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# New China M&A Regulations Effective September 8, 2006

## Introduction

The Ministry of Commerce ("MOC"), together with several other ministries[[1]](#footnote-24), has issued the Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "M&A Rules") in relation to asset and equity acquisitions in the PRC which take effect on September 8, 2006. The M&A Rules, which contain 60 articles, will supersede the existing M&A Rules, namely the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, issued on April 12, 2003. The new provisions are widely perceived as measures by the MOC to tighten supervision of foreign investors' acquisitions of domestic companies.

The purpose of this note is to provide an overview of the principal amendments and their implications.

### A. Share Exchange Rules

The new M&A Rules allow the use of shares as consideration in equity or asset acquisitions, in lieu of cash payments. In particular, an overseas acquirer company (the "Acquirer") or its shareholders may use shares of the Acquirer as consideration for new or existing shares of a domestic PRC target company. The permitted use of shares as payment for stakes in Chinese ventures opens a potentially important new financial channel.

There are however a number of pre-conditions, including the following:

* the Acquirer must be legally established in a jurisdiction that has a well-developed legal system governing the regulation of companies;
* except in the case of a special purpose vehicle (SPV), the Acquirer should be a company listed in a jurisdiction which regulates the trading of securities;
* the Acquirer and its management must not have been sanctioned by any supervisory authority during the preceding three years;
* the shares must be legally held and be lawfully transferable in accordance with the applicable laws;
* title to the shares must not be the subject of any dispute and the shares must not be subject to any lien or other encumbrance;
* the shares of the Acquirer (other than a SPV) must be traded on a recognised overseas securities exchange;
* the traded prices of the Acquirer's shares (other than in the case of a SPV) must have been stable for the year preceding the acquisition;
* the domestic company or its shareholders must engage a PRC registered agency or intermediary organisation, such as a law firm, accounting firm or investment bank to act as their adviser to conduct due diligence on the proposed acquisition. The due diligence will involve reviewing and verifying relevant documents and the financial state of the Acquirer as well as ensuring that the acquisition complies with the requirements of the M&A Rules. The adviser is also required to issue a consultation report for review and examination by the relevant authorities.

A share exchange requires the approval of the MOC. If approval is granted, the MOC will issue a Certificate of Approval which is valid for six months from the date of issue of the business licence. If the procedures for completing the change of shareholdings are not completed within that six month period, the Certificate of Approval will become invalid and the original share structure will be re-implemented.

### B. Special Purpose Vehicles

The new M&A Rules impose a series of new requirements affecting the establishment of offshore special purpose vehicles ("SPVs") by PRC individuals or companies and the conduct of IPOs of offshore SPV's holding China assets on overseas stock exchanges.

The new requirements can be summarised as follows:

* the establishment of a SPV requires MOC approval;
* any overseas listing of a SPV must be approved by the China Securities Regulatory Commission ("CSRC");
* within 30 days after the listing, the PRC domestic company must report to the MOC its plan to return the proceeds of the offshore offering to the PRC. All proceeds of the SPV's IPO must be returned to the PRC in accordance with the repatriation plan and the PRC's foreign exchange regulations.

The new provisions mean that MOC approval will now be required for the majority of private equity and venture capital financings which involve an offshore restructuring and, in particular, for all red-chip offerings.

The new M&A Rules also allow share exchanges involving the shares of an offshore SPV provided that the SPV will become listed on an overseas stock exchange within one year. MOC approval of the share exchange is required.

### C. National Economic Security

The new M&A Rules enable the MOC to block foreign investments in certain situations if they are deemed to threaten China's economic security. The M&A Rules introduce a new requirement to report to the MOC:

* a proposed transaction which would give foreign investors control of a PRC domestic enterprise engaged in a "key" industry and which will (or may) affect the national economic security of the PRC; and
* a proposed transaction which will give foreign investors control of well-known trademarks or traditional brands.

If the parties to the transaction fail to report a transaction which may affect the national economic security of the PRC, the MOC may require the termination of the transaction or measures to mitigate any adverse impact of the transaction. The new M&A Rules do not give any guidance on the meaning of terms such as "key industries" or "national economic security", thus potentially giving the MOC wide discretion to block investments citing economic concerns as the justification.

### D. Restrictions on Round-tripping Investments

The new M&A Rules restrict the availability of preferential treatment as an FIE where an offshore company owned or controlled by PRC residents or enterprises re-invests in its onshore affiliate. The following provisions are included:

* a requirement that if any parties to a M&A transaction are under common control, the ultimate controlling parties must be disclosed to the approving authorities, together with an explanation of the purpose of the M&A transaction and a statement as to whether appraisals were conducted on an arm's length basis;
* a prohibition on the use of trusts or other arrangements in the control of offshore or domestic entities;
* a provision that where an offshore company owned or controlled by PRC residents or enterprises is used to invest in a connected domestic company, the target company will only be entitled to preferential treatment as an FIE if (i) foreign investors (other than the PRC-controlled offshore company) hold 25% or more of the registered capital of the target; or (ii) the offshore company subscribes for new equity in the target company which amounts to at least 25% of the target's total registered capital.

### E. Acquisition price

The new M&A Rules require the acquisition price in M&A transactions to be determined based on a valuation of the equity interest or assets to be transferred conducted by a PRC asset valuation company. Transfers where the acquisition price is significantly lower than such valuation are prohibited. It is also prohibited for the public offering price of shares in companies listed overseas to be significantly lower than the stake value of the corresponding domestic assets.

### F. Summary

The new M&A rules make significant changes to China's regulation of the foreign acquisition of domestic companies and reflect the desire of the PRC government to absorb quality foreign capital while filtering unwanted takeovers. The introduction of share swaps as a payment method for the acquisition of interests in PRC companies is significant. However, the new power for the MOC to block transactions on the ground of national economic security has given rise to concern. The Rules are broadly drafted giving the PRC authorities wide discretion as to their interpretation. The impact of the amendments will therefore very much depend on how they interpret and enforce the new provisions.

*Notes*

*The purpose of this note is to provide a summary only of the principal changes to China's "Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors". It does not constitute legal advice and specific advice should be sought in any particular situation.*

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1. Ministries involved were the Ministry of Commerce, State-Owned Asset Supervisory and Administration Commission, the State Administration of Taxation, the State Administration of Industry and Commerce, the China Securities Regulatory Commission and the State Administration of Foreign Exchange [↑](#footnote-ref-24)