



Journal of Information, Law & Technology

Licensing and Retained Funds Regulation of Internet Third Party Payment Providers in China

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This is a **refereed article** published on 18 September 2009.

Citation: Li, W., 'Licensing and Retained Funds Regulation of Internet Third Party Payment Providers in China', 2009(2) *Journal of Information, Law & Technology (JILT)* <http://go.warwick.ac.uk/jilt/2009_2/li>

Abstract

As a newly emerging electronic payment instrument, Internet third party payment is becoming increasingly popular and influential in China and has attracted regulatory attention from the Chinese central bank -- People's Bank of China. Aiming at broad international readership and policy makers, this article introduces working mechanisms of the Internet third party payment; discusses the crucial forthcoming Chinese legislation -- the 'Measures of Management on Payment and Clearance Organisations' in detail; and analyses the international aspects of the 'Measures' by taking into account of the market situation in China. Also, the article critically analyses two key legal aspects of the regulation of Internet third party payment provider in China -- licensing and retained funds regulation. It suggests that a more light regulation approach should be adopted in the licensing issues. Meanwhile, six points, such as liquidity, ownership and insolvency, relating to retained funds regulation are also examined in detail in the article.

Keywords: Internet Third Party Payment, China, International, License, Retained Funds, Regulation,

1. Introduction

In years past, cash, paper-based negotiable instruments, and electronic funds transfers within a closed intranet of commercial banks as well as traditional payment, clearance and settlement systems, were the dominant methods of making a payment. Nowadays, new payment mechanisms have been developed and are becoming popular in both domestic and cross-border transactions in China.

In response to these commercial developments, the Chinese central bank -- People's Bank of China -- issued in 2006 the first 'China Payment System Development Report'. It was the first time that the Chinese central bank had comprehensively and systematically disclosed the latest developments, relevant data and future policy orientations of the Chinese payment system to the rest of the world.² A term 'new electronic payment instruments' appears in this official report. This term encompasses newly evolved payment instruments including Internet payment, telephone payment, mobile payment, and multiple stored-value cards.³

These new electronic payment instruments are primarily created and facilitated through non-bank Internet third party payment platform providers. This article will treat the law of non-bank Internet third party payment platform providers as the theme under discussion.

Thereafter, the terms 'non-bank Internet third party payment platform providers', 'Internet third party payment providers', 'Internet third party providers' and 'third party providers' should all be understood as referring to the same thing.

In this article, the working mechanisms of the Internet third party payment are firstly introduced. Then, the crucial forthcoming Chinese legislation -- the 'Measures of Management on Payment and Clearance Organisations' is discussed and its international aspects are analysed. Following this, two key legal aspects of the regulation of Internet third

party payment provider in China, namely, licensing and retained funds regulation, are examined in turn.

2. Working Mechanism: Virtual Accounts Payment Model

A virtual accounts payment model is the major payment model provided by the Internet third party payment services providers, although some other payment models exist as well, such as the Internet third party gateway payment model. However, it is the virtual accounts payment model that has attracted regulation interests and generated important legal issues, including the legal risk of retained funds. Therefore, the article sets out to discuss extensively its working mechanism.

The virtual accounts payment model is used to build a series of virtual accounts, held by non-banks (such as Alipay, YeePay, and Paypal which are all Internet third party payment service providers) between Internet traders. A virtual account performs similar functions as traditional bank accounts do, i.e. hosting funds, paying and receiving funds, keeping records and etc. More specifically, the virtual accounts payment can be further divided into two categories,⁴ namely the direct payment model and the third party assurance model (indirect payment model). Paypal is a good example of the direct payment model. When bank account A transfers funds to a virtual account A in Paypal, this virtual account A will *directly* transfer the funds to the recipient's virtual account B in Paypal, and after that, the recipient's real bank account B shall be credited accordingly. However, in the third party assurance model, the third party not only does transfer funds, but it also acts as an assurance agency⁵ for both customers and Internet merchants/sellers. Below are the six steps whereby funds are transferred through a third party assurance model:

- Two parties, which could be either a consumer and a business; or a customer and a customer; or a business and a business; reach an agreement for a transaction;
- The buyer transfers the funds to an Internet third party provider,⁶ where he/she has registered;
- The third party provider notifies the seller by informing that the relevant funds have been received;
- The seller should deliver the goods to the buyer within a period of time agreed by them;
- The buyer shall notify the third party when he/she receives the goods;
- The third party provider should transfer the relevant funds to the seller either immediately or within a period of time agreed by the buyer and seller with the third party provider. This is a type of escrow service.

From what has been described above, the Internet third party payment provider in China possesses three key characters:⁷

- Due to the existence of the third party provider, customers' sensitive financial data and financial record will not be disclosed to Internet merchants directly, which, to a great extent, has reduced transaction risks for customers;
- Third party providers are not directly involved in purchasing and sales of goods and services, therefore, they could keep a neutral, independent, and fair position to uphold all parties' legitimate rights;
- Accredited third party providers will only provide payment services to qualified Internet merchants that has been legitimately registered,⁸ which will greatly enhance customers' confidence in doing Internet shopping.

3. The Crucial Legislation—'Measures of Management on Payment and Clearance Organisations'

Before providing any legal analysis on licensing and retained funds of Internet third party payment providers, the author would like to introduce important legislation--the 'Measures of Management on Payment and Clearance Organisations' and international aspects of this crucial 'Measures'. The 'Measures' was intended to regulate Internet third party payment service providers and other types of payment and clearance organisations. It was supposed to be enacted by the People's Bank of China in 2005, but has been postponed until now. Its first official consultation version was released for public consultation in June 2005.⁹ However, the full text of the second version of the 'Measures of Management on Payment and Clearance Organisations' is not available, so the following contents relating to the second consultation version are based on reliable writings by scholars and journalists (primarily by He Huafeng's scholarly writings, see section 2.1.2 below for details).

