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China's New Stock Exchange for Small and Medium-Sized Enterprises

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China has a new stock exchange. On 2 September 2021, President Xi Jinping announced that China would support innovation-driven small and medium-sized enterprises (SMEs) by reforming the New Third Board (The National Equities Exchange and Quotations [NEEQ] in Beijing, operated by NEEQ Corporation Limited, also known as the Third Board). The new Beijing Stock Exchange (BSE) would act as the "primary platform" for serving such SMEs. As might be expected of an initiative announced by President Xi, the China Securities Regulatory Commission (CSRC) immediately stated that it was "excited" by the prospect of a new stock exchange and would "resolutely implement" the president's proposal.[1]

The day after President Xi's announcement, the BSE was established with equity capital of RMB1 billion (US$155 million), NEEQ as its sole shareholder and sharing the registered address of the NEEQ. Xu Ming, current chairman of NEEQ, was concurrently named chairman of BSE, along with the appointment of its Board of Directors and Board of Supervisors as well as senior administrative officials (mostly officials of CSRC and NEEQ).

Draft regulations for the BSE have been issued for public review and comments.[2] Among them, the BSE is expected to adopt a faster IPO registration process than the current one where each individual IPO is approved by the CSRC. Wider trading bands are also to be adopted – prices are allowed to rise or fall by up to 30% each day before circuit breakers are triggered compared

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[1] "Xi Says China to Set Up Beijing Stock Exchange for SMEs", https://www.reuters.com/world/china/xi-says-china-set-up-stock-exchange-beijing-2021-09-02/, accessed 5 October 2021.

[2] http://english.www.gov.cn/news/topnews/202109/07/content_WS6136bfdac6d0df57f98dfcca.html, accessed 5 October 2021.

to the 20% for the Shanghai and Shenzhen stock exchanges. No trading limit is expected to apply for shares of firms on their first trading day after an IPO.[3]

Market reactions to the move varied considerably. Many welcomed it, in the expectation that it would address long-standing constraints faced by SMEs, including innovation-driven SMEs, in China in accessing finance.[4] A dedicated new stock exchange based in Beijing would presumably focus on making access to equity capital for SMEs easier. Others argued that what is needed are better rules for existing stock exchanges in Shanghai and Shenzhen to allow SMEs to list on these exchanges and that there is little need for a totally new exchange.[5]

The context in which President Xi made his announcement, in the midst of an ongoing regulatory crackdown on China's tech companies, has not been lost on market watchers.[6] The crackdown has already cost investors an estimated \$1.5 – \$2 trillion as stock prices of many Chinese firms have fallen and has raised questions in several investors' minds about China's commitment to markets. While President Xi may be expressing support for SMEs and entrepreneurs through a new stock exchange, markets may consider that a better way to express such support would be through a more predictable set of rules and regulations under which both entrepreneurs and investors could benefit.

Definitions of what exactly constitutes an SME vary widely. Some frequently used definitions are firms that have 250 or less employees (the European Union) or 500 or less employees (the United States).[7] Small firms are typically considered to be those with 50 or less employees. There are also definitions based on annual firm turnover, though these vary even more widely across countries. Estimates of the number of SMEs worldwide differ widely too – from around 213 million[8] to 400 million.[9] The International Finance Corporation (IFC) estimates that there are about 163 million formal micro, small and medium-sized enterprises in developing countries.[10] SMEs are estimated to form about 95% of firms worldwide, contributing to 60-70% of employment, 85% of new employment and two-thirds of private sector jobs. Estimates of contributions to GDP (gross domestic product) range from 40% to 60%.[11]

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3 "The New Beijing Stock Exchange for SMEs – What We Know", https://www.china-briefing.com/news/beijing-stock-exchange-for-smes-what-we-know/, accessed 5 October 2021.

4 "China to Create New Stock Exchange for SMEs in Beijing", https://www.ft.com/content/0d358d5b-a2a6-4202-b260-000ad5008c83; "The New Beijing Stock Exchange for SMEs – What We Know", https://www.china-briefing.com/news/beijing-stock-exchange-for-smes-what-we-know/; "What is the Goal of Beijing's New Stock Exchange", https://thediplomat.com/2021/09/what-is-the-goal-of-beijings-new-stock-exchange/; and "New Beijing Stock Exchange Could Be the Financial Lifeline China's Small Companies Are Crying Out For, Analysts Say", https://www.scmp.com/business/banking-finance/article/3147474/new-beijing-stock-exchange-could-be-financial-lifeline, all accessed 5 October 2021.

