MERGERS AND ACQUISITIONS OF STATE-OWNED ENTERPRISES BY FOREIGN INVESTORS IN CHINA

by

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TABLE OF CONTENTS

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ABSTRACT

China now is one of the most attractive destinations for foreign direct investment (FDI) and mergers and acquisitions (M&As) have become an increasingly important mode of FDI entry in China since its accession to the World Trade Organization. M&As in China are expected to play a vital role in the restructuring of its inefficient State-owned enterprises. This thesis characterizes and analyzes the evolving Chinese legal regime governing M&As in the context of the ongoing economic reform. In addition, it identifies the antitrust issues arising from foreign acquisitions of Chinese domestic enterprises, which can result in market dominance and restrictive practices in China. The thesis concludes that China's M&A regime can be improved and aligned more closely with international practices as its economy becomes further integrated into the world economy.

RESUME

La Chine est devenue une des cibles les plus importantes pour l'investissement direct étranger, et les fusions et acquisitions menées par les investisseurs étrangers sont devenues façon de plus en plus courantes depuis l'accession de la Chine à l'Organisation Mondiale de Commerce. On attend à ce que les fusions et acquisitions jouent un rôle clef dans la restructuration des sociétés d'état, qui sont rendues inefficaces. Cette thèse caractérise et analyse l'évolution du cadre juridique chinois qui gère les fusions et acquisitions dans le contexte de la réforme économique en cours. De plus, la thèse identifie des questions de droit de la concurrence qui découlent des acquisitions par les investisseurs étrangers des entreprises chinoises, acquisitions qui peuvent mener à des positions dominantes et des pratiques restrictives en Chine. La thèse arrive à la conclusion que le cadre juridique chinois pour les fusions et acquisitions pourrait être amélioré et aligné plus étroitement avec les pratiques internationales au moment où la Chine devienne étroitement liée à l'économie mondiale.

PREFACE

The initiation of an open-door policy has made China one of the most attractive destinations for foreign direct investment (FDI) over the past two decades. mergers and acquisitions (M&A) has become an increasingly important mode of FDI entry in China particularly since its accession to the World Trade Organization (WTO) in 2001. With the relaxation of restrictions on foreign investments under China's WTO commitments, the invitation to foreign investors to participate in the restructuring of State-owned enterprises (SOEs) and the promulgation of new regulations to facilitate the M&As by foreign investors, China's M&A market appears to have a high potential for growth in the near future, offering foreign investors unprecedented opportunities to invest in China.

However, the current legal and regulatory frameworks governing M&As in China retain some significant obstacles to M&A transactions by foreign investors, although China is reforming its legal system rapidly and recently issued a series of important regulations liberalizing the terms for M&As by foreign investors. Dominant socialist ideology and state ownership still inject various political and social issues into many M&A transactions in China. In particular, M&As that result in market dominance and restrictive practice raise antitrust concerns for Chinese policymakers, who have to balance the market system with collective values.

The purpose of this thesis is to characterize and analyze the evolving Chinese legal regime governing M&As in the context of the ongoing economic reform. This thesis is organized as follows:

In order to provide a background for evaluating the M&A regime in China, Chapter One introduces basic information about M&As, followed by a review of M&A development in general and in China in particular. This part identifies the underlying motives for the evolution of China's M&A regime by examining the relations between China's FDI development and its open-door policy – particularly the impact of its WTO accession. Finally, the development of the SOE reform and the prospect of M&As by foreign investors are discussed in detail.

Chapter Two examines the current legal framework governing FDI and M&A transactions in China. This is done by a brief overview of the legal system in China, accompanied by an outline of China's foreign investment regime. The legal framework governing the types of Foreign Investment Enterprises (FIEs) and other investment vehicles in China is discussed here. Industrial policy and the governmental approval process also play a vital role in the foreign investment regime. The last section assesses several major laws and regulations issued recently with regard to various aspects of the M&A transactions.

