China

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New Chinese Regulations Affect M&A, Competition and Venture Capital

New regulations promulgated on August 8 will have a substantial and generally adverse impact on mergers and acquisitions by foreign companies targeting domestic companies in China. The new regulations (the Regulations) will also tighten competition law with respect to such transactions. While there will be adverse effects on foreign companies, the Regulations will, for the first time, open the way to transactions through stock swaps, which will expand the means for conducting mergers and acquisitions.

The Regulations separately allow offshore listings by Chinese companies through special purpose offshore vehicles, but new restrictions imposed on such offshore asset transfers may actually depress access to the foreign capital markets, particularly the venture capital market.

The Regulations on the Merger and Acquisition of Domestic Companies by Foreign Investors (the Regulations) were jointly promulgated by 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 (SAIC); the China Securities Regulatory Commission (CSRC); and the State Administration of Foreign Exchange (SAFE)—with MOFCOM as the lead department. The Regulations supersede Provisional Regulations promulgated in April 2003, and took effect on September 8.

M&A

Although the declared purposes of the Regulations include the acceleration and regularization of foreign investment and the introduction of advanced foreign technology and management experience, the Regulations also have other purposes that may adversely affect foreign investment, such as the protection of employment and the protection of fair competition and national economic security. While many provisions restate the requirements governing foreign investment set forth to prevent the evasion of laws and regulations through M&A transactions, the Regulations elsewhere evince a suspicion that foreign investors—through M&A activities—are acquiring domestic companies for inadequate consideration and with adverse consequences for economic security, employment and other policies.

Article 12 of the Regulations requires MOFCOM approval of any foreign-related acquisition that would result in the transfer of a controlling interest in a domestic company relating to key industries with an actual or potential effect on national economic security, or of a company with a famous trademark or venerable company registration. "National economic security" is not defined in the Regulations, which allows for the possibility of a broad interpretation. Some of the key industries are, presumably, the 16 equipment manufacturing industries relating to economic and defense security listed in the Certain Opinions Concerning Accelerated Development of the Equipment Manufacturing Industry, issued by the State Council on June 28. The absence of definitions of "key industry" and "national economic security" nevertheless opens the door to substantial administrative discretion and opportunities for opposition by domestic competitors—a phenomenon which has already emerged in the cookware industry—for industries that would not appear to raise any national security, or even cultural, concerns.

Article 13 provides that domestic companies selling assets to any foreign company must notify creditors and publish an announcement at least 15 days before notification of the transaction to the approval authority. Although this measure is presumably intended to protect creditors, no comparable requirement applies to purely domestic transactions. Moreover, Article 13 states that, in such transactions, the assets must be appraised in accordance with international practice, and transactions for obviously low consideration are prohibited. These requirements apply even to sales of non-state-owned assets, even though it is unclear why government intervention is needed to protect private companies from selling their own assets at negotiated valuations.

Stock Swaps

Chapter Four, comprising 24 of the 61 articles of the Regulations, for the first time authorizes foreign companies to acquire domestic companies through stock swaps or the issuance of new shares. This is a welcome reform—allowing the use of stock instead of cash or hard assets to make acquisitions. It can foster a closer alignment of interests between the owners and managers of the targets and those of the new owner, and it is particularly useful for foreign, technology-based companies that are short on cash.

Several restrictions to this rule apply. Article 28 requires that, generally, the foreign investor must be a listed or public company, have had a clean record for at least three years, and be domiciled and listed in jurisdictions with sound regulatory systems. This specific requirement will not apply to offshore special purpose vehicles (SPVs) established by domestic companies for overseas listing purposes. Please see the section on venture capital below for a more detailed discussion of this topic. Article 30 requires that the domestic company or its shareholders engage a consultant registered in China to conduct due diligence on the foreign company. Article 32 requires an extensive filing by the foreign company, including security interests on its assets and a report on trading in its shares during the previous six months.