3.1 Two Official Consultation Versions of the 'Measures of Management on Payment and Clearance Organisations'

3.1.1 The First Official Consultation Version

The first official consultation version of the 'Measures' consists of seven chapters and fifty-seven articles. Chapter one defines what payment and clearance organisations are,¹⁰ what 'payment and clearance' is, and what payment instructions are.¹¹ This chapter differentiates national, regional and local payment and clearance organisations, and imposes minimum capital requirements for registration of those three types of organisations which are RMB 100 million (roughly equivalent to USD 14.7 millions), RMB 50 million (roughly equivalent to USD 7.4 millions) and RMB 10 million (roughly equivalent to USD 1.5 millions) respectively. The minimum capital requirements might be flexibly altered by the People's

Bank of China in accordance with the development of payment and clearance industry and the requirements of prudential supervision.¹² It also stipulates that payment and clearance organisations cannot accept deposits, or transfer funds for participants (participants are customers who use payment and clearance organisations).¹³ This stipulation has distinguished ‘payment’ from ‘funds transfers’, since ‘payment’ is merely the exchange of payment instructions and information, without referring to the movement of funds. (In the rest of the article, the author will make it clear whether he is using payment in this sense (exchange of payment instructions) or in its conventional sense (achieving transfer of value to the beneficiary).)

Chapter two stipulates that the People’s Bank of China (including the head office and its branches) is the authoritative body which is in charge of the establishment and alteration of payment and clearance organisations,¹⁴ detailed requirements, conditions as well as administrative procedurals of establishing and altering payment and clearance organisations have also been specified.

Chapter three deals with business management of payment and clearance organisations, the authorisation of payment and clearance organisations to engage not only in exchanges and calculation of paper-based payment instruments, card-based payment instruments, but also electronic payment instruments as well as payment instruments facilitating through Internet platforms.¹⁵ This chapter deals with the requirement of payment and clearance organisations to sign contracts with payment and clearance participants so as to clarify rights and obligations of each of the parties, dispute resolution principles as well as liabilities for breach of contracts.¹⁶ Participants’ commercial secrecy shall be guarded by payment and clearance organisations.¹⁷

Chapter four deals with risk supervision, it stipulates that payment and clearance organisations should establish a risk preventative system to identify, evaluate, monitor and manage risks.¹⁸ They should establish rules and procedures for sharing losses caused by participants’ credit risk.¹⁹ Payment and clearance organisations could request participants to provide guarantee or pre-pay payment and clearance risk reserve funds. Risk reserve funds are paid by the participants to the payment and clearance organisations to support the liquidity risk arising from the participants’ lack of funds. Art 38 requires that the payment and clearance risk reserve funds have to be saved in separate special accounts to compensate a liquidity risk caused by the lack of funds of participants, the economic benefits (such as interest arising from the reserve funds) and legal rights still belong to the participants. The payment and clearance reserve funds can be used in investment, but not in high risk investments, and the proportion of funds that can be invested cannot exceed fifty percent of the whole amount of the reserve funds.²⁰ When the participants of payment and clearance organisations become insolvent, results of payment and clearance have the prior claim on the payment and clearance reserve funds and guarantee.²¹

Chapter five is concerned with takeovers and terminations. When payment and clearance organisations cannot operate properly, or have severely influenced participants’ interests as well as impacted China’s economy and finance, the People’s Bank of China is empowered to take over the organisations by itself or designate another institution to do so. Creditors and debtors’ relationships of the organisations shall not be altered after the takeover.²² The maximum period of time for a takeover shall not exceed two years.²³ This chapter also

stipulates circumstances which could lead to the termination of payment and clearance organisations, and all terminations have to be ratified by the People's Bank of China.²⁴ The People's Bank of China is also entitled to withdraw licenses of payment and clearance organisations under particular circumstances.²⁵

Chapter six lists a number of penalty rules, including fines and criminal liabilities for the above-mentioned prohibited actions such as absorbing deposits, engaging in funds transfers and high risk investments, setting up branches without authorisation and the disclosing of participants' relevant information and business confidentiality.²⁶

Chapter seven entitled 'miscellaneous', stipulates that any banking or financial institution other than specialised payment and clearance organisations are subject to these 'Measures' as long as those institutions are undertaking payment and clearance businesses which are specified by the 'Measures'.²⁷ To the author's understanding, those banking and financial institutions encompass Chinese as well as overseas commercial banks and financial institutions, but exclude both securities and insurance companies.

3.1.2 The Second Consultation Version

In 2006, the second consultation version of the 'Measures of Management on Payment and Clearance Organisations' was discussed, and a number of amendments had been made which include:

First, the second consultation version only differentiates national and provincial payment and clearance organisations instead of the three, namely national, regional and local cited in the first consultation version. The minimal capital requirement of registration for national payment and clearance organisations remains RMB 100 million (roughly equivalent to USD 14.7 million), but only RMB 30 million (roughly equivalent to USD 4.4 million) for provincial payment and clearance organisations. Moreover, the second consultation version of the 'Measures' stipulates that the investment proportion of overseas investors in a whole organisation could not exceed twenty-five percent, rather than fifty percent in the first version.²⁸

Second, added provisions in the second consultation version of the 'Measures' primarily focus on business management (chapter three in the first consultation version) and risk supervision (chapter four in the first consultation version). The second consultation version also stipulates that payment and clearance organisations are entitled to require payment and clearance participants to pay reserve funds, which is identical to the first consultation version. Furthermore, the second consultation version requires the payment and clearance organisations to pay interests arising from the reserve funds to payment and clearance participants, and the reserve funds should be maintained with separate special accounts in commercial banks, and one commercial bank may only maintain a single, special account for reserve funds (however, in the first consultation version, no such restriction has been imposed). Additionally, in every working day of commercial banks, payment and clearance organisations have to provide the fifty percent balance of the reserve funds in the special accounts in cash for guarantee purposes rather than be put to other use. Further, the time for calculation of this balance is by 3pm of every working day of the commercial banks.²⁹

Third, the second consultation version of the ‘Measures’ added that Internet third party payment providers need to establish ‘risk funds’, and top up the ‘risk funds’ in accordance to the proportions being withdrawn from the organisations’ business profits annually; the ‘risk funds’ may not be used for any forms of investment or guarantee.³⁰ It should be noted that these ‘risk funds’ paid by the payment and clearance organisations differ from the ‘risk reserve funds’ described in chapter four of the first consultation version of the ‘Measures’. The latter are funded by payment participants to payment and clearance organisations in order to backup risks arising from payment participants.

