# Moving target

## A guide to recent Chinese M&A and private equity reform

As merger and acquisition activity accelerates in China, the rules and regulations governing such activity are evolving rapidly. This article briefly summarizes China's foreign investment regime and regulatory changes that may affect M&A and private equity transactions by foreign investors.

The first law in modern times permitting foreign investment in China was the Chinese-foreign joint equity venture law adopted in 1979. Since then, and particularly in the last five years pursuant to China's accession to the WTO, China's foreign investment regime has evolved significantly. Recently, the pace of change has accelerated, with new laws, regulations or rules being adopted almost every month.

Most of the foreign investments in China to date have been direct investments in greenfield projects in the form of an equity joint venture (EJV), cooperative joint venture (CJV), wholly foreign-owned enterprise (WFOE), or, to a limited extent, foreign-invested joint stock company limited by shares (FIJSC). Separate laws, regulations and rules govern the establishment and operation of such entities, which collectively are called foreign invested enterprises or FIEs.

The areas of business in which FIEs may engage are categorized in the periodically updated *Catalogue Guiding Foreign Investment in Industry* as "encouraged," "permitted," "restricted," or "prohibited," according to the extent that the Chinese government wishes to incentivize foreign investment in particular industries. All M&A in China is subject to the restrictions on foreign investment described in the Catalogue. Most of the industries in the encouraged or permitted categories allow 100% foreign ownership, and investments in the encouraged industries are entitled to preferential treatment.

Generally, investments in the restricted industries require Chinese joint venture partners and, in some cases, that such Chinese partners retain a majority interest; such investments, moreover, are typically subject to approval by the government authority responsible for the relevant industry, in addition to the other government approvals usually required for any foreign investment. No foreign investment is allowed in the prohibited industries. However, as a result of China's implementation of its WTO access commitments, restrictions in respect of most of the industrial and service sectors will have been liberalized according to different timetables over the six-year period that began on December 11 2001 (so by the end of 2007).

With the dramatic growth of China's economy, some Chinese businesses have emerged as attractive acquisition targets for foreign investors. Such acquisition activity appears likely to constitute an increasing portion of future foreign investment into China. Apparently in response, China has issued a series of regulations governing M&A transactions by foreign investors involving various target entities in China. In the meantime, the laws regulating FIEs remain relevant to most M&A involving foreign investors, which are required to form FIEs as onshore acquisition or operating vehicles. This article will focus on the specific rules and regulations governing M&A and private equity transactions in China.

### Share-exchange transactions permitted

On August 8 2006, six Chinese government agencies jointly issued the 2006 M&A Rules, substantially amending and expanding China's 2003 M&A Rules. The new rules became effective on September 8 2006. The 2006 M&A Rules establish a general legal framework for foreign investors to acquire either equity or assets of a Chinese company in exchange for cash or stock of the foreign acquirer, requiring (among other things) approval by one or more Chinese government agencies.

Unlike under the 2003 M&A Rules, under the 2006 Rules the use of a foreign publicly listed company's shares as consideration for the exchange of Chinese equity securities in connection with an M&A transaction is (for the first time) expressly permitted and regulated. Two requirements, among others, for such a share exchange transaction are that:

- The foreign shares used as consideration must be traded on a public stock market (not traded over the counter or privately held) and must have a "stable" share price over the previous 12 months; and
- The foreign listed company (and its management) must not have been subject to any sanction by a relevant regulatory authority within the past three years.

The new rules require a multi-step government approval process for such a share exchange transaction. First, the Chinese target company submits to the Ministry of Commerce (MofCom) an advisory report issued by its M&A advisor, together with other documents related to the share ownership and trading, financial condition, and good standing of both the Chinese company and the foreign listed company. Second, if the application is satisfactory, MofCom issues a restricted approval certificate and within six months thereafter the parties must complete the equity transfers. Third, the Chinese company files a tentative foreign exchange registration with the State Administration of Foreign Exchange (SAFE) and a tentative business license registration with the State Administration of Industry and Commerce (SAIC). Fourth, MofCom issues an unrestricted approval certificate after verifying completion of the equity transfers. Fifth, the Chinese company must obtain an unrestricted foreign exchange registration certificate and a business license, from SAFE and SAIC respectively.

