A ROADMAP TO CHINA'S NEW M&A REGULATIONS

Introduction

Foreign investment through mergers and acquisitions ("M&A") with domestic Chinese companies[1] has increased substantially over the last several years. Since just before 2000, Chinese economic reform has fueled an unprecedented surge of foreign interest in a continually expanding and improving Chinese economy. Largely gone are the days when foreign investors looked upon China as a low-cost export platform for manufacturing. In short, everyone now appears to be looking for a fast way to buy into the U.S. $10 trillion GDP Chinese market.[2]

Transactions that were virtually nonexistent ten years ago are playing an increasingly important role in the development of China's economy. M&A deal activity rose 10.7 percent to 1,945 announced deals in 2006 (excluding Hong Kong) from 1,757 in 2005. Total disclosed value in 2006 amounted to U.S. $43.5 billion, representing a significant increase from U.S. $30.5 billion in 2005.[3] The Chinese market is showing all the necessary signs for continued growth apace, due, at least in part, to the support of its government, which appears to be favoring some degree of consolidation among domestic Chinese players with the catch-phrase of promoting enhanced efficiency within certain strategically important industries. Despite having a labor force that consists of 12% of the entire world's population, China's government appears to have the foresight to see that consolidation and efficiency can lead to the fostering of China's next multinational players, which are increasingly looking beyond China's borders for strategic expansion.[4]

---

[1] Note that this includes M&A activity involving purely domestic, privately owned Chinese companies as well as foreign-invested enterprises, investments generally with 25% or more foreign ownership, but which entities are domiciled in China.

[2] Central Intelligence Agency, The World Fact Book, *available at* https://www.cia.gov/library/publications/ the-world-factbook/geos/ch.html (2006 Est.) (last visited June 5, 2007).

[3] The largest announced domestic deal in 2006 was Gome Electrical Appliance's 61% acquisition of China Paradise Electronics, its competitor in home appliance retailing, for U.S. $675 million, which was, in part, paid for by offering shares in Gome as permitted under China's new M&A regulations.

[4] Although not the subject of this article, it should be noted that the People's Republic of China ("P.R.C.") is also investing abroad. Chinese outbound investments increased by U.S. $14.1 billion in 2006. Sixty one percent of such activities were compartmentalized in oil and gas related deals in Russia, Nigeria, Kazakhstan, and Singapore. However, one should expect to see more Chinese companies participating in the competitive bidding process for "foreign" acquisitions, despite a number of cultural, attitudinal, and regulatory issues that accompany Chinese companies doing business abroad.

New M&A rules

In light of all this M&A activity, the Ministry of Commerce ("MOFCOM"), the State-Owned Assets Supervision and Administration Commission ("SASAC"), the State Administration of Taxation ("SAT"), the State Administration for Industry and Commerce (the "SAIC"), the China Securities Regulatory Commission ("CSRC"), and the State Administration of Foreign Exchange ("SAFE") jointly issued the *Regulations Regarding the Acquisition of Domestic Enterprises by Foreign Investors* (the "New Regulations") that went into effect on September 8, 2006.[5] The New Regulations replaced in their entirety the "interim" 2003 *Provisional Regulations for the Acquisition of Domestic Enterprises by Foreign Investors*. "This marks the first time a regulation was jointly adopted by six ministerial departments and orchestrated by the MOFCOM."[6]

The New Regulations govern equity and asset acquisitions of domestic companies, including foreign-invested enterprises ("FIEs"), privately-held companies, and state-owned enterprises, by foreign investors. This article will highlight the new rules compared to the old rules and will also mention some fundamental consistencies between the New Regulations and the "interim" regulations. The following topics will be addressed in this article: 1) highlighted key industry protection; 2) newly-recognized stock swaps; 3) tightly-supervised round-trip investments; 4) possible forms of acquisitions; 5) anti-trust review; and 6) remaining open questions.

Highlighted key industry protection

As might be expected in China, government agencies play an important role in domestic M&A deals; perhaps far more so than in other countries. Their role as approval officials extends beyond acting merely as anti-trust or competition regulators, and their concerns are not limited simply to the economic impact of a transaction. The agencies play a broader role in reviewing and approving specific deal structure and terms and also focus much attention on the social concerns in connection with M&A deals, specifically the impact on employees. The MOFCOM and State Development & Reform Commission (the "SDRC") are the agencies with primary responsibility for supervising foreign-related M&A deals. MOFCOM is the principal foreign investment regulator and has general authority over M&A

---

[5] *Guanyu waiguo touzizhe binggou jingnei qiye de guiding* [Regulations Regarding the Acquisition of Domestic Enterprises by Foreign Investors], promulgated Aug. 8, 2006 and effective Sept. 8, 2006 (the "New Regulations").