Fourth, the second consultation version also imposed Internet third party payment providers’ obligation in working with relevant departments to fight against money laundering, as well as the informing of suspicious transactions at the earliest possible moment.³¹

3.2 International aspects of the ‘Measures of Management on Payment and Clearance Organisations’

Literally speaking, both versions of the consultation draft of the ‘Measures of Management on Payment and Clearance Organisations’ addressed very few international aspects on Internet third party payment providers and other types of payment and clearance organisations. There are at least two reasons to explain the ‘Light-Touch’ approach.

In general, China entered the World Trade Organisation (WTO) in December 2001. To date, the level of internationalisation of the Chinese banking industry is relatively low. It is the regulators’ mindset, traditions and habits that only focusing on the Chinese domestic situation but ignoring the international aspects when drafting banking legislations and regulatory measures. This mindset, understandably, formed prior to the advent of the era of globalisation and the age of the Internet.

In more specific terms, in the Internet third party payment market, over ninety-six percent of the market proportion was dominated by Chinese providers. The world’s most successful International Internet third party payment provider – Paypal - took as little as one point five percent market proportion in China in 2007,³² and there is no sign that Paypal is catching up. No wonder the Chinese regulators addressed very limited contents towards international providers in this ‘Measures’.

The limited contents relating to international aspects of payment and clearance organisations (including Internet third party payment providers) are seen in article 2 and article 13 of the first consultation version of the ‘Measures of Management on Payment and Clearance Organisations’ respectively.

Article 2 states ‘Payment and clearance organisations stated in this Measures are legal entities, which are established within the territory of the People’ Republic of China’ according to relevant laws and regulations, and which provide payment and clearance services for participants.’

‘Within the territory of the People’s Republic of China’ should be understood as ‘within the territory of China inland’ but excludes Hong Kong Special Administrative Region of the People’s Republic of China, Macau Special Administrative Region of the People’s Republic of China, and Taiwan. Since Hong Kong, Macau and Taiwan currently are under their own

legal systems and circulating their own currencies,³³ payment transactions between them and China inland should be considered as ‘cross-border’ payment. Naturally, any payment transactions between foreign countries (outside of the territory of the People’s Republic of China) and China inland should be regarded as cross-border payment as well.

Art. 13 states ‘Overseas investors are entitled to set up payment and clearance organisations jointly with investors within the territory of the People’s Republic of China; but the overseas investors’ investment proportion shall not exceed fifty percent’.

As it is mentioned in section 2.1.2 above, the second consultation version of the ‘Measures’ modifies and stipulates that the investment proportion of overseas investors in a whole organisation could not exceed twenty-five percent, rather than fifty percent in the first consultation version. What outcome could international investors expect if this restrictive rule becomes legally valid? The experiences of Paypal in China may answer this question.

Since the entry of foreign Internet third party payment providers into China, the only influential overseas player is Paypal China (which was translated as Bei Bao in Chinese³⁴). Originally affiliated with Eachnet.com,³⁵ Paypal entered the Chinese Internet third party payment market as early as 2005.³⁶ However, due to a series of reasons, Paypal China (Bei Bao) has constantly been in an adverse position in China’s Internet third party payment market.

The reasons which caused Paypal China into difficulties include but not limited to, firstly, constrained by China’s domestic financial policies, Paypal China (Bei Bao) can only support Renminbi business but not any other international currencies such as USD and GBP. Paypal China’s database was separated from Paypal international. Thus, if customers in China would like to undertake international businesses and transactions through Paypal, they could only apply via Paypal’s foreign websites rather than Paypal China (Bei Bao).³⁷ Secondly, in the rest of the world, Paypal’s great success, to some extent, is based on credit cards systems and credit cards’ overdraft function; however, debit cards are far more popular and influential than credit cards in China, thus, the competitive advantages (multi-currencies supports and credit cards’ overdraft function) established by Paypal international cannot be developed and transplanted to Paypal China (Bei Bao).³⁸ Thirdly, as illustrated in section 1 ‘working mechanism’ of Internet third party payment, Paypal adopts direct payment model. The direct payment model is based on sophisticated social credit systems, highly matured electronic commerce environment and well-established legal systems, such as systems in the United States. However, the three elements only partly exist in China at present.³⁹

Therefore, considering the story of Paypal China, the author can safely conclude that if the restrictive rules of overseas investors’ investment proportion becomes legally valid, it will further severely constrain the development of foreign investors and overseas Internet third party payment providers’ entry and expansion in the Chinese market. Paypal China should be aware of the restrictive rules. Likewise, any potential international Internet third party payment providers who are interested in the Chinese market also need to be cautious in legal risks pertaining to the restrictive rules.

4. Licenses for Internet Third Party Providers to Operate as Legitimate Providers; Are These Necessary or Not?

The first consultation version of the ‘Measure of Management on Payment and Clearance Organisations’ imposes licensing requirements on payment and clearance organisations as stated in Article 20:

‘People’s Bank of China and its branches shall issue ‘Payment and Clearance Business Licences’ to organisations within 20 working days after the receipt of applications, if the organisations’ applications have been successful;

4.1 Is Licensing Necessary?

The author suggests that there should be no license for third party providers to operate as legitimate providers for the following reasons.