### Acquisitions of listed companies

Chinese corporate investors and the state own a substantial portion of the issued shares of most Chinese listed companies. Those shares, called legal person shares or state-owned shares, were owned prior to listing and, until recently, were not freely tradable. There are two other types of shares issued by such companies which are tradable, however, namely A shares and B shares. Until recently, A shares, the most commonly traded shares on Chinese stock exchanges, were permitted to be sold only to Chinese investors. Foreign investors, on the other hand, were allowed to acquire only B shares, which are issued by a small percentage of Chinese listed companies. Thus, Chinese publicly traded companies were largely inaccessible to foreign investors. Recently, however, some foreign investors, including some prominent private equity investors, have expressed interest in making investments in listed companies in China, apparently due in part to the potential larger scale of such investments than other deals in the market and also the relatively low trading prices of such companies' securities when compared to those of comparable companies listed in other markets. Recent regulatory changes as described below, moreover, appear intended to gradually encourage such foreign investment in listed Chinese companies.

*New accounting standards for listed companies.*

On February 15 2006, China's Ministry of Finance issued a series of new and revised Accounting Standards for Business Enterprises, which will become effective on January 1 2007 for listed companies. Most of the new accounting standards reflect the approaches and principles of the International Financial Reporting Standards (IFRS). For example, the new standards provide formal accounting standards and comprehensive and detailed guidelines applicable to business combinations and consolidated financial statements akin to those established by the IFRS. By aligning Chinese accounting standards with a reliable international standard, these changes improve the likelihood that foreign investors will be able to conduct meaningful financial due diligence on listed Chinese companies.

*Share liquidity reform*

Since April 2005, the China Securities Regulatory Commission (CSRC) has promoted a share liquidity reform programme under which listed companies are being restructured to convert almost all non-tradable legal person shares into freely tradable A shares within two years. To date, more than 85% of China's listed companies have completed this programme.

*Foreign investors may acquire A shares*

Under the Administrative Measure for Strategic Investments in Listed Companies by Foreign

Investors (the FSI Rules), which became effective on January 31 2006, foreign investors are now permitted to purchase A shares directly on China's stock exchanges as "mid- or long-term strategic acquisition investments." The FSI Rules apply to acquisitions of A shares of listed companies which have completed their own share liquidity reform measures and of companies that are listed after the completion of CSRC's overall share liquidity reform. Under the FSI Rules, foreign strategic investors must either own at least $100 million of assets or have at least $500 million assets under management and must be "financially sound, credible foreign legal persons or other entities with significant management experience".

It thus appears that large private equity funds would qualify as foreign strategic investors under the FSI Rules. The FSI Rules do not impose any specific ownership percentage caps, although acquired shares are subject to a three-year lockup period after the acquisition. The FSI Rules also allow foreign strategic investors to acquire A shares through offshore subsidiaries, provided the parent agrees to be jointly and severally liable for the investment activities of such offshore subsidiaries and submits to MofCom an irrevocable letter of undertaking to that effect. Many observers expect that the FSI Rules will expand the market for acquisitions of Chinese listed companies by foreign investors.

*Non-tradable shares may be acquired*

In November 2002, several Chinese government authorities jointly issued the Notice on Relevant Issues Concerning the Transfer to Foreign Investors of Listed Company State-Owned Shares and Legal Person Shares. The shares notice provides that sales of legal person shares to foreign investors should "in principle" be conducted through an open bidding process and are subject to numerous government approvals. Since the issuance of the notice, a limited number of such transactions have been approved by the Chinese government, including Citigroup's acquisition of a minority stake in Shanghai Pudong Development Bank in May 2003 and Newbridge Capital's acquisition of a minority stake in Shenzhen Development Bank in May 2004.

