



**RECENT DEVELOPMENTS IN CHINA'S POLICIES TOWARDS
CROSS-BORDER MERGERS AND ACQUISITIONS (M&A)**

Supplement to the 2006 Investment Policy Review of China

December 2006

This document provides an assessment of the latest developments in China's policies towards cross-border M&As since the publication of the 2006 Investment Policy Review of China. It is a contribution to the OECD's co-operation with China to promote transparent and non-discriminatory investment policies in support of China's development.

I. Introduction

This note is a contribution to the OECD's co-operation with China to develop more open, transparent and non-discriminatory investment policies in support of China's development. It also forms part of a body of work on reconciling perceived needs to protect national interests with more open investment policies in all countries, currently under discussion in a continuing series of roundtables on freedom of investment, national security and "strategic" industries at the OECD in Paris.

The OECD's 2003¹ and 2006² *Investment Policy Reviews* of China recommended more open policies towards cross-border mergers and acquisitions (M&As). The 2006 Review analysed *inter alia* the 2003 *Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (referred to in this note as the 2003 *Interim Provisions*), hitherto the most comprehensive set of regulations on cross-border M&A. It welcomed the additional transparency they brought, and proposed further measures to liberalise cross-border M&A regulations, including: further relaxation of foreign ownership restrictions; increased regulatory transparency; adopting internationally-standard and transparent merger notification procedures; further improving corporate governance; and fully opening capital markets to foreign investor participation.

On 8 August 2006 the Ministry of Commerce (MOFCOM) posted in Chinese on its web site³ a new set of *Regulations on the Acquisition of Domestic Enterprises by Foreign Investors* (hereafter the 2006 *Regulations*), to take effect on 8 September 2006. The link to the text of the new regulations appears in a chronological list on the site. No invitation to submit comments on the *Regulations* is apparent on the site or in the text.

The new policy towards cross-border mergers and acquisitions is explained in the 11th five-year plan for utilising foreign investment, published by the National Development and Reform Commission (NDRC) on 9 November 2006.⁴ This states that priority will be given to quality rather than quantity of foreign investments, that emerging monopolies by foreign-invested enterprises are posing a potential threat to China's economic security and that foreign businesses are harming Chinese enterprises' capacity for independent innovation. The plan sets forth a clear industrial policy prioritising geographical areas, industrial sectors, levels of technology, environmental protection and efficient use of natural resources. In response to perceived rising concern over foreign acquisitions of leading Chinese firms in critical sectors, the plan provides for increased supervision of sensitive acquisitions to ensure that what are termed "critical industries and enterprises" remain under Chinese control.

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1. OECD (2003), *Investment Policy Review of China: Progress and Reform Challenges*, Paris.
 2. OECD (2006), *Investment Policy Review of China: Open Policies towards Mergers and Acquisitions*, Paris.
 3. <http://www.fdi.gov.cn>
 4. Xinhua News Agency, 9 November 2006 and <http://www.ndrc.gov.cn>. The term "11th five-year plan" is misleading because this is the first five-year plan for utilising foreign investment to be published in China and it is unlikely that foreign capital utilisation was included in all earlier national economic plans.

II. Main findings

The 2006 *Regulations* represent a further opening toward cross-border mergers and acquisitions (M&As) in line with standard international practice in that they allow for the first time the acquisition of equity interests held by shareholders of a Chinese domestic company by payment of equity interests held by shareholders of an overseas company or new shares issued by an overseas company.

The 2006 *Regulations* increase corporate transparency by requiring parties to a cross-border acquisition to disclose whether or not they are affiliated with each other and, if they are under the common control of the same entity, to provide additional information regarding the purpose of the acquisition and whether the appraisal results conform to fair market value. They also make specific and detailed provision for the use of special-purpose entities overseas by Chinese domestic firms making acquisitions in China—an important addition in view of the generally unrecorded but widespread practice of “round-tripping” by Chinese companies seeking to benefit from incentives offered to foreign investors.

