

**Comparison of the Legal Institutions of Enterprise
Financing in China and the United States**

by

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As an important activity of an enterprise, financing is restricted by laws. It's very significant to know the legal issues related to raising capital in the United States and China, including the differences between these two countries. This article will introduce and discuss the legal issues on the enterprise's right to finance, stocks, bonds, private lending and start-up enterprises financing.

一、 Enterprises' rights to finance and the regulatory regime with respect to financing in the United States and China

China adopts relatively strict regulatory regime with respect to financing. As a result, it's regulated by the law system. Enterprise's behavior is always regarded as "Illegal Fund-Raising" and "Illegal Securities Activities" due to their irregularities in financing. So, it will incur criminal and administrative liabilities. There are crimes of frauds in issuing stocks or bonds, such as "crime of taking deposits from the public illegally", "crime of issuing stocks or enterprise/company bonds absent required approvals", "crime of illegal fund raising by fraudulent means" and "crime of illegal business". Besides, Chinese enterprises possess unequal rights to finance. The right of raising capital includes issuing an IPO and debenture openly, which must be verified and approved by the governmental regulatory bodies. Otherwise, any enterprise or individual can't issue shares and bonds at all.

However, in the United States, mechanism of registration with respect to securities issuance is well established. In the U.S., the enterprise need to register, fully and truthfully disclose information in order to finance through issuing securities. The rights to finance are automatically obtained and fairly equal. There is private placement mechanisms not involving public offering in the U.S., certain small-amount issuances are exempted from registration. All in all, the legal infrastructure is friendly to enterprise financing.

二、 General comparison of enterprise financing through securities

China's Securities Law (2005) does not prescribe the definition of "securities". Securities in enterprise financing are limited to two types: stocks and corporate bonds. Investment agreements, stock certificates limited liability companies are not "securities", and thus not regulated by Securities Law. As a result, the adjusting range of Securities Law is very limited, which only includes how to offer stocks and company bonds publicly to finance and how to trade on a stock exchange.

By comparison, in the U.S., the definition "securities" under Securities Act of 1933 is broad. In that law, almost all the activities of investment and public offering stocks & company bonds to finance are adjusted. For that reason, investment agreements, even angleworms and prints are deemed "securities". The securities laws instead of contract laws in the U.S. regulate the investment activities. Enterprise can seek financing from the public as long as they fully utilize their rights and resources, fulfill the registration requirements, and disclose the true information of the enterprise to the public. But in China, the "investment agreements" are regulated by contract laws instead of securities laws.

三、 Legal mechanisms with respect to stock financing

(一) Financing through public offering of stocks

Public offering of stocks is an important method for Chinese enterprise to raise capital. A joint stock limited company has the right to finance by that way if it's legally incorporated and has existed for 3 years or more continuously. However, a limited liability enterprise and other forms of business organization (like partnership) don't have this right. For the companies limited by shares, the financial targets are as follows: Having a positive net profit of over 30 million yuan accumulatively for the latest 3 accounting years; Having a net cash flow of over 50 million yuan accumulatively, or having a business income of over 0.3 billion yuan accumulatively for the latest 3 accounting years; Having a total amount of stock capital of not less than 30 million yuan before issuance; And the proportion of its latest intangible assets

(upon deduction of its land use right, right to aquatic breeding and right to mining) in its net assets not being higher than 20%.

In March 31st 2009, China Securities Regulatory Commission(CSRC) distributed a new rule named 《Temporal Measures for the Administration of Initial Public Offering and Listing of Stocks on Growth Enterprise Market》. It says: only a joint stock limited company which has been established by law for more than 3 years has the right of public offering and listing of stocks on the Growth Enterprise Market. And then, the company must have a positive net profit of over 10 million yuan accumulatively for the latest 2 accounting years and it's keeping growing persistently. Or the company has a positive net profit of over 5 million yuan accumulatively for the latest 1 accounting years, the business income is over 50 million yuan accumulatively for the latest 1 accounting years, the growth rate of the business income is not less than 30% for the latest 2 accounting years, and the total amount of stock capital is not less than 30 million yuan after issuance. Certainly, an enterprise can't issue stocks publicly without the approval of CSRC. In addition, not all the qualified companies can be approved luckily but the companies not qualified all have no chance to get the opportunity and right to raise capital by offering stocks publicly.