[6] Kalley Chen & Menghan Zhao, *The New M&A Regulations--A New Landscape*, King & Wood China Bulletin 2006 Special Issue Vol. 21, Oct. 2006, at 51 [*hereinafter* Chen].

approvals. The size of the deal will determine the level of the MOFCOM, and possibly the SDRC, approval required. Deals in excess of U.S. $100 million will generally need MOFCOM's approval in Beijing, while smaller deals are generally approved at the provincial or local levels. The nature of the target may also lead to involvement of other regulators. The SASAC, which has supervisory authority over state-owned assets, will play a role when the target is a state-owned enterprise ("SOE").[7] Other industry-specific agencies may have some approval authority depending on the nature of the deal and the target. The deal may also require approval of SAFE, if the deal proposes to use certain kinds of consideration.

The general consensus among foreign investors regarding the New Regulations is that these regulations are moderately protectionist in nature. Approval officials, under Article 12 of the New Regulations, are given broad discretion in reviewing deals that may touch on national or economic security as well as deals involving "well-known" trademarks in China.[8]

The P.R.C. government has been anticipating the adoption of these New Regulations since the adoption of the interim regulations in 2003. There has been a number of high profile deals delayed during their approval process as the New Regulations were being drafted and implemented. The most prominent example of such delay has been the Carlyle Group's ("Carlyle") planned acquisition of Xugong Group Construction Machinery Co. (a company routinely described as China's "Caterpillar, Inc."). The deal was signed in October 2005, and Carlyle originally planned to buy 100% of Xugong. MOFCOM refused to approve the deal. In the interim, Carlyle changed its plans to only acquire 50% of Xugong, hoping for government approval. The most recent update on this deal indicates that Carlyle has agreed to acquire a 45% stake in Xugong, in a presumed final attempt at obtaining MOFCOM approval.

---

[7] M&A deals involving listed companies and SOEs generally are more complex and are subject to much closer scrutiny. There are numerous regulations on acquisition of SOEs or their assets. There also are special regulations for acquisition of listed companies. All of these separate regulations are outside the scope of this article.

[8] New Regulations, *supra* note 5, art. 12. There are two categories of transactions required to be reported to the MOFCOM for approval under Article 12: the first is transactions in which foreign investors acquire the actual controlling right of any major industry, or which have a relation thereto, or which may have a potential impact on the economic security of China. The second category is transactions which may result in transfer of the actual controlling rights of a domestic enterprise owning any famous trademark or traditional Chinese brand, though it may not have an impact on any major industry or the economic security of the Chinese state. If the parties fail to report any of the above listed transactions to MOFCOM for approval, MOFCOM and other relevant authorities can impede the transaction or put in place other sanctions.

Newly-recognized stock swaps

Recognition of cross-border stock swaps is one of the novel aspects of the New Regulations. Cross-border stock swaps were permissible under the interim regulations, but no details were included, thus approval was never given. It is a significant forward step for the New Regulations to provide the legal basis and a clear approval process for such transactions.

According to prominent Chinese practitioners, the New Regulations, however, adopt a conservative approach to cross-border stock swaps in terms of the restrictions imposed regarding the competence (or wherewithal) of a foreign or domestic entity and in terms of the procedures pursuant to which the relevant authorities are to issue approval certificates.[9] The criteria to satisfy the threshold for approval are as follows:

1. The foreign investor must be lawfully registered in its home jurisdiction, and its management shall not have been penalized by relevant supervisory authorities (in its home jurisdiction) in the past three years.
2. The jurisdiction in which the foreign investor is registered must have a complete and mature corporate law system.
3. The foreign investor must be a listed company (not OTC traded), and its home jurisdiction must have a complete and mature securities law system (SPVs, defined below, are excepted).
4. The trading price for the shares of the offshore listed company must have been stable for the most recent one year.[10]
5. A P.R.C. registered M&A consultant must be engaged to conduct due diligence on the foreign company, and its report must be approved by the MOFCOM.
6. Foreign acquirers must pre-execute documents which would roll back the acquisition if certain steps are not completed within the time required.