On the other hand, the 2006 *Regulations* add a new screening requirement on cross-border M&A transactions in which the foreign investor obtains controlling rights of a domestic enterprise if the acquisition:

- Involves a major industry.
- Has or may have an impact on national economic security.
- May result in the transfer of famous trademarks or traditional Chinese brands.

The lack of definition of terms including “major industry”, “impact” on “national economic security”, “famous” trademarks and “traditional” Chinese brands appears to render the new screening requirement less than wholly transparent. Foreign investors seeking to merge with or acquire domestic Chinese enterprises, the domestic enterprises targeted for merger or acquisition, and the Chinese government agencies charged with implementing the new regulations may not have enough information to be able to apply these terms to an actual transaction. Pending the publication of detailed implementing regulations, if any, the new screening process may have a serious unintended discouraging effect on investments.

The new screening measures covering cross-border acquisitions which have or may have an impact on “national economic security” appear to go beyond measures to safeguard essential security interests. This also raises an issue of compatibility with international commitments.

Since the extra layer of screening is added after the merger or acquisition, it amounts to an ex-post restriction which can substantially impede the stability of cross-border merger or acquisition transactions.

“Famous trademarks” can be certified by a People’s Court and also by Chinese administrative agencies, including the Trademark Office of the State Administration for Industry and Commerce. Since People’s Court certifications are not listed publicly, it is difficult for foreign investors to see whether a trademark falls into the category of “famous trademarks”. It is not usual for developed countries to restrict cross-border mergers or acquisition by reason of “famous” trademark or “traditional” brands.

The creation of a new layer of screening is in addition to the examination and approval process based on the *Catalogues for Guidance of Foreign Investment Industries*, which the Chinese authorities have been invited in both the 2003 and 2006 OECD *Reviews* to make more transparent and eventually replace with a closed list. It does not appear consistent with the repeatedly expressed intention of the Chinese authorities to streamline foreign investment approval procedures.

The law concerning the control of strategic investment in listed companies by foreign investors was promulgated on 31 December 2005 and came into force on 30 January 2006. This law provides the relevant procedures for merger and acquisition of domestic listed companies by foreign investors. However, the relationship between the 2006 *Regulations* and this law is unclear, and therefore it remains uncertain whether the 2006 *Regulations* should be applied to a foreign investor merging with or acquiring a Chinese listed company.

The OECD's 2006 *Review* also noted that "the 2003 *Interim Provisions* contain regulations on pre-merger notification that appear to discriminate against foreign investors and others that are based on unquantifiable pre-merger notification thresholds". The *Review* welcomed the Chinese government's intention to promulgate a non-discriminatory anti-monopoly law and meanwhile recommended changes to the merger notification procedures in the 2003 *Interim Provisions* to increase their transparency. It was understood informally from the Chinese authorities that they intended to replace the discriminatory merger notification procedures in the 2003 *Interim Provisions* with a merger notification procedure in the anti-monopoly law that did not distinguish between domestic enterprises and foreign investors. This reassurance was needed in view of recent calls from some officials for the new anti-monopoly law to block undesirable cross-border acquisitions, following a report by the State Administration for Industry and Commerce (SAIC) in 2004 that foreign companies were building monopolies in China (an allegation that MOFCOM has since publicly refuted). The merger notification procedures in the 2006 *Regulations* do not reflect the OECD's recommendations and are essentially the same as those in the 2003 *Interim Provisions*. It remains to be seen whether these procedures will be rescinded when the anti-monopoly law is promulgated and whether there will be any distinction in the anti-monopoly law between domestic enterprises and foreign investors.

Finally, according to the terms of its accession to the WTO⁵, China has agreed to make available to WTO Members, upon request, all laws, regulations and other measures pertaining to or affecting trade in goods, services, TRIPS or the control of foreign exchange before such measures are implemented and enforced. China has also agreed to provide a reasonable period for comment to the appropriate authorities before such measures are implemented, except where to do so would impede law enforcement. As the 2006 *Regulations* pertain *inter alia* to the control of foreign exchange, it would be reasonable to expect that they would have been notified to relevant external parties, preferably in English translation as well as in Chinese, in sufficient time to take their comments into account. It appears that such notification did not take place. China has recently introduced a system of soliciting public comment before finalising legislation. This initiative is a step forward, but its implementation remains incomplete. Procedures for receiving comments are not always transparent and sufficient time is not always provided for responses.