The first reason is that the second consultant version of the ‘Measures’ requested that, ‘to obtain licences, third party providers’ shareholders, who possess more than ten percent of shares, have to specialise in the IT industry or finance industry’, also ‘more than a five percent alteration of shares has to be ratified by the People’s Bank of China’. However, these requirements are over-restrictive. This is because in the case of third party providers, as human resources and cutting-edge technology are their core competitive advantages, rather than financial resources, many third party providers, including the leading ones are financially supported by venture capital.⁴⁰ Over-stringent entrance standards to obtain licenses may have the unintended effect of reducing competition.⁴¹

The second reason is that the original intention of the ‘Measures of Management on Payment and Clearance Organisations’ was to regulate those unregulated funds retained by Internet third party providers. However, the scope of this ‘Measures’ goes far wider than that. In China, payment and clearance organisations not only encompass Internet third party payment providers, but more importantly, they also encompass commercial banks, banks cards network providers, such as Visa cards and Master cards associations, the Chief Clearance Centre of the People’s Bank of China and the CNAPS, and other relevant participants such as the branch of SWIFT and telecommunication operators (in a broad sense). It is unreasonable to draw a uniform standard for all those very different forms of payment and clearance organisations.⁴² As can be seen from the first consultation version of the ‘Measures’,⁴³ the minimum capital requirement for setting up nationwide payment and clearance organisations is RMB 100 Million (roughly about USD 14.7 millions). This standard for someone who wishes to set up a nationwide commercial bank to engage payment and clearance business is too low, since the minimum capital requirement for setting up a nationwide commercial bank is RMB 1 Billion (roughly about USD 147 millions) required by the ‘Law of People’s Republic of China on Commercial Banks’;⁴⁴ but for someone who wishes to set up a pure Internet third party payment provider, RMB 100 Million is not easily achievable for most new incoming competitors. Even for some current Internet third party payment market leaders, RMB 100 Million is a prohibitive requirement. For example, the registration capital of ChinaBank Payment (网银在线) is only RMB 10 Million (roughly about USD 1.5 millions).⁴⁵ On the other hand, for China UnionPay, the leader of China bank cards, this

company's initial registration capital was RMB 1.65 Billion (roughly about USD 242 millions). Furthermore, for Visa cards and Master cards organisations whose registration capital was much higher than China UnionPay, the proposed RMB 100 Million entry requirement is negligible.

Therefore, it is advisable not to draw a universal standard for different types of payment and clearance organisations. Even if entry standards should be set up, then different payment and clearance organisations need to be considered separately by taking into account different risks pertaining to different sorts of payment and clearance organisations. And since those payment and clearance organisations other than the new Internet third party payment providers have been already regulated under relevant law (regardless the effectiveness of such regulation), for example, the commercial banks regulated by the 'Law of the People's Republic of China on Commercial Banks' and its relevant operational rules, there is only the Internet third party provider that is in an unregulated position. Thus, the 'Measures of Management on Payment and Clearance Organisations' may consider changing its name to the 'Measures of Management on Online/Internet Third Party Payment Platform Providers' or similar terms, and specifically aim at regulating new Internet third party payment service providers.

4.2 Let the Market Talk

Having analyzed that, the author suggests that it might be better to leave the market entry of new electronic third party providers to the market rather than rely on licensing or the government.

First, free market competition makes electronic payment more powerful and issuing licenses, to some extent, may restrain innovation, which includes both technological innovation and business model innovation. The reason why Internet third party providers have succeeded is because they are providing cutting-edge, advanced technology, and undertaking those businesses which commercial banks are either unwilling or incapable of doing. For example, telephone payment is a brand new payment channel⁴⁶ initially developed by YeePay, and has spread nationwide to other Internet third party payment providers. In addition, the Shanghai IPS (Shanghai Huan Xun), for example, has developed a mobile WAP payment platform, which is based on the popularity of the WAP mobile purchase websites. Consumers can use WAP websites via mobile phone and IPS accounts to complete the payment process.⁴⁷ All these innovations are developed without licensing scheme. We can imagine that if licensing had been introduced, emerging high technology companies, such as YeePay, may not allowed to enter the electronic payment market, and subsequently contribute their new ideas.

From a business model innovation perspective, Internet third party providers have been expanding their businesses from C2C payment, which was where third party providers originated, to the B2C payment market and even the B2B payment market.⁴⁸ These technological and business models innovations are all undertaken spontaneously by Internet third parties themselves and stimulated by stiff market competition, without any payment and clearance licensing from the government. It is conceivable that the innovation can be slow if strict payment and clearance licensing rules are imposed.

Second, market competition is the best way to eliminate disqualified Internet third party providers. From the feedback of the electronic payment market, the competition environment for all third party providers, especially for newcomers, is tough.⁴⁹ Elimination is a visible ongoing process; the number of Internet third party providers has been substantially reduced from more than 50 in 2005, to around 20 in 2007. Some small and weak players were acquired by strong providers. For example, YeePay acquired WestPay⁵⁰ in July, 2006.⁵¹ Further, the third party payment industry is only at a the very early stage of its development,⁵² which above all needs the market itself, rather than the Chinese government and regulation, to restrict its market access and its potential market elimination. Therefore, it is suggested that the People's Bank of China focuses on other crucial issues, such as the regulation of retained funds, consumer protection, and prevention of Internet fraud and gambling, rather than setting up strict and probably excessive licensing scheme for new players to enter the emerging market.

In sum, as the Chinese ancient saint Laozi said, 'the first class morality is by doing everything when doing nothing'⁵³ is not required for Internet third party payment service providers to enter the electronic payment market as legitimate players might be a proper choice at the current stage.

5. Retained Funds in Internet Third Party Payment Providers

It should be, first of all, noted that 'retained funds' are different from 'reserve funds'. 'Reserve funds' which are requested by the 'Measures of Management on Payment and Clearance Organisations' are paid by payment and clearance participants to payment and clearance organisations. By contrast, 'retained funds' are primarily generated from escrow service providers by Internet third party providers.

It is also helpful to note that the retained funds is not a unique phenomenon in Internet third party payment, rather, it has been existing for a long time in traditional banking payment practice.

5.1 The Regulation of Retained Funds in Internet Third Party Providers

There are a series of points regarding the regulation of retained funds that have to be considered, and the author shall make his arguments to these points one by one though some points may overlap with one another.

The first relevant point is payment efficiency. An important original motivation in developing Internet payment is to make payment, especially small value payments, easier, quicker and more convenient than traditional payment mechanisms. Retained funds in third party providers reduce the efficiency of the Internet payment industry as a whole.

