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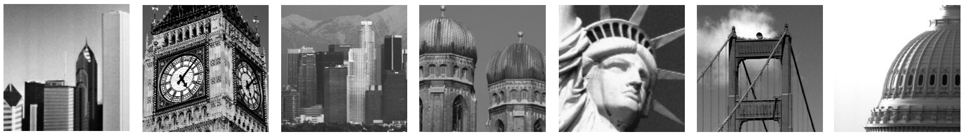

Private Equity Newsletter

New Rules For Chinese Company M&A Transactions Involving Foreign Investors

PENpoints

China's new M&A rules introduce some major changes that may impact Chinese M&A activity by foreign investors

On August 8, 2006, six Chinese government agencies[1] jointly issued the 2006 M&A Rules[2] (substantially amending and expanding China's 2003 M&A Rules[3]), effective September 8, 2006.

The 2006 M&A Rules establish a general legal framework for foreign investors (both strategic and financial investors) to acquire either equity or assets of a Chinese company in exchange for cash or stock of the foreign acquiror, requiring (among other things) approval by one or more Chinese government agencies. If the Chinese target company is publicly listed, the foreign investors' acquisition is also subject to another set of recently adopted rules[4], as discussed in our May 16, 2006 PEN article entitled *1,200 New Targets: China's Foreign Strategic Investments Rules*.

The 2006 M&A Rules' three most notable changes (as compared to the 2003 M&A Rules) for a foreign investor are:

1. Share Exchange Expressly Permitted

The 2006 M&A Rules expressly permit (and regulate) for the first time 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. Two major requirements, among others, for such a share-exchange transaction are:

- The foreign shares used as consideration must be traded on a public stock market (i.e., not traded over the counter or privately held) and must have a "stable" share price over the previous 12 months.[5]
- 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 must submit to a Chinese government agency[6] a due diligence 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, the Chinese government agency issues a restricted approval certificate and within six months thereafter the parties must complete the equity transfers. Third, the Chinese government agency issues an unrestricted approval certificate after verifying completion of the equity transfers. Fourth, the Chinese company is required to obtain a foreign exchange registration certificate and a business license, respectively, by registering with two other Chinese government agencies.[7]

2. National-Economic-Security Safeguards

The 2006 M&A Rules require foreign investors to notify a Chinese government agency[8] 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 the agency 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. In addition, the new rules place the onus on the parties to determine whether a transaction triggers the notification requirement. It is also unclear whether these new rules require notice in advance of consummating a proposed M&A transaction or merely require notice after the transaction's completion. Finally it is not clear whether the new rules grant the Chinese government agency power to block a transaction after an advance notice has been filed.

It appears that the Chinese authorities are keen to protect their key industries and assets, a reaction not completely dissimilar to the U.S. Congress's reaction to, and interference in, the Chinese National Offshore Oil Corporation's (CNOOC) proposed purchase of American oil company Unocal in 2005. This is also consistent with the Chinese authorities' consideration of The Carlyle Group's agreement to acquire an 85% stake in Xugong Group Construction Machinery, China's largest construction machinery manufacturer and distributor, for $375 million, which although signed October 25, 2005, has yet to receive approval.

3. Interest of Domestic Persons in Foreign Companies Requires Chinese Government Approval

The 2006 M&A Rules require approval by a Chinese government agency[9] where a "domestic person" in China establishes or controls a foreign company and the foreign company acquires a Chinese affiliated company.[10] Requirements for approval are unclear and the terms "domestic person"[11] in China, "control"[12] and "affiliated company" are undefined.

When foreign investors acquire 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.

PENnotes

1. The six Chinese government agencies are Ministry of Commerce ("MofCom"), State Administration of Foreign Exchange ("SAFE"), State Administration of Industry and Commerce ("SAIC"), China Securities Regulatory Commission, State-Owned Assets Supervision and Administration Commission, and State Administration of Taxation.
2. The formal title of the 2006 M&A Rules is *Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.
3. The formal title of the 2003 M&A Rules is *Provisional Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.
4. *Measures on Strategic Investments in Listed Companies by Foreign Investors*.
5. The exchange of a foreign company's shares for a Chinese company's shares is subject to a special rule where (a) the Chinese company is forming a special purpose vehicle (an "SPV"), such as a holding company to own the Chinese company, (b) the SPV is controlled by Chinese persons (possibly interpreted very broadly to include even small equity ownership by Chinese persons, as prescribed in SAFE's Circular 75 (see footnote 12 below)), and (c) the parties intend to take the SPV (and hence the Chinese subsidiary) public. Under this special rule, the SPV's shares are not required to be publicly listed (e.g., the shares can be privately held) at the time of the exchange.
6. MofCom.
7. SAFE for the foreign exchange registration and SAIC for the business license issuance, with tentative registration previously filed when MofCom issued the restricted approval certificate as described in the second step above.
8. MofCom.
9. MofCom.
10. Another government agency, SAFE, already requires a registration (not approval) in a similar situation, in its circular issued October 21, 2005 ("Circular 75").
11. A similar term in Circular 75, "domestic resident," is broadly defined to mean any Chinese legal entity or natural person with a Chinese identity card or passport or who regularly resides in China because of economic interests.
12. The term "control" in Circular 75 is broadly defined to mean the right to operate, to benefit from, or to decide the policies of an SPV or a Chinese company.

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