5. World Trade Organization (2001), Decision of 10 November 2001 on the Accession of the People's Republic of China, WT/L/432, section C, Transparency.

III. Policy options for consideration

Drawing on practices which OECD Members have also encouraged each other to adopt, policy options for consideration include:

- Clarifying the conditions of application of the new screening procedures, in particular by listing sectors qualifying as “major industry”, defining “national economic security” and “impact”, and explaining the criteria for identifying “famous” trademarks and “traditional” Chinese brands.
- Reducing the number of stages required in examination and approval procedures. The 2006 *Regulations* appear to introduce new complexities to the examination and approval process for cross-border M&As. Any implementing regulations adopted to clarify the 2006 *Regulations* would be more encouraging to investment in China if they moved in the direction of greater transparency, clarity and simplicity.
- Using existing remedies which may be less restrictive than the additional procedures in the 2006 *Regulations* while still achieving the legitimate objectives which may underpin the introduction of the new screening process.
- Reconsidering the merger notification procedures in the 2006 *Regulations* in the light of the 2006 *OECD Investment Policy Review*, including the possibility of rescinding them when the anti-monopoly law comes into force.
- Providing drafts of new laws and regulations affecting or potentially affecting foreign investors in Chinese and English to appropriate co-operation partners, including the OECD, sufficiently in advance of promulgation to receive and consider comments.

ANNEX

DIFFERENCES BETWEEN THE 2003 *INTERIM PROVISIONS* AND 2006 *REGULATIONS*

The new regulations add to Article 6 requiring examination and approval a paragraph stipulating that if the enterprise being acquired is a domestic listed company, it shall also carry out relevant procedures with the securities regulatory authority of the State Council, i.e. the China Securities Regulatory Commission (CSRC), pursuant to the *Measures Governing Strategic Investment Made by Foreign Investors in Listed Companies*.

Two articles in the 2006 *Regulations* did not appear in the 2003 *Interim Provisions*. These make explicit the application of current tax and foreign exchange legislation to enterprises acquired by foreign investors and do not appear to add any extra legal obligation. Article 7 of the new regulations states that the parties involved in the enterprise being acquired by a foreign investor shall pay taxes in accordance with tax regulations of China and accept supervision of tax authorities. Article 8 states that the parties involved with the enterprise being acquired by a foreign investor shall handle procedures with the relevant authority in charge of administration of foreign exchange approval, registration, filing and amendment in a timely manner in compliance with Chinese foreign exchange laws and administrative regulations.

As in the 2003 *Interim Provisions*, the contribution made by foreign investors is expected to be at least 25% of the registered capital. If it is less, then the approval certificate for the new enterprise will be marked “foreign investment proportion less than 25%”. The 2006 *Regulations* add that this phrase will also be added to the enterprise’s business licence and foreign exchange certificate, and that the enterprise shall not enjoy treatment of a foreign-invested enterprise (FIE). Any foreign loans it may borrow shall be handled in accordance with the relevant regulations governing foreign loans borrowed by non-FIEs, except as otherwise provided by laws and administrative regulations.

The 2006 *Regulations* include a new clause on the acquisition by a domestic company, enterprise or natural person of an affiliate of the domestic company in the name of an overseas company lawfully established or controlled outside China. This states that such an enterprise shall not enjoy FIE treatment unless the overseas company subscribes to any increased capital of the domestic company or contributes additional capital to the enterprise newly formed after acquisition and the amount of the increased capital exceeds 25% of the new enterprise’s registered capital. Where the contribution made by any foreign investor other than the actual controlling party of the FIE to the registered capital of the enterprise is higher than 25%, the enterprise shall enjoy FIE treatment.