For the People's Bank of China and the official 'Measures', it is advisable to leave the efficiency issue to the market, instead of rigidly and inflexibly stipulating that 'funds cannot be retained by Internet third party payment providers for more than a certain number of days (for example 3 days)'. This is due to the fact that, how long the funds shall be retained, largely depends on how efficient relevant goods and services can be delivered, which in turn, requires the cooperation and dealing with logistics which is out of the control of third party

providers. Market power and the need for the efficient settlement of funds from buyers and sellers will urge all providers to improve the efficiency of their systems.

The second relevant point is liquidity. Some scholars might suggest that retained funds will reduce the liquidity not only within the Internet payment industry, but also the whole financial system with the dramatically explosive growth of transaction volume through third party platforms. However, the author suggests that, the liquidity issue can escape from the scope of the People's Bank of China and the formal 'Measures', because the Internet third party providers hold the retained funds in commercial banks. Commercial banks will treat the retained funds as normal deposits, and invest them to make profits in the conventional manner. Thus, for buyers and sellers, funds are retained, but for commercial banks and the whole financial system, the funds are not retained.⁵⁴

The third relevant point is the Internet third party providers' intention to retain funds. In fact, the structure of 'virtual accounts model' of Internet third party providers is not the only reason for the generation of retained funds. Besides, Internet third party payment providers themselves might postpone the payment intentionally, retain the funds, take advantage of the large amount of accumulated funds and gain maximum profits by all means, such as high risk investments. For example, in Alipay's users' agreement, Alipay explicitly states that:

'You understand that Alipay is neither a bank nor a financial institution, and Alipay's services are not financial services; in accordance with the law of the People's Republic of China, Alipay is unable to facilitate a real-time funds transfer service, and you agree and accept a reasonable duration of time in which the funds are transferred'.⁵⁵

And also

'You agree that during the time that your funds are in custody or received on your behalf or paid on your behalf, Alipay bears no risk if the funds depreciate, and Alipay bears no responsibility to pay you any interest arising from the retained funds'.⁵⁶

Having analyzed Internet third party providers' psychological intention to retain the funds in a float, how can they actually profit from the retained funds? At present, the practice is that the interest arising from the retained funds saved in commercial banks is the major source of income for most Internet third party providers.⁵⁷ Almost all the Internet third party providers only open and maintain their accounts in small, new commercial banks. Due to the fact that currently, deposit-taking and loan-issuing are still the main profit channels for the majority of Chinese domestic commercial banks, and also due to the conventional ideas of the majority of ordinary people who do not trust small, newly-founded commercial banks as much as they trust the 'Big Four' state-owned commercial banks,⁵⁸ they tend to save their money in the one of the latter. Thus, the 'Big Four' is rarely in a position of a deposit shortage. In contrast, those small, newly-established commercial banks and local city/rural commercial banks often struggle to take on sufficient deposits to survive and to develop. Naturally, the increasingly large amounts of funds retained by Internet third party payment providers has become an obvious target for small and new commercial banks to compete with. With the increasingly large quantity and growing stability of such retained funds, Internet third party providers have been gaining more and more bargaining power when choosing which commercial bank to open and maintain accounts. Third party providers, normally, will invariably choose the bank which offers the highest interest rates.⁵⁹ This sort of bargaining power and high interest rates

are stimulating Internet third party providers to retain their customers' funds as long as they can.

A pertinent question is whether the People's Bank of China and the formal 'Measures' should reduce the third party providers' retaining of funds as long as possible in order to gain maximum profits. The author suggests that the answer should be no. This is because the tactic is merely a temporary phenomenon. Currently, Internet third party providers are still competing with each other by reducing commission fees charged from Internet payment users, and majority of the Internet third party providers cannot, in reality, survive by charging transaction commission fees.⁶⁰ Therefore, their intention to earn the interest arising from retained funds is understandable. With further development of the electronic payment industry and e-payment 1.0 upgrading to e-payment 2.0 completely, more channels of profit-making shall be created, for example, the charging of higher service fees by providing personalised and diversified payment products. Third party providers' desire to retain funds is likely to be gradually reduced by market forces and thus regulation is not required.

The fourth relevant point is the ownership of retained funds. What is the ownership of the retained funds? Do the retained funds belong to originators (buyers), beneficiaries (sellers), or the Internet third party providers?

Taking the example of Alipay, when originators (buyers) top up their Alipay virtual accounts, funds are transferred from the originators' accounts to Alipay's accounts, because the originators' virtual accounts belong to Alipay. At this point, Alipay is playing the role of the custodian in respect of the funds; this relationship between originators and Alipay is called a 'storage contractual relationship' in Chinese contract law. As stated by Alipay in its users' agreement:

'Custody: you can top up your Alipay accounts with the methods specified by this service, and entrust Alipay to hold your funds on your behalf.'⁶¹

From this statement, it can be seen that when the originators' funds enter Alipay's accounts, the ownership of the funds has not been assigned. The originator is still the owner of the funds until the funds enter beneficiaries' (sellers) accounts maintained by the beneficiaries' commercial banks. When the funds enter beneficiaries' accounts, or the beneficiary declares to accept the funds, the ownership of the funds is eventually assigned to the beneficiaries. Therefore, as the custodian of the funds, Alipay does not possess the ownership of the funds from the beginning to the end; rather, Alipay is just fulfilling its custody/storage obligation to those funds.⁶²

On this basis, according to 'contracts for storage' in the '1999 Contract Law of People's Republic of China',

'On the expiry of the storage time period or when the storing party claims and gets back the article before the expiry, the safekeeping party shall return to the storing party the original article and the fruits generated therefrom'.⁶³

Alipay owns the obligation of paying interest to all its customers. Further, Alipay cannot explain why the interest arising from the retained funds has not been paid to either the originators or the beneficiaries.