Chapter Three presents the viable deal structures under the current M&A regime in China. Mergers, equity acquisitions and asset acquisitions are examined respectively. In the section concerning equity acquisitions, direct equity acquisitions are discussed in detail, and investments in listed and non-listed SOEs are examined separately. Acquisitions of the shares in listed SOEs are further assessed in terms of tradable and non-tradable shares.

Chapter Four discusses the antitrust issues arising from M&As by foreign investors that result in market dominance and restrictive practices in China. This part identifies the competition-restrictive practices by some Multinational Companies, and then assesses the merger control system newly established in China. Also introduced in this part is the rationale for merger control. Finally, China's antitrust legislation and its proposed antitrust law are discussed extensively.

This thesis concludes that China's M&A regime should be improved and rendered closer to the international standard and practice as China's economy becomes further integrated into the world economy. A uniform M&A law overseen by a single enforcement agency will be key to this purpose.

1. OVERVIEW OF M&As

Firms undertake M&As globally in the pursuit of new market development, efficiency gains through synergies, and sustainable competitive edges. In the recipients' view, FDI, including M&As, brings various economic benefits such as employment, technology and management skill enhancement. Recently, M&As commonly used in mature economies are finding their place in China as an instrument to rescue distressed SOEs.

1.1. M&As Defined

When considering M&As by foreign investors, it is important to understand the concept of FDI. FDI is an investment involving "control of a resident entity in one economy by an enterprise resident in another economy", and a long-term relationship "reflecting an investor's lasting interest in a foreign entity".[1] In an FDI, as opposed to a simple portfolio investment, the investor exerts "significant influence on the management" of the foreign entity, which as a rule of thumb translates into a foreign ownership of 10 percent or more of "voting shares" therein.[2]

There are generally two ways by which a firm can undertake FDI in a host country[3]: (a) greenfield investment by establishing an entirely new operation in the host country, or (b) a merger or acquisition targeting an existing local firm in

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[1] See the definition by the United Nations Conference on Trade and Development (UNCTAD), online: UNCTAD <http://www.unctad.org/Templates/Page.asp?intItemID=3164&lang=1> (date accessed: 07/12/2004).

[2] *Ibid.* See also UNCTAD, *Development and Globalization: Facts and Figures 2004*, (New York and Geneva, UN, 2004) at 32. Acquisitions involving less than 10 percent constitute portfolio investment, which does not give the foreign investor a significant influence on the management of the enterprise. See *infra note 4* at 99 and "Portfolio investment" at 101.

[3] The country of the acquirer is the "home country" and the country of the target firm is the "host country". See *infra note 4*.

that country.[4] The transactions involving foreign investors are referred to as cross-border M&As or FDI through M&As. "In a cross-border merger, the assets and operations of two firms belonging to two different countries are combined to establish a new legal entity." "In a cross-border acquisition, the control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter."[5] Acquisitions can be minority stakes with foreign ownership of 10 to 49 percent of the target firm's voting shares, majority stakes with foreign ownership of 50 to 99 percent, or true mergers with foreign ownership of 100 percent. The percentage of the expected shareholdings in target firms reflects the foreign firm's corporate strategies as well as the host country's FDI policies.[6]

In the global economic environment, the changes in technology, capital markets and regulatory frameworks push firms to defend and enhance their competitive edges through M&As. M&As can provide firms the fastest way to expand internationally without the need to build the duplicative infrastructures. Local production facilities and networks of sales, marketing and distribution can be obtained much more efficiently and effectively through M&As than through greenfield investments. Other basic factors motivating firms to undertake M&As include diversification, market development, increased market share, efficiency gains through synergies, greater size and related executives' personal benefits.[7]

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[4] See UNCTAD, *World Investment Report 2000*, (New York and Geneva, UN, 2000) [hereinafter *WIP 2000*], at 99.

[5] *Ibid.*

[6] *Ibid.* at 101.