This is further elaborated by another new clause requiring application to MOFCOM for examination and approval of the acquisition of any company inside China affiliating to a domestic company, enterprise or natural person made in the name of an overseas company lawfully established or controlled by a domestic company, enterprise or natural person. The parties concerned shall not circumvent the above requirements by making domestic investment through an FIE or otherwise.

The examination and approval authority specified in the 2006 *Regulations* is the Ministry of Commerce (MOFCOM) at national and provincial level, unchanged from the 2003 *Interim Provisions*, except that the approval authority was the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) prior to a restructuring of ministries later in 2003. The registration authority also remains the State Administration of Industry and Commerce (SAIC). The 2006 *Regulations* add that the foreign exchange control authority shall be the State Administration of Foreign Exchange (SAFE) and its local branches.

Article 12 of the 2006 *Regulations* adds a new requirement that application for examination and approval must also be made when a foreign investor obtains the actual controlling rights of a domestic enterprise if the acquisition involves any major industry, or has or may have an impact on national economy security, or may result in transfer of the actual controlling right of the domestic enterprise owning any famous trademarks or traditional Chinese brands. If the party concerned fails to make an application to MOFCOM and its acquisition causes or may cause a significant impact on national economy security, MOFCOM, together with the relevant authorities in charge, may demand that the party concerned ceases the transaction and that it transfers relevant equity interests and assets, and they may take any other effective action to eliminate the impact of the acquisition on national economic security.

The requirement in the 2003 *Interim Provisions* that a domestic enterprise selling assets shall give notice to creditors and make a public announcement in a newspaper at provincial level or above within ten days of the adoption of the resolution to sell the assets has been altered in the 2006 *Regulations*. The enterprise must now carry out the same obligations fifteen days before the investor submits application documents to the examination and approval authority.

Article 15 of the 2006 *Regulations* adds a new clause on related party transactions. The parties to an acquisition must make it clear whether or not there is any relation of affiliation between them. If both are under the control of a single party, they must disclose this fact to the examination and approval authority and explain whether or not the acquisition purpose and appraisal results conform to fair market value. Neither party may circumvent these requirements by means of trusteeship, holding and through agency, or otherwise.

Article 9 of the 2003 *Interim Provisions* states that where an FIE established after an equity merger or acquisition increases its registered capital, investors shall publish a schedule for capital contribution in the contract and articles of association of the FIE. If the capital contribution is to be paid in a lump sum, this must be contributed within six months from the date of issue of the FIE business licence. If it is to be paid in instalments, the investors' first instalment shall be not less than 15% of their respective capital subscription and must be made within three months from the date of issue of the FIE business licence.

The 2006 *Regulations* include a slight alteration to the stipulation of the 2003 *Interim Provisions* in this regard. Article 16 states that where a foreign investor subscribes to any increased capital of a domestic company, the shareholder(s) of the limited liability company or the domestic shareholding company established by means of sponsorship shall contribute no less than 20% of the increased registered capital when the domestic company applies for its FIE business licence. The schedule for contributions to the rest of the enterprise's increased registered capital shall be in conformity to the Company Law, relevant laws and regulations on foreign investment and the provisions of the Regulations on Administration of Company Registration. Relevant stipulations of other laws and administrative regulations shall also be followed where necessary.

An entire new Chapter IV entitled *The Acquisition of a Domestic Company by a Foreign Investor through Payment of Equity Interests* has been added in the 2006 *Regulations*. This form of payment for acquisition is not covered in the 2003 *Interim Provisions*.

The new regulations allow the acquisition of any equity interests held by shareholders of a Chinese domestic company through payment of equity interests held by shareholders of an overseas company or additional stocks issued by the overseas company.

The acquiring company must be lawfully established in a jurisdiction with a complete corporate legal system. No punishment must have been imposed on the company or its managers for the previous three years. Unless it is a special-purpose company, it must be listed in a place with a complete and mature system of securities exchange.