Presumably, some scholars might suggest that, according to ‘contracts for storage’ in the ‘Contract Law of People’s Republic of China’,

‘A safekeeping party keeping in store currency may return the currency of the same kind and in the same amount. In case of storing other replaceable articles, the safekeeping party may return to the storing party articles of the same category, quality and quantity according to the terms of the contract.’⁶⁴

Alipay, which is the safekeeping party in the above sense, may return the currency of the same kind and *in the same amount*. However, it is the author’s understandings that, article 378 does not emphasize the amount of currency that needs to be returned by the safekeeping party, rather, this article emphasize ‘in case of storing replaceable things’, the safekeeping party may return the storing party the same category of things, because the things are replaceable. When it comes to the current situation in discussion, since the two articles deal with different issues, and article 377 shall be applied, rather than article 378.

Furthermore, from a practical perspective, the author suggests that it is not necessary for the regulator and for the formal ‘Measures’ to explicitly state whether the ownership of retained funds belongs to buyers or sellers, rather than the Internet third party providers. Such a statement, presumably, would not prevent third party providers from taking away the interest arising from retained funds in reality by means of contract terms.

The fifth relevant point is how to control the use of retained funds by Internet third party providers in accounts of third party providers. For reserve funds, both the first and the second consultation versions of the ‘Measures of Management on Payment and Clearance’ have been given some attention, however, the control of retained funds has, hitherto, not been addressed yet in the ‘Measures’ from publicly accessible resources.

There are three reasons why retained funds should be controlled, namely 1) consumer protection; 2) liquidity risk avoidance and settlement risk avoidance; 3) prevention of money laundering.

The author suggests that the first two reasons justify imposing restrictions on the investment of retained funds. For instance, the formal ‘Measures’ could stipulate that retained funds may only be invested in low risk industries, such as saving in reliable commercial banks or purchasing governmental bonds.

Anti-money laundering, the third reason of controlling retained funds, justifies monitoring and reporting suspicious retained funds transactions. In fact, Internet third party providers, as a type of payment and clearance organisation, had already had an anti-money laundering duty imposed by the ‘Law of the People’s Republic of China on Anti-Money Laundering’⁶⁵ and the ‘Measure of Management on Financial Institutions Reporting Large Value and Suspicious Transactions’,⁶⁶ and relevant legislations. Thus, the formal ‘Measures of Management on Payment and Clearance Organisations’ could leave this issue out.

The sixth relevant point considers the implications of an Internet third party provider going insolvent. For reserve funds, when the participants of payment and clearance organisations go insolvent, the results of payment and clearance have the prior claim on the payment and clearance reserve funds and guarantee.⁶⁷ But for retained funds, both the first and the second

consultation versions of the ‘Measures’ have not specified how to deal with insolvency in detail. Only one article in the first consultation version of the ‘Measures’ substantially touched on the insolvency of payment and clearance organisations. It stated that:

‘Payment and clearance organisations which go insolvent due to dismissal,⁶⁸ its licence being withdrawn, or being declared to be bankrupted, should be dealt with by relevant legislations and regulations.’⁶⁹

The ‘relevant legislations and regulations’ in this article, presumably mean the ‘Law of the People’s Republic of China on Enterprise Bankruptcy’⁷⁰ and its affiliated rules. Thus, the ‘Measures’ does not to treat payment and clearance organisations separately, but considers them as ordinary enterprises when insolvency occurs.⁷¹

The author suggests that a set of comprehensive rules need to be established to deal with the insolvency of payment and clearance organisations, since their insolvency influence is much wider than ordinary enterprises. Regarding the retained funds in insolvency, the formal ‘Measures’ could oblige insolvent Internet third party payment providers to refund the retained funds to their owners (originators or beneficiaries), thus taking those funds outside the scope of the insolvency. In any event, the retained funds cannot be liquidated by liquidators, since the ownership of the retained funds does not belong to the payment and clearance organisations (the debtors) as previously noted.⁷²

In sum, it is the author’s opinion that among the above six relevant points on retained funds, the formal ‘Measures’ could leave the first four points, which are efficiency, liquidity, intention and ownership to the market; but specifically address the last two points, namely the control of retained funds and insolvency.

6. Conclusion

This article concludes that at present no licensing rules should be applied to regulate the entry of Internet third party payment providers to this emerging market. Some legal issues pertaining to retained funds need to be carefully addressed by the forthcoming formal ‘Measures of Management on Payment and Clearance Organisations’, while other legal issues on retained funds may be left to electronic payment market itself.

For international businesses who are interested in the great market potential in China, it is advisable for them to be fully aware of legal risks pertaining to Internet third party payment market, following the latest development of relevant laws, especially the licensing issues, and to make wise business decisions.

Besides that, some other interesting legal issues have not yet been discussed in this article. Those unaddressed issues include the legal status of Internet third party payment providers, the comparison among the regulatory approaches of Internet third party payment providers in China and the US as well as the EU; the trend of combination of Internet payment and mobile payment; and etc. The author did not intend to lessen the importance of these unaddressed issues, but comparatively speaking, licensing and retained funds are the two most urgent problems to be tackled.

Endnote

¹ The author is grateful to his supervisor Professor Chris Reed for his kind supports on the completion of this article and thanks to Nicholas Lloyd very much for English proofreading.

² See the document ‘Central Bank Issues ‘China Payment System Development Report’ for the First Time’, available at: <<http://www.pbc.gov.cn/showaccdoc.asp?col=100&id=2191>> accessed on 27 March 2009.

³ Department of Payment System, PBoC (2007), (eds.), 2006 China Payment System Development Report (Beijing: China Finance Press), p 30.

⁴ It is also reasonable to split the fourth type of Internet payment (virtual accounts model) into two, so that the Internet payment consists of five major categories.

⁵ The assurance agency assures, i.e. performance by the seller. Some third party provider, i.e. Alipay assures all aspects of performance; while some providers, i.e. Yeepay, only assure partial performance.

⁶ This third party provider, in name, is non-financial institution, but in Chinese law, has not been officially defined yet.

⁷ Dong Guozhe, ‘Survival and Development of Third Party Payment Service Providers’, available at: <<http://www.e-gov.org.cn/dianzishangwu/hangyedianzishangwu/200707/67542.html>> accessed on 27 August 2009.

