to lend the money to big enterprises with good credit record.
- b. Lack of small and medium banks mainly serving SME's.
- c. In order to improve bank service for SME's, the People's Bank of China issued *Guidance on Further Strengthening and Improving Financing Service for SME's Opinion* in 1999. In these opinions, the People's Bank provided general guidance for improving SME's financing service. However, since there was still no specific and stable policy support to benefit SME's, the incentive is still not enough.

(2) Legislative Recommendation

Promote the development of banks limited by shares and city commercial banks, which provide their financing service mainly to SME's. Uniform, definite, and steady preferential fostering policies regarding loan to SME's should be stipulated in related laws and regulations so as to give commercial banks incentives to loan SME's.

2. Credit System of SME's

(1) Legal Requirements

In April 2001, ten ministries and commissions including the State Economic and Trade Commission ("SETC") promulgated *Strengthening Credit Management of SME's 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 SME's 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 SME's. 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 SME's

In order to reduce loan risks, banks generally require debtor to provide mortgage or reliable guarantee for the loan. SME's, 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 SME's. 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 SME's got loans through such security.

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 SME's to get loans from foreign entities. In reality, it is very hard for SME's 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 SME's 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 People's Court, when enterprises borrow and lend among themselves, 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 levied as well. But the principal shall be returned.

(2) Impediments

It is impossible for SME's to get loan from big enterprise that has spare capital, where affect the flow of capital and its effective utilization to some extent.

(3) Legislation Recommendation

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 and the trust and investment company (the trustee) give 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.

(2) Impediments

There are many legal disputes in China over trust loans and 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.

(3) Legislation Recommendation

- 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

1. 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 SME's have no access to such financial instrument.

3. Legislation Recommendations

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

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 to clarify and specify the support policies of SME's financing, guarantee the continuity, standardization and stability of the policies in support of SME's and enhance the efficiency and force of such support.

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