Competition

Although China's anti-monopoly law has yet to be enacted, the Regulations expand existing notification requirements for foreign-related M&A transactions. Notification is required under Article 51 if any of the following thresholds are met: (i) a party's sales in China during the year exceed RMB1.5 billion; (ii) the acquirer has acquired more than 10 related enterprises in China during the year; (iii) a party's market share in China is 20% or larger; or (iv) a party's market share will increase to 25% or larger after the transaction. Only (iii) and (iv) constitute competition concerns in international practice. Moreover, even if none of these thresholds are met, domestic enterprises with a competitive interest in the transaction, relevant departments, or industry associations may petition MOFCOM or SAIC for a hearing because the foreign party's market share is too large or will otherwise materially impact economic competition. MOFCOM and SAIC, together or separately, will have 90 days to determine whether a hearing is required before deciding whether or not to approve the transaction. This provision, together with the others concerning economic security and domestically-held trademarks, allows substantial opportunity for domestic competitors to intervene in acquisitions. Indeed, such hearings were held outside the presence of the foreign party in at least one instance even before the Regulations took effect.

Other notification criteria, as well as grounds for an exemption, are carried over from the Provisional Regulations to Articles 53 and 54 of the Regulations. Two of those thresholds are identical to items (iii) and (iv) under Article 51, while others apply to the value of sales, the size of assets and the number of subsidiaries in China. The partial redundancy seemingly is due to the fact that Articles 53 and 54 apply to any acquisition by a foreign company—including acquisitions of subsidiaries of foreign companies—while Article 51 applies only to acquisitions of domestically-owned companies. If this is, in fact, the reason for the redundancy, it is unclear whether both sets of notification requirements must be addressed with respect to acquisitions of domestically-owned companies.

The suspicion of foreign acquisitions on competition grounds is not universally held in official circles. The head of MOFCOM's Research Center on Transnational Corporations recently reported that no domestic industry is monopolized by foreign companies, and efforts to restrict the entry of foreign companies into China are themselves anti-competitive. However, the trend toward tighter restriction is manifest.

Venture Capital

Chapter Four, Section 3 also allows domestic companies to establish offshore SPVs for the purpose of overseas listings. While such recognition of the offshore SPV structure and offshore listings is a welcome development, the Regulations also subject such SPVs to MOFCOM approval and offshore listings to CSRC approval, extending Chinese jurisdiction to offshore corporate and securities activities to a greater extent than has heretofore been the case. Moreover, the proceeds of an offshore listing, as well as the dividends and the proceeds of changes in the capital structure of domestic shareholders, must be repatriated within six months.

These latter regulatory requirements threaten to limit offshore exit options and depress foreign venture capital investment in China barely a year after the industry persuaded SAFE to relax unnecessarily restrictive controls on overseas investments by Chinese citizens that were promulgated in the name of foreign exchange control and the prevention of tax evasion. The Regulations reflect not just ongoing concern over outward currency flows and tax evasion, but also a determination to maintain Chinese

control over domestic assets. The latter concern is consistent with the Notice Concerning Strengthening the Administration of Foreign-Invested Value-Added Telecommunications Business Operations recently issued by the Ministry of Information Industry (MII), which asserted MII jurisdiction over the formation of offshore SPVs in the value-added telecommunications industry.

Conclusion

The Regulations open the door to acquisitions of domestic companies by stock swaps, opening a new door for foreign companies wanting to expand in China. The Regulations also, however, impose new limitations and restrictions on all M&A transactions by foreign companies, a move which appears to reflect a rise in economic nationalism.

The Regulations separately acknowledge that domestic companies have legitimate reasons to establish offshore SPVs as offshore listing vehicles—which would foster capital formation and aid smaller domestic companies in particular—but they also tighten regulatory requirements with respect to such activities. The result will be to narrow, rather than expand, the opportunities for foreign venture capital.

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