*Mandatory tender offer rule relaxed*

The Administrative Measures on the Takeover of Listed Companies issued by the CSRC on September 28 2002 required a foreign investor who purchased 30% or more of the outstanding shares of a Chinese listed company to make a "general offer" to all shareholders of the listed company to purchase all of their shares. This requirement may be waived by the CSRC under certain conditions. On July 31 2006, CSRC issued its new Administrative Measures on the Takeover of Listed Companies, which became effective on September 1 2006. Under the new measures, when a foreign investor purchases 30% or more of the outstanding shares of a Chinese listed company, the investor is not required to make a general offer for all shares of the listed company. Rather, it may make a general offer to purchase any amount of shares from the company's shareholders provided that the aggregate amount of shares proposed to be purchased through the general offer is not less than 5% of all issued shares of the listed company. The relaxation of mandatory tender offer requirements provides potential investors in public companies with far greater flexibility and less costly access to controlling stakes.

## New company law

China's new Company Law, which became effective on January 1 2006, contains many important revisions intended to improve structuring flexibility for investors and operational efficiency for Chinese companies. The new Company Law applies to limited liability companies (LLCs), joint stock companies limited by shares (JSCs) and FIEs, except where laws and regulations that specifically govern FIEs provide otherwise. On April 24 2006, several Chinese authorities jointly issued the Implementing Opinions on Several Issues Concerning the Application of the Law in the Administration of the Examination, Approval and Registration of Foreign-invested Companies to confirm and clarify the application of certain amendments to the new Company Law applicable to FIEs. Below are summaries of certain notable amendments that are relevant to foreign investments, particularly private equity investments, in China.

*Greater flexibility on voting rights and profit distributions*

The new Company Law introduces greater flexibility for shareholders in determining their voting and profit distribution rights in an LLC and JSC. Because such flexibility also extends to an FIJSC, the corporate governance rules applicable to which are generally regulated under the new Company Law, foreign investors may now consider forming a FIJSC, instead of other types of FIEs, in order to retain greater flexibility when determining the capital structure.

*Restrictions on company investment eliminated*

Previously, the aggregate amount of a company's investment in other companies was limited to 50% of its net assets. The new Company Law eliminates this and allows a company to freely invest in another company as long as it does not assume any joint and several liabilities for the investee's debts. This change in law, which also applies to FIEs, substantially liberalizes the restrictions on corporate investment activity, another potential source of increased M&A activity in China.

*New corporate governance provisions*

The new Company Law addresses corporate governance and duties and liabilities of directors and officers. It explicitly imposes duties of care and loyalty on directors, supervisors, and members of senior management. However, the new Company Law does not provide any specific guidance on fiduciary duty standards (for example, it does not address business judgment rule standards for directors or officers).

## New government approval requirements

The 2006 M&A Rules require foreign investors to notify MofCom if a proposed M&A transaction results in foreign investors controlling any Chinese company that involves or affects:

- A key domestic industry;
- National economic security; or
- Well-known or traditional trademarks or brand names.

If MofCom is not properly notified, the agency may require termination of the transaction, divestment of equity interests or assets, or any other action required to dissipate negative effects to national economic security resulting from the transaction.

These new economic-security-safeguard provisions are both broad and vague regarding which industries are key, when national economic security is affected, and what trademarks and brand names are well-known or traditional. The new rules also place the onus on the parties to determine whether a transaction triggers the notification requirement. In addition, it is not clear whether the new rules grant MofCom the power to block a transaction after an advance notice has been filed.

The 2006 M&A Rules require approval by MofCom where a domestic person (a company, enterprise or natural person) in China establishes or controls a foreign company and the foreign company acquires a Chinese affiliated company. Requirements for approval are unclear and the terms "domestic person" in China and "control" are undefined. It is not clear how this approval requirement will be applied in relation to the so-called Circular 75 issued by SAFE, which covers similar transactions and already requires a registration process with SAFE.

When foreign investors acquire an interest in a Chinese company, it is common (particularly in a private equity or venture capital context) for the foreign investors to offer selected Chinese persons (such as an owner or manager of the Chinese company who remains with the company post-acquisition) an opportunity to own, at and after the closing, equity interests in the foreign company established to make the acquisition. Whether such a transaction would trigger the approval requirement under the 2006 M&A Rules is unclear.

## Conclusion

Substantial regulatory changes in China are reshaping, and in many cases, improving, the country's legal environment for M&A and private equity. Although foreign investors remain exposed to the risks created by substantial government involvement in transactions and vague regulations, as China's legal regime continues to evolve and becomes more flexible, M&A and private equity activity seems likely to increase.

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