5 "China's New Stock Exchange Eyes Small, Medium-Sized Companies", https://www.voanews.com/a/china-s-new-stock-exchange-eyes-small-medium-sized-companies/6232320.html, accessed 5 October 2021.

6 Ibid.

7 https://stats.oecd.org/glossary/detail.asp?ID=3123 and https://ec.europa.eu/growth/smes/sme-definition_en, all accessed 5 October 2021.

8 https://www.statista.com/statistics/1261592/global-smes/, accessed 5 October 2021.

9 https://globalnaps.org/issue/small-medium-enterprises-smes/, accessed 5 October 2021.

10 https://www.worldbank.org/en/topic/smefinance, accessed 5 October 2021.

11 Ibid.

For SMEs, despite providing a large share of employment and accounting for a significant portion of GDP, access to finance is a common, global problem. According to the World Bank, access to finance is the second most cited obstacle facing SMEs in emerging markets and developing countries. SMEs are less likely to obtain bank loans than large firms. Instead, they rely on internal funds, suppliers' credit, or cash from friends and family to launch and initially run their enterprises. The IFC estimates that the aggregate funding gap for loans for 65 million formal micro and SMEs (about 40% of the total) in developing countries is nearly US$5.2 trillion per year, about 1.4 times the total amount of worldwide lending to such firms.[12] While estimates of the need for equity financing, particularly through formal stock exchanges and for SMEs in developing countries, are harder to come by, recent studies have shown that such gaps could be large. In terms of estimated equity financing gap to GDP ratio, SMEs face significant constraints even in European countries such as Greece (54%), Sweden (20%) and the UK (11%).[13]

When SMEs raise external funds, it is mostly loans from banks. Equity from capital markets is typically a source of financing for large corporations, but not for SMEs. Reasons include (i) complex and costly listing requirements; (ii) lack of awareness or financial knowledge of the process of accessing capital markets; (iii) disclosure requirements that many SMEs see as onerous and intrusive; and (iv) investor disinterest in light of the low liquidity of SME stocks.

Many countries have tried to address these issues and help SMEs access equity markets by establishing dedicated or "alternative" markets targeted at SMEs. In these markets, typically, listing fees are lower, listing and disclosure requirements are less stringent and professional help from financial advisors is available to help smaller firms undertake listings at times. The World Federation of Exchanges lists 33 such SME-focused equity markets around the world; in 2017, about 6,800 companies were listed with a total market capitalisation of about US$1.3 trillion.[14]

Global experience in promoting equity markets for SMEs shows that most SMEs do not seem to use such markets, even when they are available. In addition, such dedicated SME markets tend to serve relatively larger firms, rather than the typical SME in the country. One area where SME exchanges do seem to make a difference when compared to traditional stock exchanges is that they cater more to service-sector firms, even though there is a concentration of information technology firms in this segment too.

There were an estimated 38 million SMEs in China in 2019.[15] SMEs comprise 94% of all businesses in China, accounting for nearly 60% of GDP and generating about 70% of all urban employment. About 55% of SMEs are in the service sector, mostly in wholesale, retail and leasing services, and another 30% is in the industrial sector. The OECD estimates that Chinese SMEs contribute about half of all business tax revenues. The classification of SMEs in China, based on the number of employees, annual revenue and total assets, is complex, with different criteria applied to different economic sectors. For example, a medium-sized agricultural

12 https://www.worldbank.org/en/topic/smefinance, accessed 5 October 2021.

13 https://www.fi-compass.eu/news/2020/03/gap-analysis-sme-financing-new-fi-compass-report-published, accessed 5 October 2021.

14 https://www.world-exchanges.org/news/articles/world-federation-exchanges-publishes-report-global-sme-markets, accessed 5 October 2021.

