

The New M&A Regulations of the People's Republic of China

The new "Regulations Concerning the Merger and Acquisition of Domestic Enterprises by Foreign Investors" (the "**New M&A Regulations**") were promulgated on 8 August 2006.

The New M&A Regulations regulate the acquisition of equity interest in and assets from PRC domestic enterprises, the incorporation of an offshore entity for the purposes of listing China assets via an offshore IPO, the establishment of foreign-invested enterprises ("**FIEs**") by offshore companies set up or controlled by PRC domestic enterprises and PRC residents, and the swapping of shares between a foreign company or its shareholders and the shareholders of a PRC domestic enterprise.

1. Definitions of "Equity Acquisition" And "Asset Acquisition"

The New M&A Regulations lay down the following definitions.

(a) A "**Merger or Acquisition of a PRC Domestic Enterprise by Foreign Investors**" (or "**M&A transaction**") could mean either an Equity Acquisition or an Asset Acquisition.

(b) An "**Equity Acquisition**" is defined as the acquisition by foreign investors of equity interest in a PRC domestic company, or the subscription by foreign investors of new equity in a PRC domestic company, resulting in the conversion of such PRC domestic company to a FIE.

(c) An "**Asset Acquisition**" is defined as including both (i) the establishment of a FIE by foreign investors with the purpose of using such FIE to acquire and operate assets purchased from PRC domestic companies; and (ii) the direct acquisition of assets from PRC domestic companies by foreign investors who then use those assets for establishing a FIE.

2. Basic Principles For Conducting M&A Transactions

(a) Protection of State-owned Assets

The New M&A Regulations establish the basic tenet that a M&A transaction conducted by foreign investors must not lead to the loss of State-owned assets, and that if that transaction involves the transfer of State-owned assets or a change of State-owned control of a PRC listed company, then relevant regulations governing the administration of State-owned assets must be complied with.

(b) Safeguarding of Economic Security

Another basic tenet being introduced by the M&A Regulations is the requirement to report to MOFCOM where:

(i) a proposed M&A transaction will result in foreign investors acquiring actual control of, or will involve, important or priority industries, and the economic security of the State will or may thereby be jeopardized; or

(ii) a proposed M&A transaction will result in foreign investors owning famous or well known PRC trademarks, or result in the transfer of actual control of PRC domestic enterprises which have a very old and established reputation.

If no report is made by the relevant parties in the above situations, MOFCOM may, jointly with other PRC government departments, require the relevant parties to terminate the M&A transaction or to adopt and implement effective measures (such as the transfer of shares or assets) in order to eliminate the adverse impact on the economic security of the State. Hence, MOFCOM and other government departments may stop a M&A transaction involving the transfer of famous or well known PRC trademarks, or well known and established PRC domestic enterprises in sensitive industries, by citing concerns over economic security.

(c) Market Entry Restrictions

As in the case of the old regulations, the New M&A Regulations impose the requirement that M&A transactions conducted by foreign investors must comply with the limitations on foreign ownership interest in different industries as outlined in the Foreign Investment Industries Guidance Catalogue ("**Catalogue**"). Foreign investors are prohibited from conducting an Equity Acquisition or Asset Acquisition involving those PRC domestic companies which are engaged in industries in which foreign investment is prohibited. A M&A transaction can only be carried out in a restricted or sensitive industry where the majority ownership interest or control remains with Chinese shareholders, as required by the Catalogue, after the acquisition.

(d) Acquisition Price

The price of the acquisition should be determined on the basis of the valuation report prepared by a PRC asset valuation company entrusted by the parties to the acquisition. If State-owned assets are involved in an Equity Acquisition or Asset Acquisition, the price for the acquisition should be determined in accordance with the relevant regulations governing the management of State-owned assets. The acquisition price should not be, prima facie, lower than the appraised value of the relevant equity interest or assets of the target company as stated in the valuation report.

(e) Payment of Price for Acquisition or Equity Subscription

(i) Foreign investors who establish a new FIE through the acquisition of equity in or assets of a PRC domestic company should pay the acquisition price in full within 3 months from the date of issuance of the business licence of the FIE. If the approval authorities have agreed to grant an extension of time for the payment of the acquisition price, then at least 60% of the acquisition price should be paid within 6 months, and the remaining 40% should be settled within 1 year, from the date of issuance of the business licence.