Although most commentators agree that it is good to finally have clear rules and requirements laid out in the New Regulations, such strict conditions as described above have thus far made, and are expected to continue to make, the use of a stock-swap structure far less likely than the use of cash.

---

[9] Chen, *supra* note 6, at 51.

[10] New Regulations, *supra* note 5, art. 29.

Tightly-Supervised Round-Trip Investments

Another spotlight of the New Regulations is Article 11, which is designed to provide tight control over "round-trip investments."[11] It was previously very common for Chinese companies to remove, legally and illegally, funds offshore and re-invest into China as an FIE, obtaining access to tax breaks and other favorable treatments available mainly to certain manufacturing FIEs. Such investments must now be approved by the MOFCOM in Beijing, regardless of the size of the transaction. In addition, such investments will not be eligible for the tax breaks or other favorable treatments without the injection of additional foreign funds. Moreover, any "cover" arrangement, such as a trust or agency, must be disclosed.

The New Regulations also introduce, and narrowly define the use of, special purpose vehicles ("SPV").[12] The SPV is confined to an offshore entity directly or indirectly controlled by the Chinese individuals or enterprises with the goal of an overseas listing, the main assets of which are its rights and interests in a domestic affiliate entity. In order to conduct a swap using SPV shares, the overseas listing of the SPV must be approved by the CSRC. The establishment of the FIE and the swap transaction will also require the approval of MOFCOM. Within thirty days of overseas listing, the domestic FIE must report to MOFCOM on its plan to repatriate its offering proceeds to China. If the SPV fails to complete the overseas listing within one year of the issuance of the business license of the FIE, or if the FIE fails its reporting duty, the share swap would be unwound. This timeframe renders the use of this structure unlikely.

It is worth noting, however, that these SPV provisions in the New Regulations are only applicable to the Chinese persons, individuals or enterprises. Let us not forget, though, that an FIE *is* considered under Chinese law to be a Chinese (legal) person and, therefore, is subject to these provisions. The timeframe associated with the use of the SPV structure has generally been described as unrealistically short, especially the one-year limit of overseas listing. It overly limits the use of this option by venture capital funds and other investors with exit strategies of something more in the range of three to five years.

---

[11] New Regulations, *supra* note 5, art. 11.

[12] It is common to use SPVs in round-trip investments. However, in certain special industry sectors, such as telecommunications, advertising, and educational institutions, where special qualifications or experience are necessary pre-conditions, an SPV cannot become a qualified acquirer without such qualifications or experience. Rongkang Wang, *Mergers and Acquisitions by Foreign Investors in China (Part II of III)--Investing Vehicles*, King and Wood China Bulletin, Feb. 2007, *available at* http://www.kingandwood.com/Bulletin/Bulletin%20PDF/en_2007-01-China-wangrongkang.pdf (last visited June 5, 2007).

Acquisition forms (asset or equity)

Like the interim regulations, the New Regulations permit asset or equity acquisitions. The basic concepts, and relative pros and cons, of such structures are essentially the same as in the United States, but it is common to use the asset structure because of certain difficulties faced in performing due diligence in China. Unfortunately, identifying liabilities, whether they are on or off the books, is a challenge, especially where most companies have several sets of books-- one understating profits for the tax authorities, another one overstating assets and profits for potential suitors, and a third set that is probably accurate in all respects.

One key difference in asset deals in China is that foreign companies are not allowed to operate assets directly in China. Therefore, as part of the acquisition process, you also must apply for, and establish, an entity in China (typically a WFOE, a wholly foreign-owned enterprise) in which to hold and operate the assets. Typically, the required registered capital contributions of such an entity are used to acquire the target assets.

Equity transactions may be structured as direct or indirect acquisitions. Indirect offshore acquisitions are possible where the target is a foreign offshore company that holds an interest in an FIE in China. It allows one to acquire the equity of the offshore SPV, which does not result in the need for Chinese government approval and also does not trigger statutory preemptive rights of other investors to acquire the interest being transferred available under China's Company Law.[13] For direct acquisitions, Chinese government approval is required, and any other investors in the FIE will have statutory preemptive rights to acquire the interest being transferred as prescribed under the Company Law. If the target is a purely domestic enterprise, in other words, one that has no foreign investment, then conversion into an FIE will be required, adding yet another layer of approval (as is the case for asset acquisitions).