[7] See UNCTAD Press Release 03/10/2000, "Survival in Global Business Arena Is Key Driver of Crossborder Merger and Acquisition Boom: Questions Mount in Developed and Developing Countries as Merger Activity Hits Record Levels, States New UNCTAD Report", online: UNCTAD <http://www.unctad.org/Templates/Webflyer.asp?docID=2928&intItemID=2023&lang=1> (date accessed: 8/12/2004) [hereinafter UNCTAC Press Release]. See also Figure V.1 "The driving forces of cross-border M&As", *WIP 2000*, at 154. For a review of theories explaining FDI flows, see generally Werner Soontiens & Siriporn Haemputchayakul, "Sustainable Globalization and Emerging Economies: The Impact of Foreign Direct Investment in Thailand", Curtin University of Technology, Australia, online: <http://blake.montclair.edu/~cibconf/conference/DATA/Theme2/Australia1.pdf> (date accessed: 21/7/2004).

However, the impact of cross-border M&As on the host country's economic development can be "double-edged". Though FDI brings various economic benefits such as employment, technology and management skill enhancement, many host countries express the concern that FDI entry through M&As is "less beneficial for economic development than through greenfield investment".[8] In the view of host countries cross-border M&As "do not add to productive capacity ... but simply transfer ownership and control from domestic to foreign hands". Post-acquisition integration usually results in the substantial restructuring of the acquired firms, which may involve significant layoffs and technological changes such as shutdown of R&D capacities. If the foreign acquirers are giant Multinational Companies (MNCs), they may rapidly dominate the domestic market and substantially lessen the competition through acquiring the local competitors. Such M&As "can lead to strategic firms or even entire industries falling under foreign control", which may be seen as "eroding national sovereignty".[9] In addition, these concerns might be fueled by the colonial experience of many developing countries and by the view that FDI was "a modern form of economic colonialism".[10] Thus, most developing countries strictly regulate the foreign investment by "limitations on foreign equity ownership, local content requirements, local employment requirements, and minimum export requirements".[11]

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[8] *Supra* note 4, at 159.

[9] *Ibid.* at 159 and Box V.3 "Determinants of the mode of FDI entry" at 145.World Investment Report 2000 concludes that "under normal circumstances, greenfield FDI is more useful, in terms of its developmental impact, to host countries than cross-border M&As. However, under exceptional circumstances - such as an economic crisis or major privatizations - cross-border M&As can play a useful role, which greenfield FDI may not be able to play, at least within the desired time-frame." See UNCTAD Press Release, *supra* note 7.

[10] See S. Lall, "Implications of Cross-Border Mergers and Acquisitions by TNCs in Developing Countries: A Beginner's Guide", Working Paper Number 88, QEH Working Paper Series, Queen Elizabeth House, University of Oxford (June 2002).

[11] See Asian Development Bank, *Asian Development Outlook 2004, (New York: Oxford University Press, 2004),* at Chapter III "Foreign Direct Investments in Developing Asia: Trends".

1.2. M&A in a Globalized World

1.2.1. Worldwide M&As

According to the recent *World Investment Report*, M&As have been the driving forces behind the rapid increase in global FDI flows for the past decade. In 2000 the ratio of M&A values to FDI reached more than 85 percent.[12] The value of global M&A transactions rose tenfold from about US$100 billion in 1988 to more than US$1000 billion at a peak in 2000. [13] The worldwide annual number of M&As tripled between 1990 and 2000, [14] and the total number reached 30,200 in 2003.[15] A survey of worldwide investment decisions found that for the next five years only 6 percent of intended investments would be by way of greenfield investment whereas about 37 percent would be by way of M&A.[16]

M&As occur primarily through acquisitions rather than mergers. Less than 3 percent of the total number of M&As are officially classified as mergers and the rest are acquisitions. In addition, acquisitions do not always mean that the investor acquires the majority of the target firm's shares. In developing countries, about one third of acquisitions are of a minority interest.[17]

M&As can be classified as horizontal "between competing firms in the same industry", vertical "between client-supplier or buyer-seller relationships", or conglomerate "between companies in unrelated activities".[18] About 70 percent of the M&As are horizontal in terms of value, whereas that share is 50 percent in

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[12] See G. Garnier, "International M&A activity: impact of globalisation", *Mergers & Acquisitions NOTE*, J.H. Schmidt (Ed.), DG ECFIN European Commission, No. 1, October 2004, at 7.