The equity interests contributed by the overseas company in payment for acquisition of a domestic company must be: lawfully held and transferable according to law; subject to no dispute of ownership or lien; lawfully listed for public trade on an overseas securities exchange market; in the form of shares whose trading price has been stable for the previous year.

To acquire a domestic company through payment of equity interests, the domestic company or its shareholders must hire an acquisition consultant to conduct due diligence and issue an acquisition consultant report on the application documents, the overseas company's financial status, and conformity with the 2006 *Regulations*. The acquisition consultant must have a good reputation, possess working experience within the industry, have no record of significant illegal acts, and be able to analyse the legal system of the jurisdiction where the company is registered and listed and the company's financial status.

The examination and approval process by which a foreign investor applies to MOFCOM to acquire a domestic Chinese company through payment of equity interests is similar to that for other forms of acquisition, except that an extra set of documents is required:

- A description of any major changes in regard to the equity interests and assets of the domestic company during the previous year.
- An acquisition consultant report.
- Certifications of incorporation of the domestic company and the overseas company involved in the acquisition or identification materials of their shareholders.
- A description of the status in regard to the equity shares held by shareholders of the overseas company and a name list of shareholders holding over 5% of the overseas company's shares.
- The articles of association of the overseas company and a description of any external security provided by the company.
- An audited financial report of the overseas company for the most recent year and a status report regarding the transactions of its stocks for the preceding six months.

MOFCOM shall examine the acquisition application within 30 days of receiving application documents. An approval certificate valid for six months from the date of issue of the business licence

shall be issued if all requirements are met. The domestic company being acquired must complete change formalities within 30 days of receiving the certificate. It will then receive an FIE business licence and an FIE foreign exchange certificate, both valid for eight months from the issue date. When handling the formalities of registration of changes with the relevant registration authority, the domestic company must provide in advance documents signed by its legal representative for future restoration of its equity structure, if applicable, including but not limited to the letter of application for change of equity interests, amended articles of association and equity transfer agreement. Within six months of the issue of the business licence the domestic company or its shareholders shall apply to MOFCOM and SAFE for examination and approval and registration of making overseas investment and establishment of overseas enterprise, including in their submission the approval certificate and business licence. MOFCOM issues a new approval certificate for overseas investment by the Chinese enterprise and a new FIE approval certificate. The domestic company must then apply within thirty days for an ordinary business licence and foreign exchange certificate. If the domestic company and the overseas company fail to complete procedures for change of equity interest within six months of the issue of the original business licence, the certificates of approval become null and void and the registration authority shall examine and approve to change the registration to its pre-acquisition state in accordance with the relevant equity change documents submitted earlier. If additional stocks are not issued by the domestic company before the registration authority approves the change of registration then the domestic company shall reduce its registered capital accordingly and make a public announcement in the newspapers under the Company Law.

The domestic company may not distribute profit to shareholders, provide any guarantee to its affiliates or pay any amount incurred from the equity transfer, reduction of funds, liquidation or any other accounts of capital-related items before obtaining the first certificate of approval and foreign exchange certificate.

Chapter IV of the 2006 *Regulations* also includes provisions on special-purpose companies, which are defined as any overseas company controlled, directly or indirectly, by a domestic company or Chinese natural person inside China for overseas listing of its/his/her share interests. The section applies to acquisitions of equity interests held by shareholders of domestic companies or additional stocks issued by domestic companies through payment of equity interests by shareholders of special-purpose companies or additional stocks issued by special-purpose companies for purposes of overseas listing.

Transactions for purpose of overseas listing of special-purpose companies must be approved by the China Securities Regulatory Commission (CSRC). The county or region where overseas listing of a special-purpose company is proposed must have complete legal and supervisory systems, and the local securities supervisory and administration authorities must have entered into memorandum of understanding on co-operation with the CSRC and co-operate effectively with it.

A domestic company providing its share interests for overseas listing must meet these requirements:

- The title to its property rights is clear without question and there is no dispute, existing or threatened, regarding its property rights.
- It has a complete system for business operation and is capable of maintaining constant operation.

- It possesses a healthy and complete company operation structure and internal management system.
- No record shows any commitment of any material violation of law by the company and its shareholders in the previous three years.