(ii) For an Equity Acquisition which involves the subscription for new equity in the target company, or which involves the promotion of a new company limited by shares, the shareholders are required to pay not less than 20% of the subscription price for the new equity at the same time when the application for the business licence is submitted, and the remaining balance of such subscription price can be paid in accordance with the time period which complies with the "PRC Company Law" and the "Regulations of the PRC on Administration of Company Registration" (effective as from 1 January 2006). Hence, if a FIE is formed as a result of a subscription for new equity by foreign investors in a PRC company, then foreign investors have to pay at least 20% of the subscription price for the new equity before the issuance of the business licence of the FIE.

(iii) If foreign investors intend to establish a FIE through an Asset Acquisition, the time for capital contribution shall be determined in accordance with the provisions of the joint venture contract and articles

of association of the FIE. If foreign investors were to establish a FIE for the purpose of purchasing and operating assets acquired from PRC domestic companies, an amount of capital contribution which is equivalent to the price of those assets to be acquired shall be paid within the time period for the payment of acquisition price set out in sub-clause (e)(i) above. The remainder of the capital contribution may be paid within a time period which complies with the regulations governing capital contributions in FIEs (i.e. within 6 months if capital is to be contributed in one lump sum, or by instalments with the first instalment being not less than 15% of the capital subscription and to be paid within 3 months after date of issuance of the business licence).

(iv) When foreign investors establish a FIE through a M&A transaction and if the equity interest of such foreign investors is less than 25% of the target company's registered capital, the foreign investors' capital contribution should be made within 3 months from the date of issuance of the new business licence where capital is to be contributed in cash, or within 6 months from the date of issuance of the new business licence if capital is to be contributed in the form of non-cash assets or industrial property rights.

(f) Registered Capital and Total Investment

The amounts of registered capital and total investment of a FIE to be formed from an Equity Acquisition or Asset Acquisition shall comply with the following ratios:

Registered Capital	Total Investment
Less than US\$2.1 million	Cannot exceed 1.43 times the amount of registered capital
US\$2.1 million to US\$5 million	Cannot exceed 2 times the amount of registered capital
US\$5 million to US\$12 million	Cannot exceed 2.5 times the amount of registered capital
More than US\$12 million	Cannot exceed 3 times the amount of registered capital

3. M&A Transactions Conducted By PRC Domestic Enterprises And Residents Using Offshore Entities

The New M&A Regulations expressly lay down provisions to regulate the use of offshore entities owned or controlled by PRC domestic enterprises or PRC residents to make an Equity Acquisition or Asset Acquisition, and disallow the target company or the converted FIE to enjoy preferential treatments which are generally available to "genuine" FIEs set up by foreign investors.

The New M&A Regulations stipulate the following requirements:

(a) If the offshore investor and the PRC target company are connected parties (i.e. owned or ultimately controlled by the same shareholders who are PRC domestic enterprises or residents), then the proposed M&A transaction must be reported to MOFCOM for examination and approval by following the procedures laid down in the New M&A Regulations;

(b) The connected parties to the proposed M&A transaction have to make a full and complete disclosure of the identities of the de facto controllers of the offshore investor and the target company, and have to provide

a comprehensive explanation of the purpose of making the acquisition, which explanation should also demonstrate that the appraisal process to determine the transfer price has been conducted fairly and in accordance with market practices.

A FIE formed as a result of a M&A transaction conducted between connected parties can still enjoy the preferential treatments available to genuine FIEs if the Equity Acquisition is made by means of subscription of new equity by the foreign investor or if, after completing the acquisition, the foreign investor subscribes for new equity in the target company, and such new equity amounts to 25% or more of the total registered capital of the target company.