[13] See Annex tables B.7 & B.8, "Cross-border M&A sales/purchases,by region/economy of seller/purchaser 1988-2002", *World Investment Report 2003* (New York and Geneva, UN, 2003) [hereinafter *WIP 2003*].

[14] *Supra* note 12.

[15] See "M&A overview", *Mergers & Acquisitions NOTE*, J.H. Schmidt (Ed.), DG ECFIN European Commission, No. 1, October 2004, at 2.

[16] See F. Hatem, *International Investment towards the Year 2002* (Paris, UN, 1998), at 40.

[17] *Supra* note 4 at 99 and Table IV. 1. "Cross-border M&As, by percentage ownership, 1987-1999" at 101.

[18] *Ibid.* at 101.

terms of number.[19] Vertical M&As have increased since the mid-1990s whereas conglomerate M&As have diminished since the late-1980s.[20] While many of the M&As in the late 1980s were driven by the quest for "short-term financial gains", most M&As currently appear to have "strategic or economic motivations such as the search for efficiency".[21]

Transactions between developed countries account for most of M&A activities. In 2000, M&As amounted to over US$1000 billion in developed countries, while less than US$100 billion in developing countries.[22] In addition, firms from developing countries are not major players in the outbound M&As.[23] It was not until the late 1990s that developing countries emerged as important recipients of FDI through inbound M&As.[24]

1.2.2. M&A in Asia

Asia is one of the most rapidly liberalizing host regions for FDI, and FDI has contributed significantly to the economic development of the Asian countries over many years. In order to attract FDI, most Asian countries have made many "national policy changes in a direction favorable to investors".[25] They lifted the restrictions on foreign investments, simplified approval procedures, relaxed foreign exchange controls, and granted various incentives to attract foreign investment.[26]

The Asian countries have ranked high in the attractiveness of their economies to foreign investors due to their "potential market growth, cost advantages and

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19 *Ibid.* and also Figure IV.2 & Annex Table A.IV.I.

20 *Ibid.* at 101 and Figure IV.2 "World cross-border M&As, by type, 1987-1999" at 102.

21 *Ibid.* at 102 and Figure IV.3 "Shares of M&As motivated by short-term financial gains in cross-border M&As, 1987-1999" at 103.

22 *Ibid.* Annex Tables B.7 & B.8.

23 *Ibid.* at 120.

24 *Ibid.* at 121. The ratio of M&A to total FDI in developing countries increased from zero in the late 1980s to half of the total in the late 1990s. See s*upra* note 12.

25 *Supra* note 13, at 40.

26 For instance, China relaxed foreign shareholding limitations in the domestic airlines industry from 35 percent to 49 percent. See s*upra* note 13, at 48.

FDI-friendly attitudes".[27] Though Europe and North America remain major recipients of global FDI, Asia has emerged as another attractive destination. The economies in this region have increasingly received large shares of FDI in the world since the 1990s.[28]

The booming FDI inflows in Asia are attributed to two reasons: "Globalization and M&As". On the one hand, globalization has pushed MNCs to shift their investments to the regions with "greater cost advantages" and potential market growth, in order to increase their "economic efficiency and competitiveness". While EU firms increasingly have invested in "countries bordering the new Member States", North American counterparts have invested more in Asian countries and in China in particular.[29] On the other hand, the increasing number of M&As and their exploding values make M&As become an important mode of FDI entry in Asia, especially after the Asian Financial Crisis which led to the "relaxation of restrictions on foreign equity participation" and the "huge devaluation of the currencies and assets" in that region.[30] Asia became the world's third largest destinations for M&As in 2000-2003 behind EU and North America.[31] The value of M&As in Asia rose more than 128 times between 1987 and 2001, from only US$256.1 million to US$32.9 billion. Hong Kong (China), Republic of Korea, Philippines, Singapore and China were the top five recipients of M&A flows between 1997 and 2001.[32]