15 https://www.statista.com/statistics/783899/china-number-of-small-to-medium-size-enterprises/, accessed 5 October 2021.

enterprise is required to have a minimum of 500 employees and a small-sized construction enterprise can have a maximum business revenue of US$8.5 million. In general, compared to the SMEs in many other economies, SMEs in China are relatively large.[16]

Despite their importance to the Chinese economy, one of the biggest obstacles faced by SMEs in China is access to finance. Surveys have shown that SMEs in China report greater hurdles to accessing financing than those in other countries. Despite recent growth in credit to SMEs which has been faster than overall credit growth due to government policies, Chinese SMEs continue to face high collateral and guarantee requirements from banks. Banks, in turn, attribute such requirements as well as higher interest rates on SME loans to the relatively higher risk and resulting higher non-performing loans on their SME portfolios. Access to finance also differs between regions. SMEs in smaller cities face greater hurdles than those in larger cities.[17]

Enhancing SMEs' access to finance, particularly credit, has been a policy priority of the government. SMEs enjoy tax exemptions and state-owned banks are encouraged to lend to SMEs. The establishment of the BSE is yet another step in supporting SMEs. The difficulties that SMEs face in dealing with existing large exchanges and the reforms needed to enhance access for SMEs in those exchanges are well known. It may be easier for China to support innovation-focused SMEs within the context of a new exchange as opposed to trying to reform existing exchanges. This could also be one reason for the structuring of the BSE as a corporate entity rather than as a public entity, similar to the two existing stock exchanges. A new exchange, with its own trading and listing rules, could also potentially limit broader market volatility that may arise from implementing such new rules at existing exchanges.

The promotion of SMEs is also in sync with the ongoing emphasis on "common prosperity". Resentment of digital behemoths in China has been growing among small firms.[18] Large Chinese internet platforms that purport to provide SMEs with new opportunities through online access have instead been accused of squeezing such firms through imposing high commissions and prohibitions on listing on multiple platforms. The tech giants have also been buying out smaller innovative companies that may be potential competition in future. Enhancing access to capital markets for smaller firms would therefore be a way to enable them to raise capital for growth and expansion without having to sell out to the large firms. Such access also enables founders, angel investors, friends and family who may have utilised personal capital for initial growth to cash out at least part of their equity through capital market listings in addition to raising capital from the public.

The establishment of BSE can also be seen as part of China's industrial policy as it relates to its focus on SMEs with specialised, sophisticated, distinctive and/or innovative ("*Zhuan, Jing, Te, Xin*" (SSDI)) output. As early as 2011, the "Twelfth Five-Year Plan for the Growth of Small and Medium-sized Enterprises" issued by the Ministry of Industry and Information Technology (MIIT) set "specialization, refinement, distinction and innovation" as some of the basic principles to promote the growth of SMEs. Compared to even traditional manufacturing SMEs, the financing difficulties faced by innovation-focused SMEs are potentially more serious. The large proportion of human and intellectual capital in such firms usually makes

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16 Ibid.

17 "Tackling Small and Medium-Sized Enterprises (SMEs) Financing in China", 2020, Lam, W R and Liu Y, *Annals of Economics and Finance*, 21-1, 209-239.

18 https://www.cnbc.com/2021/08/12/chinas-tech-giants-generate-billions-but-squeezed-small-businesses.html, accessed 5 October 2021.

these firms "asset-light" and lacking in "hard assets" that can be used as collateral for bank loans. The inherent riskiness of such ventures also makes it difficult for them to raise financing. Since 2019, the MIIT has identified more than 4,700 SSDIs. In addition, there are more than 40,000 provincial level SSDIs. However, only 306 of the MIIT-identified SSDIs are currently listed. The establishment of the BSE could broaden the sources of financing for more SSDIs.

Geographical considerations could be another factor driving the establishment of the BSE. The existing two exchanges are both in the economically advanced southeast coastal area. The establishment of a stock exchange in Beijing is expected to help bridge the gap in capital market resource allocation between the South and the North. Beijing is also the base for many domestic scientific research institutions and researchers that boast large number of scientific and technological achievements every year. Private equity and venture capital funds are also active in Beijing. Nevertheless, Beijing has been less successful in translating its intellectual prowess into innovation-based commercial successes. Shanghai has more SSDIs than Beijing. The view is that one reason for Beijing's relatively weak performance in this area is the lack of strong capital market infrastructure, that could be possibly addressed by the BSE.

China also continues to address issues relating to deleveraging large and indebted corporates, strengthening regulations on shadow banks and addressing issues related to local government financing vehicles. To further address overall financial risks in the economy, the focus on diversifying sources of finance for SMEs from banks to capital markets could be a positive step. Enabling better capital market access for smaller innovative firms in China therefore has several arguments in its favour.