⁸ There are two layers of meaning regarding ‘legitimately registered Internet merchants’. One is that the Internet merchants/sellers themselves have been legitimately registered under the requirements of relevant Chinese commercial law and administrative law (dealing with traditional offline merchants). This has been emphasized within the ‘Guidelines on Online Trading (provisional)’ issued by the Ministry of Commerce, People’s Republic of China on 6th of March, 2007. The other meaning of ‘legitimately registered Internet merchants’ refers to those Internet merchants who open up their business on Internet merchants platform providers, as well as other properly registered platform providers, such as Taobao.com (China’s largest C2C trading platform provider, which belongs to the Alibaba group). Taobao.com requests all sellers to register by verifying their real names along with their Chinese national ID cards and numbers as well as the sellers’ bank accounts details.

⁹ The full Chinese text of the first consultant version of ‘Measures of Management on Payment and Clearance Organisations’, available at: <<http://www.pbc.gov.cn/detail.asp?col=910&ID=84>> accessed on 27 August 2009.

¹⁰ Art. 2, first consultation version of the ‘Measures of Management on Payment and Clearance Organisations’.

¹¹ Id., Art. 3.

¹² Id., Art. 4.

¹³ Id., Art. 7.

¹⁴ Id., Art. 11.

¹⁵ Id., Art. 26.

¹⁶ Id., Art. 29.

¹⁷ Id., Art. 31.

¹⁸ Id., Art. 35.

¹⁹ Id., Art. 36.

²⁰ Id., Art. 38 (1), (2) & (3).

²¹ Id., Art. 39.

²² Id., Art. 42.

²³ Id., Art. 44.

²⁴ Id., Art. 46.

²⁵ Id., Art. 49.

²⁶ Id., Art. 52.

²⁷ Id., Art. 54.

²⁸ He Huafeng, 'Electronic payment will be regulated, and third party payment providers are concerned about licensing to be issued by the central bank', available at:

<http://news.ccw.com.cn/internet/htm2007/20070125_237986.shtml> accessed on 27 August 2009.

²⁹ Id.

³⁰ Id.

³¹ Id.

³² See the figure of 'China Internet third party payment market transaction proportion in the second quarter of 2007' by Iresearch, available at: <http://www.iresearch.com.cn/consulting/online_payment/Graph.asp?id=9576> accessed on 26 August 2009.

³³ See more details on Hong Kong Legal System, available at: <<http://www.doj.gov.hk/eng/legal/>> accessed on 27 August 2009. See more details about Macau returns to China and the Macau legal system, available at: <<http://english.peopledaily.com.cn/english/199912/15/eng19991215R109.html>> & <http://en.wikipedia.org/wiki/Legal_system_of_Macau> accessed on 14 July 2009. See more details on Taiwan legal system, available at: <<http://law.cua.edu/ComparativeLaw/Taiwan/index.htm>> accessed on 14 July 2009.

³⁴ See Paypal China, available at: <<https://www.paypal.com/cn/cgi-bin/webscr?cmd=home-general&nav=0>> accessed on 26 August 2009.

³⁵ See Eachnet, available at: <<http://www.eachnet.com/>> accessed on 26 August 2009.

³⁶ Feng Chu, 'Three years of lifespan: Paypal's way in China', available at: <<http://news.pconline.com.cn/hy/0905/1642855.html>> accessed on 26 August 2009.

³⁷ Id.

³⁸ Id.

³⁹ Id.

⁴⁰ See an interview to the CEO of QuickMoney, Mr. Guan Guoguang, 'Third party providers can save time and energy by focusing on attracting large and influential customers', available at:

<<http://www.jxdii.gov.cn/zwga/2007/25556.html>> accessed on 27 August 2008.

⁴¹ ‘Four Pitfalls on ‘Measures of Management on Payment and Clearance Organisations’, available at: <http://www.hur.cn/Article/fagui/200709/675741.html>> accessed on 4 April 2008.

⁴² Professor Pan Xinping, the Director of Research Centre for Finance and Technology, Chinese Academy of Sciences, ‘Six Advice before the Enactment of the Measures of Management on Payment and Clearance Organisations’, available at: <http://bank.jrj.com.cn/news/2007-06-20/000002347706.html>> accessed on 27 August 2009.

⁴³ http://www.pbc.gov.cn/detail_frame.asp?col=910&id=84&keyword=&isFromDetail=1> accessed on 27 August 2009.

⁴⁴ See Article 13.

⁴⁵ See the official website of ChinaBank Payment, available at: http://www.chinabank.com.cn/gateway/about_us/index.shtml> accessed on 27 August 2008.

⁴⁶ See in-depth analysis on telephone payment in ‘Telephone Payment: Innovative Product or Innovative Concept?’, available at: <http://tech.sina.com.cn/i/2006-08-02/16531067518.shtml>> accessed on 27 August 2009.

⁴⁷ IPS WAP payment introduction, available at: http://www.ips.com.cn/eng/products/pr_07.shtml> accessed on 9 May 2008.

⁴⁸ ‘Electronic payment market has been severely differentiated, and B2C model becomes the new growing point’, available at: <http://www.jxdii.gov.cn/zwga/2008/36257.html>> accessed on 27 August 2009.

⁴⁹ See Chapter two of ‘Some suggestions on elevating YeePay’s competitive advantages’ by Sun Wen, who was a former staff from YeePay. The paper, ‘Some suggestions on elevating YeePay’s competitive advantages’ was an excellent and detailed business paper on electronic payment written by him after working in electronic payment industry for a long time, and Chapter one, two and three of this paper is available at: <http://sunwen.net/>> accessed on 27 August 2009.

⁵⁰ Before being acquired by YeePay, WestPay is the unique Internet third party payment provider in western China. See its website: <http://www.yetcool.com/case/westpay/index.htm>> accessed on 27 August 2009.