1.3. M&A Development in China

M&As were virtually unknown in China a decade ago. To the surprise of the world, China's M&A activities have developed dramatically into a common feature of its economic landscape just over several years. While the rest of the world is experiencing an M&A downturn, China's M&A activity is on the fast

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[27] *Supra* note 12.
[28] *Supra* note 11.
[29] *Supra* note 12.
[30] See Soontiens & Haemputchayakul, *supra* note 7. See also s*upra* note 12.
[31] *Supra* note 12.
[32] *Supra* note 11.

track. M&A transactions in China have increased by 70 percent annually over the past five years.[33] China overtook Japan to become the most active M&A market in Asia in 2002,[34] and accounted for 20 percent of the total number of cross-border M&As in Asia in 2000-2003.[35] In the *PricewaterhouseCoopers*' 2002 M&A survey, most responded that M&As in China would continue to gain momentum.[36] In addition to China's accession to the World Trade Organization (WTO), the increased pace of M&A activities has been fueled by China's restructuring its State-owned Enterprises (SOEs) and increasing investment from Foreign Investment Enterprises (FIEs) due to the liberalization of FDI regimes. Please note that this thesis covers the topics primarily on the inbound FDI through M&As that is the current mainstream in China, and does not seek to cover the emergent outbound M&A activities initiated by domestic companies.

1.3.1. Open-door Policy and Foreign Investment

Since China's former leader, Deng Xiaoping, initiated the open-door economic policy that opened up Chinese economy to the outside world in 1978, its foreign investment regime has developed dramatically. Deng's pragmatic dictum – "White cat, black cat: what does it matter as long as it catches mice"[37] – invented a new economic model between socialism and capitalism. Subsequent to Deng's visit to the South China in 1992, the Chinese government has championed the establishment of a "socialist market economy"[38]. Over the past two decades, the "institutional infrastructure towards FDI in China has experienced a fundamental

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[33] See "Restructuring cash welcome", *China Daily,* 20 November 2003.

[34] See "Foreign Investment in China", the US-China Business Council, online: <http://www.uschina.org/statistics/2003foreigninvestment.html> (Last Updated: 23 May 2003).

[35] *Supra* note 12.

[36] See B. Ye & S. Tam, "What's ahead for China's M&A market?", PricewaterhouseCoopers HK, March 2003, online: <http://www.pwchk.com/home/printeng/china_m&a_market.html> (date accessed: 9/12/2004).

[37] See O. Schell , "Deng's Revolution", *Newsweek,* 3 March 1997.

[38] The notion of the "socialist market economy" was officially endorsed by the Chinese Communist Party's 14th Congress in 1992, replacing the previous conceptual cohabitation of the "socialist commodity economy" and "socialist planned economy". A socialist market economy is similar to any other market economy except that in a socialist market economy, state ownership is regarded as being the main market force. This has been reflected in the *Company Law* which has a separate chapter on State-owned Enterprises.

change" and China has become one of the most attractive destinations for foreign investment in the world.[39]

Access to the fastest growth prospect, a potentially huge market and cheap skilled labor has attracted foreign investors to increasingly invest in China. Given its "location advantages", China is attractive to the "market-seeking, efficiency-seeking and resource-seeking investors".[40] Rapidly economic growth in China has stimulated the "local demand for consumer durables and nondurables", which is attractive to the market-seeking investors;[41] China's huge population with "high literacy and education rates" suggest that its labor is skilled and cheap, which attracts the efficiency-seeking investors; China's huge natural resource and competitive physical infrastructure particularly in the coastal areas are also attractive to the resource-seeking investors. A recent business environment survey indicated that "China is ... attractive ... in the macroeconomic environment, market opportunities and policy towards FDI".[42] Surveys of world investment locations ranked China at the top of FDI destinations over the next few years.[43] FDI inflows to China grew from US$3.5 billion in 1990 to US$52.7 billion in 2002 when China overtook the United States to become the largest recipient of the world FDI for the first time.[44]