According to the Securities Law in America, an enterprise which finances by public offering of stocks has right to do that naturally. As long as it has finished the procedures of registration according to the law and made its information available to the public. Therefore, whether the enterprise can raise funds totally depends on the choice of the investors. Moreover, there are no profit targets for an enterprise if it wants to raise capital. And then, for a Chinese enterprise which applies for that, it always takes several months theoretically, but 1-3 years in practice to realize its dream. But in the States, there is a 20-day mandatory waiting period after registration, and no transaction is allowed during this period. Absolutely, it takes much less time for the enterprise to begin to raise capital. As is mentioned above, there are many differences between the system of approval in China and the system of registration in the United

States on the legal issues related to raising capital by equity financing.

With regard to initial public offering (also named “capital increase issue”), it needs to be verified and approved by CSRC. The regulations require the company to have the capability of making profits continuously and a sound financial status. Specifically, the average net assets yield rates for the recent 3 accounting years shall not be lower than 6%, and separate from each other for 1 year or more. By comparison, no specific requirements with respect to performance and timing are imposed on enterprises. It’s convenient to conduct small-amount public refinancing at small and medium enterprise board. The process of small-amount refinancing less than \$10,000,000 is significantly simplified.

(二) Non-Public Offer of Stocks

Since the Enterprise Law and Securities Law began to take effect in January 1st, 2006, China has established legal mechanism for non-public offering of stocks. An enterprise can raise funds from targeted shareholders. And according to the Article 10 of Securities Law, companies limited by shares can issue securities to less than 200 specific targets are deemed non-public offerings. For any securities that are not issued in a public manner, the means of advertising, public inducement or public issuance in any disguised form shall not be adopted. Generally speaking, making a non-public issuance requires to raise capital towards specified shareholders and the number of shareholders is no more than 200. If the number exceeds this number, or the objects are unspecified public, it is regarded as public issuance. The Securities Law also demands “approval from CSRC is required for listed company to make a non-public stock offering of stocks” and “the targets of listed companies’ non-public offering cannot exceed 10 persons, if targets are overseas strategic investors, pre-approval pertinent department at State council is required”. As a result, the “non-public offer of stocks” in China is similar to, but at the same time, different from the private placement in the States.

U.S. securities law provides exemptions from registration for non-public private placements. Rule 506, named “safe harbor” of Regulation D (1982) provides an exemption: the company may sell its securities to an unlimited number of “accredited investors” and up to 35 other purchases. The company cannot use general solicitation or advertising to market the securities. Purchasers must be sophisticated, either with a purchaser representative, or are qualified institutional investors. “Accredited investors” includes eight types of entities or individuals, such as: a director, executive officer, or general partner of the company selling the securities; a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase; a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year.

(三) Legal Mechanisms of Exemption for Small-amount Offerings

Rule 504 of Regulation D provides an exemption from the registration requirements of the federal securities laws for some companies when they offer and sell up to \$1,000,000 of their securities in any 12-month period. It’s a cost and time saving method for small and growing business to raise capital. Rule 505 of Regulation D allows some companies offering their securities to have those securities exempted from the registration requirements of the federal securities laws. To qualify for this exemption, a company:

- Can only offer and sell up to \$5 million of its securities in any 12-month period;
- May sell to an unlimited number of "accredited investors" and up to 35 other persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions;
- Must inform purchasers that they receive "restricted" securities, meaning that the securities cannot be sold for at least a year without registering them; and

- Cannot use general solicitation or advertising to sell the securities.

In China, corporations should not issue securities to non-specified objects, while it is allowed to making a issuance of securities to less than 200 specified objects. However, there's no limitation on the total amount of issuance and no relative regulations on small-sum issuance.

In China, private lending is legal and valid. Private lending can be loans between individuals or individual and enterprise, except between enterprises. Loan agreements between enterprises are invalid. The interests rate in private lending cannot exceed four times the bank loan interest over the same period. It is legal for enterprises to borrow money from individuals, while Chinese laws don't stipulate any limitations with respect to the number of lenders and the amount of the loan. Private loan should avoid the risks associated with illegal fund raising and illegal taking deposits from the public

四、 Legal Mechanism Relating to Debt Financing

Chinese enterprises can raise capital by issuing bonds, which include enterprises bonds of companies and corporate bonds of listed companies. The enterprises bonds need to be verified and approved by National Development and Reform Commission, while corporate bonds of listed companies need to be verified and approved by China Securities Regulatory Commission.