Due the removal of Article 12 from the revised Company Law,[14] it is now also possible for FIE operating companies in China (as opposed to holding, or investment, companies, as they are labeled in China) to invest into other companies. Holding companies have been permitted for a number of years,

---

[13] *See generally Gongsifa* [Company Law], eff. Jan. 1, 2006 [*hereinafter* Company Law].

[14] *See generally* Company Law, *supra* note 13. Article 12 of the prior version of the Company Law limited investments in other companies by domestic companies to an amount not greater than 50% of the net asset value of the acquirer company (and specifically excluding any increase from capitalization of the profit derived from the company invested in). *Gongsifa* [Company Law], eff. Jul. 1, 1994 (repealed and replaced by the Company Law, *supra* note 13).

although the establishment criteria are very steep--such as requiring U.S. $100 million or more in assets or U.S. $30 million in assets and at least 10 investments already in China. As a result, only the largest companies investing in China have opted for this path, especially since there remains no ability to consolidate for tax and accounting purposes in China. In terms of M&A investments by operating FIEs (non-holding companies) in China, there remain certain criteria with which to comply:[15]

1. The FIE's registered capital must have been paid in full;
2. The FIE must have begun to make profits; and
3. The FIE has no record of unlawful activities.

Finally, M&A deals must comply with China's industrial policies regarding foreign investments. China controls foreign investments through an industrial catalogue, which divides investments into three categories: encouraged, restricted, and prohibited. If a particular industry or investment is not listed in the industrial catalogue, then it is permitted. M&A transactions are not excepted from these sectoral restrictions. One cannot accomplish through M&A what one would not be permitted to do otherwise by direct, greenfield, investment.

Antitrust review

The antitrust review in the New Regulations remains the same as that of the old regulations. During the examination and authorization process in connection with an M&A transaction, the MOFCOM and the SAIC themselves, or upon request by a domestic competitor, a trade association, or by other government agencies, may review whether an acquisition will result in "over-concentration" in an industry.[16] Although the regulations have a detailed procedure, for the most part, this review does not pose a problem. It should be noted, however, that China recently adopted the Anti-Monopoly Law of the People's Republic of China,[17] which may prove to be a more effective weapon for the regulatory authorities in China, both in terms of preventing over-concentration and, potentially, as a means of

[15] *See* Wai shang tou zi qi ye jing nei tou zi de zan xing gui ding [Interim Provisions for Domestic Investment by Foreign-funded Companies] (promulgated by the MOFCOM and the SAIC, July 25, 2000, effective September 1, 2000), arts. 5 & 6, *available at* http://wzs.mofcom.gov.cn/aarticle/zcfb/200208/20020800036017.html (last visited June 5, 2007).

[16] New Regulations, *supra* note 5, arts. 51-54.

[17] *Zhonghua renmin gongheguo banlongduanfa* [Anti-Monopoly Law of the People's Republic of China], to be effective August 1, 2008.

protecting certain domestic industries, or players within certain industries, from foreign domination.

Open questions

Although it is encouraging that the New Regulations have clarified many vague elements of the prior "interim" regulations, there remain some unanswered questions.

The New Regulations create the key industry protection rules as stated above, but it is not clear at all as to what constitutes these key industries, how national economic security is defined, and what Chinese brands are traditional and well-known trademarks. Not surprisingly, most practitioners see this as providing very broad discretion to approval authorities.

Another article that poses significant questions is Article 40 of the New Regulations. This article provides that "the offshore security listing of special purpose vehicles shall receive the approval of the competent security regulatory commission of the State Council."[18] The question that remains unanswered is: exactly how far does this provision reach? At first glance, it seems clear that all of the SPV's offshore listings should be approved by the CSRC. However, some practitioners in China think that this provision only applies to the offshore listing of SPVs that acquire domestic companies through equity interest transactions.[19] The lawyers opine based mainly on the text structure and the internal cohesion of the New Regulations. Although the arguments supporting their contentions are persuasive, there is undoubtedly still a need for definitive and authoritative interpretations from the likes of MOFCOM, the CSRC, or other relevant government agencies.

---

[18] New Regulations, *supra* note 5, art. 40.

[19] Jianping Wang, *Interpretation of Article 40 of the New M&A Regulations – Share Swap or Cash Deal?*, King and Wood China Bulletin, August 2006, *available at* http://www.kingandwood.com/Bulletin/Bulletin%20PDF/en_2006-08-China-wangjianping.pdf, (last visited June 5, 2007).