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[39] For a summary of the institutional evolution towards FDI in China, see J. Chen & Y. H. Song, "FDI in China: Institutional Evolution and its Impact on Different Sources", Proceedings of the 15th Annual Conference of the Association for Chinese Economics Studies Australia (ACESA), online: <http://mams.rmit.edu.au/l85gl0z02ukp.pdf> (date accessed: 5/11/2004).

[40] See *supra* note 13, at 42.

[41] For instance, China is the largest market in the world for machine tools, the second largest market for transmission and distribution equipment and the fourth largest market for automobiles. See Box II.4 "China and India – what explains their different FDI performance", *Ibid.* at 44. See also *supra* note 12.

[42] *Supra* note 13, at 43.

[43] *Supra* note 12.

[44] See Bank of China Group, "Foreign Direct Investment in China", 1 January 2003, online: TDCTRADE <http://www.tdctrade.com/econforum/boc/boc030101.htm> (date accessed: 9/12/2004).

Foreign investment also has played a significant role in the rapid growth of China's economy.[45] The ratio of the industrial output contributed by FIEs in the national gross industrial output of China has been steadily increasing in the past decade and has exceeded 30 percent.[46] The share of FIEs in total Chinese exports increased from less than 9 percent in 1989 to 50 percent in 2002. In some high-tech industries, that share was as high as 91 percent in electronics circuits and 96 percent in mobile phones respectively.[47]

1.3.2. Impact of China's WTO Accession

After the long-march negotiation process, China eventually became a formal member of the WTO on 11 December 2001. As a rules-based system, the WTO requires its members to operate with "openness and transparency" and stresses the "central role of markets and private enterprise".[48] In the short term, the impact of the WTO membership means that the previously protected domestic markets are gradually opened up to foreign investors. In particular, China opted to significantly cut tariffs in manufactured goods, open many services to various degrees of foreign investment and follow the WTO codes on foreign investment.[49] In the long run, the more significant impact would be improving the "rule of law" and perfecting the foreign investment environment in China.[50]

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[45] See also P. Bottelier, "The Role of Foreign Direct Investment and Multinational Corporations in China's Development – China's Response to the Asian Crisis" (1998), online: <http://www.worldbank.org/html/extdr/offrep/eap/pbsp090898.htm> (date accessed: 01/08/2004).

[46] See E. L Turner III & C. Zhou, "China's M&A Roadmap", *Asian Financial Law Briefing*, Vol 3 Issue 2, March 2003, Pacific Business Press, Hong Kong.

[47] See UNCTAD, *World Investment Report 2002*, (New York and Geneva, UN, 2002) [hereinafter *WIP 2002*], at 162 - 163.

[48] See "the WTO", online: <http://www.wto.org/english/thewto_e/thewto_e.htm> (date accessed: 9/12/2004).

[49] See information with regard to the effects of China's accession agreement on specific sectors, online: US Department of Commerce<http://www.mac.doc.gov/china> (date accessed: 9/12/2004). See also "China's Protocol of Accession, accompanying Working Party Report and Goods and Services Schedules", online: World Trade Organization <http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm> (date accessed: 9/12/2004).

[50] See *2003 Guide to Mergers & Acquisitions - China*, a Publication of Baker & McKenzie, at 1.