A domestic company wishing to establish a special-purpose company overseas must apply to MOFCOM for examination and approval, submitting the following documents in addition to those normally required for establishing an overseas investment:

- The identification certificate of the ultimate controlling person of the proposed special-purpose company.
- The business plan of the proposed special-purpose company for overseas listing.
- The evaluation report provided by the acquisition consultant regarding the issuing price of the special-purpose company's stocks to be listed overseas.

The total value of stock issuing price for overseas listing of the special-purpose company shall not be lower than the equity value of the acquired domestic company as appraised by the relevant Chinese assets evaluation organ.

For purpose of acquisition of a domestic company by its special-purpose company through payment of equity interests, the domestic company must also submit to MOFCOM:

- The relevant approval certificate and documents for making overseas investment and establishing overseas enterprise when the special-purpose company was set up.
- The overseas investment foreign exchange registration form of the special-purpose company.
- The identification certificate of the ultimate controlling person or the incorporation certificate and articles of association of the special-purpose company.
- The business plan of the special-purpose company for overseas listing.
- The evaluation report provided by the acquisition consultant regarding the issuing price of the special-purpose company's stocks to be listed overseas.

If a domestic company targets an overseas company holding any equity shares of a special-purpose company as the main body through which an overseas listing will be made, the domestic company must submit these application documents:

- The incorporation certificate and articles of association of the targeted overseas company.
- Detailed descriptions of the transaction arrangements and price conversion assessment made by and between the special-purpose company and the targeted overseas company regarding the equity interests of the acquired domestic company.

MOFCOM shall issue an official reply of approval in principle if it consents to these documents submitted. The Domestic Company shall submit listing application documents to the CSRC, which must decide whether or not to grant approval within 20 days. After approval is granted, the domestic company shall apply to obtain from MOFCOM the formal approval certificate, valid for one year from issue of the business licence. Any change in the equity interests of the special-purpose company due to acquisition must be registered with MOFCOM and the local SAFE office. Within 30 days of receiving the certificate of approval, the domestic company must register these with MOFCOM and SAFE, who then issue an FIE business licence and an FIE foreign exchange certificate to the domestic company, both valid for fourteen months from date of issue. It must also provide in advance documents signed by its legal representative for the purpose of future restoration of its equity structure, if applicable, including the letter of application for change of equity interests, amended articles of association and equity transfer agreement. Within 30 days of overseas listing by the domestic company or its affiliate, the domestic company must report to MOFCOM regarding the overseas listing and relevant financing revenue returning plan and must apply for issuance of a new FIE approval certificate. Simultaneously, within 30 days of completion of the overseas listing, the domestic company shall report it to the CSRC and submit a financing revenue returning plan to SAFE. Within 30 days of receiving the approval certificate the domestic company must apply to MOFCOM and SAFE for an FIE business licence. If the company fails to report to MOFCOM in time, its original approval certificate becomes null and void and its equity structure is restored to its status preceding the acquisition.

The overseas listing revenue of a special-purpose company shall be arranged for returning for use within China in accordance with the revenue returning plan submitted to SAFE by:

- Providing a business loan to the domestic company.
- Establishing a new FIE in China.
- Acquisition of the domestic company.

The profits, dividends and foreign exchange income obtained by capital variation received by the domestic company and natural person(s) from its special-purpose company shall be returned to China within six months of receipt. Profits and dividends can be deposited in a foreign exchange current account or provided for foreign exchange settlement. Subject to SAFE approval, the foreign exchange income from capital variation can be maintained in a special account of capital items or provided for settlement.

If a domestic company fails to obtain its final approval certificate within one year from the issue date of the original business licence, its original approval certificate becomes invalid.

After the special-purpose company has completed its overseas listing and the domestic company has obtained its final approval certificate and business licence, any further acquisition of the domestic company through payment of equity interests of the special-purpose company must be done in accordance with the procedures outlined above for acquisition of domestic company by a foreign investor through payment of equity interests.