However, it is an open question as to whether enhancing capital market access for SMEs needs a dedicated new stock exchange. The BSE is not China's first attempt at establishing a market for SMEs and innovative firms. China's two existing stock markets – Shanghai and Shenzhen exchanges (established in 1990) – have each set up markets for attracting SMEs and innovative (technology) firms. Shenzhen's ChiNext Board, established in 2009, has about 800 firms listed. These are "innovative enterprises" that "have led to the creation of a national SME support system", as per the stock exchange's website.[19] The Star Market, or Shanghai's Science and Technology Innovation Board, was established in 2019. Dubbed as China's answer to the NASDAQ, the Star Market currently has a listing of 340 firms. The NEEQ was also founded in 2013 for the SMEs. Its objective was to raise financing from venture capital and private equity funds to other institutional investors for SMEs. At its peak, it had nearly 10,000 listed SMEs. However, since the 2015 market volatility, listings have come down to about 8,000 currently. Macau is also reportedly planning a new NASDAQ-style exchange for start-ups to raise equity capital.

However, none of these existing efforts have been as successful as the Chinese authorities may have wished. The amount that SMEs raised in equity from Chinese capital markets is just 1% of the amount borrowed from banks and other financial institutions. None of these SME markets have yet grown into China's equivalent of the NASDAQ, possibly due to a variety of reasons ranging from complex regulatory aspects of China's equity markets to the lack of investor interest in firms listed on these exchanges.

Sixty-six firms currently listed on the NEEQ, with a total market capitalisation of about RMB186 billion (about US$30 billion), are expected to migrate (or be encouraged to migrate) to the BSE. Twelve of these firms are among the SSDIs identified by MIIT (reflecting the

[19] http://www.szse.cn/English/products/equity/ChiNext/, accessed 5 October 2021.

initial positive expectations, equity prices of nearly 90% of these firms rose in the first few trading days immediately following the establishment of the BSE). The NEEQ has a three-tier classification for its listings – base, innovation and select. The "select" tier comprises NEEQ's largest firms and the draft listing rules on the BSE are nearly identical to those applicable to this tier. Firms in the "innovation" tier that have been listed for more than 12 months on the NEEQ will also be eligible to apply for listing on the BSE. Essentially, this means that the BSE will, at least at the beginning, serve the relatively larger firms in China's SME universe.

In addition to migration of firms from the NEEQ to the BSE, some of the existing large tech firms may also list on the BSE, even though they are not exactly "SMEs". Attracting firms that may face difficulties with their current listings in the United States, especially as the ongoing regulatory tightening in the United States continues, may be another way for BSE listings to grow quickly. According to the chairman of the US Securities and Exchange Commission, Chinese companies will be permitted to continue to be listed on US stock exchanges after 2024 on the proviso that the auditors of Chinese firms are themselves subject to audit – an "audit of the auditors" – by the Public Company Accounting Oversight Board of the United States, as required under the Sarbanes-Oxley Act of 2002.[20] This is likely to affect nearly 270 Chinese and China-related firms that may find it attractive, or even imperative, to move their listings back to China. Domestic and international political considerations, as much as economic, are therefore likely to drive listings at the BSE.

Even if the size of the BSE as measured by its market capitalisation does grow rapidly, how much the BSE will contribute to genuinely financing the "typical" SME in China will depend on the size of firms listed and the capital that they are able to mobilise from investors – important metrics of the BSE's success. Global experience shows that this will take time and China's own experience shows that it is no exception.

Will the BSE be more successful than China's earlier attempts at promoting market access for SMEs? China's commitment to setting up the BSE is clearly demonstrated by the fact that the proposal came from President Xi himself. Given such high-profile endorsement of the initiative, all possible levers will be pushed by the government and regulatory authorities to ensure the success of the initiative. However, push at the highest levels clearly does not, by itself, guarantee success. The Star Market at the Shanghai Stock Exchange, an initiative announced by President Xi at the China International Import Expo in Shanghai in 2018, continues to face challenges. Given the difficulties in accessing finance that SMEs globally face, China's latest experiment to address SME financing constraints will undoubtedly be closely watched for lessons that it may offer.

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[20] Gary Gensler, "SEC Chair: Chinese Firms Need to Open Their Books", *Wall Street Journal*, 13 September 2021, https://www.wsj.com/articles/china-accounting-standards-shell-company-vie-investment-sarbanes-oxley-sec-gensler-11631563524, accessed 5 October 2021.