In its WTO accession documents, China has made significant commitments on trade liberalization that are expected to improve market access across the manufacturing sector. Trade liberalization will significantly reduce the "import licensing and quotas" that have protected certain key manufacturing industries in China over the past decades. China has agreed to eliminate some FDI entry requirements, including "limitations on foreign equity ownership", "trade and foreign exchange balancing requirements" and "local content requirements". In addition, the approval of foreign investment projects will no longer be "contingent on specific requirements related to technology transfer and conducting R&D". The relaxation of restrictions on foreign investment in a number of manufacturing industries would most likely result in a consolidation of foreign affiliates in China.[51]

China has made great commitments that should substantially increase market access to a broad range of the services sector. Previous emphasis on guiding FDI into the manufacturing sector has led to market saturation and overcapacity in that sector, whereas China's service sector is highly underdeveloped and accounts for "only one third of its GDP". As the foreign investment in the service sector used to be largely restricted, the liberalization will expand the scope of permitted business activities and will relax the "geographic and ownership restrictions" in this sector. Of the most interest to foreign investors is the liberalization in several key service industries, notably, telecommunications, insurance and banking. Thus, liberalization in this fast growing sector will broaden the targets of the forthcoming large-scale M&As by foreign investors, and this sector may replace the manufacturing sector as the "engine of FDI growth".[52]

China also has committed to reform its legal and regulatory system in terms of "transparency, notice and comment, uniform application of laws and judicial

[51] *Supra* note 4, at 54 – 55.

[52] *Ibid.* From a sectoral point of view, the breakdown between industry and service shows the predominance of the service sectors, accounting for roughly two thirds of all M&A transactions in 2003. See *supra* note 15.

review", which will strengthen the rule of law in China.[53] In taking its WTO commitments, China has revised a large number of laws, regulations and other norms in order to promote "the smooth functioning of markets", including those affecting FDI.[54]

Thus, WTO membership is a driving force of the booming M&A activities in China as various restrictions on foreign investment are being lifted. Under such circumstances, medium- to large-sized SOEs, which normally have dominant market position and possess valuable assets but often are associated with operating inefficiency, have attracted particular attention from foreign investors.

1.3.3. Restructuring of State-owned Enterprises[55]

The WTO accession makes China become an even more attractive destination for foreign investment, but greater global competition thereafter also deepens the reform of inefficient SOEs in China.[56] In the process of establishing a socialist market economy, the restructuring of SOEs remains the priority to the economic structural reform in China.[57] Most of the SOEs are operating inefficiently and desperately require reform.[58] However, restructuring the SOEs was not easy due

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[53] *Supra* note 49.

[54] In the first two months of 2001, the various ministries and commissions of the State Council reportedly reviewed some 2300 laws and regulations, of which 830 were identified as in need of repeal and 325 as in need of revision. See X. H. Nan, "WTO: Fa de Chongxin Goujia [WTO: The Restructuring of Law]", *Nanfang Zhoumo* [Southern Weekend], 25 October 2001. In particular, to bring China's foreign investment laws into conformity with those WTO requirements, the Standing Committee of the National People's Congress amended the Wholly Foreign Owned Enterprise Law, the Sino-Foreign Contractual Joint Venture Law, and the Sino-Foreign Equity Joint Venture Law in 2000 and 2001. See Investment Climate Statement, *infra* note 119.

[55] Article 64 of the *Company Law* defines a wholly State-owned company as a limited company established solely by the State-authorized Investment Institution or by a department authorized by the State.

[56] See "WTO forces State firm shake-up", *Business Weekly*, 23 November 2001.

[57] China's former President Jiang Zemin made the remarks during the annual session of the National People's Congress. See "Jiang Zemin on SOE, Rural Reforms", *People's Daily*, 14 March 2002. See also "State Enterprises Biggest Challenge to Chinese Reform", the *Economist* (UK), 14 December 1996.