4. Using Shares Swap To Conduct A M&A Transaction

Using shares swap to conduct a M&A transaction is defined in the New M&A Regulations as an arrangement whereby a foreign company or its shareholders use(s) the shares of that foreign company as consideration to pay the acquisition price for purchasing the equity or for subscribing for new equity of a PRC domestic company. The New M&A Regulations is the first piece of legislation to lay down specifically the pre-requisite conditions which must be fulfilled before foreign investors are permitted to use the shares of a foreign company to pay the price for an Equity Acquisition or Asset Acquisition. Although cross-border shares swaps were not prohibited under PRC law, the rules for carrying out a M&A transaction using shares swaps and the criteria for obtaining the requisite approvals from MOFCOM and SAFE had, prior to promulgation of the New M&A Regulations, never been made public. The New M&A Regulations therefore represent a major legislative development which will, hopefully, facilitate cross-border shares swaps in future.

(a) The foreign company, the shares of which are used as consideration in a M&A transaction, should fulfil the following criteria:

(i) Such foreign company was legally established, and its place of incorporation has an adequate and complete legal system for the supervision and regulation of companies;

(ii) Such foreign company and its management have not suffered any punishment imposed by the competent regulatory body during the past 3 years;

(iii) Unless it is a special purpose vehicle (or SPV) mentioned in Clause 5 below, such foreign company should be a listed company and the place of listing of its shares has an adequate and complete system for regulating the trading of securities.

(b) The shares of both the foreign company and the PRC domestic company involved in a cross-border shares swap are required to meet the following conditions:

(i) Such shares are legally owned by the relevant parties who have the power to transfer the same under applicable laws;

(ii) The title to such shares is not subject to any dispute, and no pledge or other encumbrance exists over such shares;

(iii) The shares of the foreign company (other than a SPV) are shares which are listed and can openly be traded on an offshore stock exchange;

(iv) The traded prices of the shares of such foreign company (other than a SPV) had remained stable during the preceding one year period.

(c) The PRC domestic company and its shareholders have to engage a PRC registered consultant ("**M&A Consultant**"), who will be required to conduct due diligence on the documents evidencing the fulfilment of the conditions listed in sub-clauses (a) and (b) above, and to produce a report. The M&A Consultant must possess good reputation and the relevant experience, have no record of illegal activities, and also possess the ability to investigate and analyse the legal system in the place of incorporation and listing of the foreign company, and the financial condition of that foreign company.

(d) The use of shares swap as a method to conduct a M&A transaction is required to be approved by MOFCOM. To apply for such approval, the PRC domestic company has to submit relevant documents to MOFCOM, including a report on the major transactions affecting the ownership interests of that domestic company during the past one year, the report of the M&A Consultant, the certification papers for commencement of business of the foreign company and the PRC domestic company, the identification papers of the shareholders of these companies, the name list of those shareholders holding 5% or more of the issued share capital of the foreign company, a report on the creation of security interests by the foreign company, the audited financial statements for the immediately preceding year of the foreign company, and a report on the trading of that foreign company's shares for the immediately preceding half year period.

(e) If approval is granted, MOFCOM will issue a Certificate of Approval with the remark that the target company is the subject of a M&A transaction to be conducted by means of a shares swap, and such Certificate of Approval will remain effective for a period of 6 months from the date of issuance of business licence. The New M&A Regulations expressly stipulate that if all the registration formalities for the change of shareholding in the foreign company and the PRC domestic company are not completed within the 6-month period from the date of issuance of the new business licence, then the above-mentioned Certificate of Approval approving the M&A transaction and the "Certificate of Approval approving the Making of an Overseas Investment by a PRC Company" will automatically lapse.

5. Special Purpose Vehicle ("SPV")

The New M&A Regulations also lay down specific requirements relating to the incorporation of a SPV by PRC domestic companies or PRC residents for the purpose of listing business or assets in China through conducting an IPO of that SPV or that SPV's parent company on an overseas stock exchange.

(a) The New M&A Regulations stipulate that such an IPO requires the approval of the State Council's securities supervision and regulatory body (i.e. CSRC). Furthermore, the country or place where the IPO of the SPV or its parent company is to be conducted should possess an adequate and complete legal and regulatory system, and the securities regulatory body of such country or place should have signed a memorandum of understanding with CSRC for the supervision and control of the securities industry and should have maintained a co-operation relationship with CSRC.