According to the 16th Article of Securities Law of PRC, a public issuance of corporate bonds shall meet the following requirements:(1) The net asset of a joint stock limited company is no less than RMB 30 million yuan and the net asset of a limited-liability company is no less than RMB 60 million yuan;(2) The accumulated bond balance constitutes no more than 40 % of the net asset of a company;(3) The average distributable profits over the latest 3 years are sufficient to pay the 1-year interests of corporate bonds;(4) The investment of raised funds complies with the

industrial policies of the state;(5) The yield rate of bonds does not surpass the level of interest rate as set by the State Council; and(6) Any other requirements as prescribed by the State Council. The funds as raised through public issuance of corporate bonds shall be used for the verified purposes and shall not be used for covering any deficit or non-production expenditure.

Also, Article 12 of Regulations for the Administration of Enterprise Bonds says: “To issue enterprise bonds, the following conditions must be met: (1) the enterprise size reaches the level required by the state; (2) the enterprise establishes the financial and accounting system in conformity with the state regulations; (3) the enterprise can repay its debts; (4) the enterprise enjoys a sound economic benefit and has been made profits for three consecutive years prior to the issuance of the enterprise bonds; (5) the future investments for the raised funds meet the national industrial policies.” The interest rates for the enterprise bonds shall not be 40% higher than those for the term deposits of residents during the same period.

Generally speaking, in China, the amount of capital raised by bonds is small, Chinese listed companies prefer financing through stock offerings, while bond offerings are ignored. In contrast, issuing bonds is a common choice for qualified companies in USA, because issuing stock could violate the shareholders’ interest., and to some degree suggest inappropriate management.

五、 Start-up Financing and Venture Capital

China provides growth enterprise market for the fund raising of promising growth enterprises and high-tech enterprises. Administrative Measures for Initial Public Offerings and Listing on the Growth Enterprise Market (GEM), which will come into effect in May, 2009, listed conditions for issuance: A promoter shall be a joint-stock company legally established and having been operating continuously for three years or more. For a limited liability company which is totally changed into a joint-stock company by converting its net assets value as shown in its account book into shares,

the time of continuous operation may be calculated from the date when the limited liability company is established.

The promoter's financial status shall satisfy the following requirements:

1. it has been gaining profits for the latest two consecutive years, and its accumulative net profits gained in the latest two years are 10 million yuan or more and have been growing continuously; or it made profits in the latest year and the net profits are 5 million yuan or more, and its business income in the latest year is 50 million yuan or more and the growth rate of its business income in the latest two years is 30% or more (the net profits shall be calculated on the basis of the amount before or after deducting the non-recurring profit and loss, whichever is smaller);
2. its net assets before offering is 20 million yuan or more;
3. it has no loss to cover in the latest period; and
4. the total amount of capital stock after offering is over 30 million yuan.

The CSRC (China Securities Regulatory Commission) shall, within five days after receiving the application document, make a decision on whether to accept it or not. If the CSRC accepts the application document, the relevant functional department shall make a preliminary examination on the document, and such document shall be subject to the examination and approval of the issuance review committee of the second board. If the application for issuance of stocks is disapproved by the CSRC, the promoter may file another application with the CSRC six months later from the date when the decision of disapproval is made by the CSRC.

An effective financing method for start-up enterprises to raise money is to seek venture capital. The form of start-up enterprises could be a company or limited liability partnership. Venture capitalist can have equity interest in the enterprise, own its stocks, can also become a limited partner who does not participate in the management. The liability of each shareholder is limited to the amount individually invested, and the shares could be transferred privately. So, with a mature legal

protection, it is easy for start-up enterprises to seek venture capital.

China's venture capitals industry is not developed and there are not much venture backed companies. Capitals are entering into Chinese markets. Focusing on venture capital investments is one of the ways to reap massive profits. Moreover, there are extraordinary sources of second bord listed company. As indicated by status from The CSRC, until October 2007, there are 195 listed companies in the growth enterprise market of USA, Britain, HK, and Singapore from China Mainland. Looking from the first round of offering, the amount raised fall between 1.8 million CNY and 4.1 billion. In the USA, it is comparatively easy for start-up enterprises to raise money, for there are many venture capitalists and investment companies with fully developed legal institutions.

To sum up, China has a set of legal institutions with respect to private lending, public offerings and non-public offerings of securities, and start-up equity financing. The U.S. has relatively developed legal institutions with respect to the scope of "securities", public offerings of securities, private placements, exemption for small-amount offerings and start-up financing, etc. Knowing the regulations of raising capital is beneficial for entrepreneur to fully take advantage of the two capital markets.