⁵¹ ‘YeePay successfully acquired WestPay’, available at: <http://www.yeepay.com/about/html/news/news0607.html>> accessed on 27 August 2009. There is an argument that allowing payment service providers to fail creates a risk to the system, and also to individual payers/payees. However, in reality, the market exit rampart for Internet payment is rather high, which causes unsuccessful providers difficult to exit through insolvency, and those successful Internet payment providers and mature and well-established Internet companies do have strong interests to integrate resources (such as customers resource and technology resource) through acquisition. Therefore, risks arising from providers’ insolvency are relatively low. Hou Tao, ‘Opportunities and Challenges on Third Party Payment Platforms’, available at: http://news.xinhuanet.com/ec/2005-12/13/content_3914016.htm> accessed on 27 August 2009.

⁵² ‘Survey report on current applications and development trends of electronic payment in China’ by ‘Zhongjing Zongheng Economics Consultant’, available at: <http://36021.com.cn/yjbg/IT/a/200802/32641.html>> accessed on 9 May 2008.

⁵³ Chapter 38, Dao De Jing (the Book of the Way), by Lao Zi.

⁵⁴ This idea was kindly suggested by the author’s supervisor, Professor Chris Reed.

⁵⁵ Alipay’s Users’ Agreement, Art. 7(1), point 9. The original text in Chinese is ‘您了解本公司并不是银行或金融机构, ’支付宝’服务非金融业务, 按照中华人民共和国法律规定, 支付

宝服务并无法进行‘即时’之金额转账服务，资金于途中流转的时间在合理范围内您是予以认同的，available at: <http://help.alipay.com/support/help_detail.htm?help_id=1515> accessed on 27 August 2009.

⁵⁶ Alipay’s Users’ Agreement, Art. 7(1), point 10. The original text in Chinese is ‘您同意，本公司无须对您使用支付宝服务期间由本公司保管或代收或代付的款项的货币贬值承担风险，并且本公司无须向您支付此等款项的孳息’，available at: <http://help.alipay.com/support/help_detail.htm?help_id=1515> accessed on 27 August 2009.

⁵⁷ ‘Central Bank: New Policy for Electronic Payment’, *Internet Weekly*, 14th Nov. 2005. From the academic database of ‘China National Knowledge Infrastructure’, available at: <<http://www.cnki.net>>

⁵⁸ Namely, Bank of China, Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB) and China Agricultural Bank (CAB).

⁵⁹ ‘Central Bank: New Policy for Electronic Payment’, *Internet Weekly*, 14th Nov. 2005. From the academic database of ‘China National Knowledge Infrastructure’, available at: <<http://www.cnki.net>>

⁶⁰ ‘New policy will reorganize third party providers, and new regulation will be released in the third quarter’, available at: <<http://tech.163.com/06/0711/09/2LO81BTV000915BE.html>> accessed on 27 August 2009.

⁶¹ Art. 2, part 2 (1), Alipay services agreement, available at: <http://help.alipay.com/support/help_detail.htm?help_id=1515> accessed on 27 August 2009. The text in Chinese is ‘代管：您可以使用本服务指定的方式向您的支付宝账户充值，并委托本公司代为保管。’

⁶² The concept of storage in Chinese law is different from common law, in which concepts of storage (bailment) only apply to physical items, and not to intangibles like payment. However, in concepts of storage, the Chinese law treats the ownership of tangibles and intangibles (such as the currency and payment) in the same way.

⁶³ Art. 377, the ‘Contract Law of People’s Republic of China’. The original Chinese text is ‘第三百七十七条 保管期间届满或者寄存人提前领取保管物的，保管人应当将原物及其孳息归还寄存人。’ The full text in English is available at: <<http://www.chinairlaw.com/english/laws/laws2-19.htm>> accessed on 27 August 2009.

⁶⁴ Art. 378, the ‘Contract Law of People’s Republic of China’. It’s original Chinese text is ‘第三百七十八条 保管人保管货币的，可以返还相同种类、数量的货币。保管其他可替代物的，可以按照约定返还相同种类、品质、数量的物品。’ The full text in English is available at: <<http://www.chinairlaw.com/english/laws/laws2-19.htm>> accessed on 27 August 2009.

⁶⁵ The Law of the People’s Republic of China on Anti-Money Laundering is adopted at the 24th session of the Standing Committee of the 10th National People’s Congress of the People’s Republic of China and entered into effect as of January 1, 2007. See the full text in English is available at: <http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/BasicLaws/P020070112534061253671.pdf> accessed on 9 May 2008.

⁶⁶ See full text of the ‘Measures’ in Chinese, available at: <http://www1.www.gov.cn/ziliao/flfg/2006-11/15/content_442981.htm> accessed on 27 August 2009.

⁶⁷ Art. 39, first consultation version of the ‘Measures of Management on Payment and Clearance Organisations’.

⁶⁸ Under Chinese law, dismissal occurs when the state or an official administrative body (in current case, the administrative body is the People’s Bank of China) stops the activities of a company or arranges their transfer to another company or organisation, at which point the company ceases to exist as a legal entity. See reasons and the procedural of dismissal of payment and clearance organisations in Art. 46, 47& 48, first consultation version of the ‘Measures of Management on Payment and Clearance Organisations’.

⁶⁹ Art. 50, first consultation version of the ‘Measures of Management on Payment and Clearance Organisations’.

⁷⁰ The new ‘Law of People’s Republic of China on Enterprise Bankruptcy’ was adopted at the 23rd Meeting of the Standing Committee of the Tenth National People’s Congress and promulgated by the President of the People’s Republic of China on August 27, 2006, and came into force on June 1, 2007. See the full text in English, available at: <<http://www.kingandwood.com/Bulletin/Bulletin%20PDF/Bankruptcy%20Law.pdf>> accessed on 10 May 2008. Also see the full text in Chinese, available at: <http://www.gov.cn/flfg/2006-08/28/content_371296.htm> accessed on 10 May 2008.

⁷¹ In the UK, there are specific rules to allow settlement and clearing systems rules to prevail over insolvency law, and liquidator cannot upset payment and settlement.

⁷² According to the Art. 30 and Art. 107 of the 2007 ‘Law of the People’s Republic of China on Enterprises Bankruptcy’, the property to be liquidated should belong to the debtors, in current case, belong to the payment and clearance organisations. See full text of the law, available at: <http://www.novexcn.com/enterprise_bankruptcy.html> accessed on 27 August 2009.

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