(b) The establishment of a SPV also requires approval from MOFCOM, which approval will only be granted if the PRC domestic company (whose shares or assets are to be transferred to the SPV) fulfils certain conditions and delivers to MOFCOM certain documents, including the identification papers of the ultimate controllers of the SPV, the overseas IPO plan, and the appraisal report of the M&A Consultant containing an evaluation of the projected IPO price of the SPV.

(c) Within 30 days after the offshore IPO has been completed, the PRC domestic company should submit a report to MOFCOM and CSRC reporting on the listing conditions and the plan for the repatriation of the IPO proceeds.

(d) The New M&A Regulations further require that all proceeds received from an IPO of the SPV should be remitted to China in accordance with the repatriation plan previously submitted to SAFE and also in accordance with the foreign exchange control regulations of the PRC.

6. Provisions On Anti-Monopoly

As in the case of the old regulations, the New M&A Regulations expressly confer powers on MOFCOM and SAIC to review each M&A transaction, whether to be conducted onshore or offshore, to determine whether there is any breach of the anti-monopoly rules set out in these Regulations.

(a) Onshore Acquisition

The investors in a proposed M&A transaction are required to report to MOFCOM and SAIC if a foreign investor's proposed acquisition of a PRC domestic enterprise falls within one of the following categories:

(i) the business turnover of any one party to the proposed M&A transaction in the China market exceeds RMB1.5 billion in the year of completing the proposed M&A transaction;

(ii) the foreign investor has already acquired more than 10 PRC domestic companies engaging in the same or related businesses as the target company during the past one year;

(iii) the market share in China of any one party to the proposed M&A transaction has reached 20%; or

(iv) the proposed M&A transaction would result in the market share in China of any one party to such transaction reaching 25%.

The reference to any one party to a proposed M&A transaction includes the affiliates of the foreign investor.

After considering such issues as market competition, over-concentration and the economic security of the State, MOFCOM and SAIC will decide whether to grant approval for the proposed M&A transaction within 90 days after the date of receipt of the acquisition plan and relevant application materials.

(b) Offshore Acquisition

If an offshore acquisition of one foreign company by another foreign company to be conducted outside China is characterized by any of the following circumstances, then the acquiring party in such offshore transaction is required to submit the acquisition plan to MOFCOM and SAIC before it makes any public announcement of such acquisition plan, or at the same time when it submits such acquisition plan to the competition authority in its home country for approval:

(i) any party to the offshore acquisition already owns assets in China with a value exceeding RMB3 billion;

(ii) the business turnover in the China market of any party to the offshore acquisition exceeds RMB1.5 billion in the year of completing the offshore acquisition;

(iii) the market share in China of any party to the offshore acquisition and its affiliates has reached 20%;

(iv) the offshore acquisition would result in the market share in China of any party to the offshore acquisition and its affiliates reaching 25%; or

(v) the offshore acquisition would result in any party to the offshore acquisition having directly or indirectly an equity interest in more than 15 FIEs engaging in the same or related businesses.

(c) Parties to a proposed M&A transaction can apply to MOFCOM and SAIC for a waiver of the requirement to submit a report or acquisition plan as prescribed in sub-clauses (a) and (b) above if any of the following circumstances exist in relation to the proposed transaction:

(i) such M&A transaction is capable of enhancing fair competition in the market place;

(ii) such M&A transaction will restructure a loss making enterprise and can safeguard the employment of employees of that enterprise;

(iii) such M&A transaction will attract advanced technology and management talent, and can enhance international competitiveness of PRC enterprises; or

(iv) such M&A transaction can improve the environment.

7. Impact on FIEs

The New M&A Regulations apply to an Equity Acquisition or Asset Acquisition to be made by an investment holding company established by foreign investors.

Where a M&A transaction falls into one of the following categories:

(a) the acquisition of equity in an existing FIE by foreign investors from the shareholders of that FIE, or the subscription of new equity by foreign investors in that FIE; or

(b) the making of an Equity Acquisition or Asset Acquisition by foreign investors using an existing FIE (already established by them) as the acquirer in the M&A transaction;

such M&A transaction will be examined and approved in accordance with the relevant PRC laws and regulations governing foreign investment. However, in areas where the relevant PRC laws or regulations do not impose any specific requirements, then the New M&A Regulations will still apply.