[58] Although their contribution to the gross value of industrial output decreased to 34 percent in 1995, the SOEs employed 67 percent of the industrial workers and accounted for 52 percent of the capital funds and 66 percent of the fixed assets. See J. Sun, "State-Owned

to the "socialist ideology" and the crucial roles SOEs played in China's economic and social life. Yang & Zhang summarized the evolution of SOEs into three stages,[59] which has great impact on the FDI development in China.[60]

The first stage was from the foundation of the People's Republic of China (PRC) to the initiation of the economic reform policy. The communist ideology contemplated the state ownership of property and the means of production which emphasized central planning and maximum production.[61] Since the Chinese Communist Party (CCP) nationalized almost all industrial and commercial enterprises in the 1950s, the state ownership had remained universal until the onset of economic reform in the late 1970s.[62] During the early years, the SOE played a broad range of social and political functions as well as its economic role. Rather than the government, the SOE took the responsibility to provide a "cradle-to-grave" social welfare for its own employees: "lifetime employment, housing, pensions, healthcare, childcare, education, shopping and entertainment".[63] In terms of SOE governance, the government ministries exercised the supervisory powers associated with state ownership. As a distinctive feature of an SOE, an internal CCP commission was established therein, monitoring not only "political and social aspects of SOE governance", but also operational functions such as "employment policies or production goals". On the

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Enterprises in China: Soft Budget Constraints and Competition" Department of Economics, Washington University, 20 August 1999, online: <http://www.isnie.org/ISNIE99/Papers/sun.pdf> (date accessed: 16/12/2004).

[59] See R.L. Yang & Y. S. Zhang, "Globalization and China's SOEs Reform", a paper presented at the International Conference "Sharing the Prosperity of Globalization", WIDER/UNU, Finland, 6 September 2003.

[60] *Supra* note 33.

[61] Since the goal was to maximize production, not profits, the SOEs obtained most of their inputs through state allocation, sold their outputs to the state/other SOEs subject to the price controls, and all the profit and loss were balanced by the state budget. See P. M. Norton, "Privatization of State-Owned Enterprises Through Foreign Investment", an O'Melveny & Myers' research report, June 2003, online: O'Melveny & Myers <http://www.omm.com/webcode/webdata/content/publications/privitization.pdf> (date accessed: 9/12/2004).

[62] *Ibid.* In 1978, private enterprises accounted for only 0.2% of national industrial output, while SOEs and collectively owned enterprises controlled the rest of the economy. See Owen, Sun & Zheng, *infra* note 370, at 4.

[63] Supra note 61.

contrary, the SOE management had virtually little discretion over business operations so that they had no incentive to adopt the best available management practices or most efficient technological solutions.[64]

The central planning, maximum production, minimal incentive, onerous social welfare burdens, and monopolistic market practices have contributed to the SOE inefficiency, which includes "product obsolescence, quality deterioration, and high production and operating costs".[65] Since the 1960s the "state ownership of the means of production" could no longer work as well as before and almost collapsed after the "cultural revolution" in particular. In 1978 China had to restructure its central planning economic system by "introducing market competition, opening up and encouraging the development of private economy".[66]

The second stage was from the initiation of the economic reform till the 15th Chinese Communist Party Congress (CCPC) in 1997. A series of SOE reform measures were launched to improve the SOE operating efficiency, including the "dichotomy of government and firms, manager responsibility system, delegating greater managerial autonomy, establishing modern corporation system".[67] However, the efforts to reform SOEs were constrained by various political, social and institutional factors, among which was an ideology hostile to private ownership. Since the Chinese government had little intention to privatize the SOEs, the SOE management still had no incentive to takes good care of the state owned assets like their counterparts in private competitors.[68] As the result, the

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[64] *Ibid.* For a summary of corporate governance in SOEs, see generally S. Tenev & C. Zhang, *Corporate Governance and Enterprise Reform in China* (Washington: World Bank and International Finance Corporation, 2002).

[65] See Y. F. Lin, F. Cai & Z. Li, *The China Miracle: Development Strategy and Economic Reform* (Hong Kong: The Chinese University Press, 1996) at c. 3.3.

[66] Supra note 59.

[67] *Ibid.* In 1993, the 8th National People's Congress amended the *Constitution* and promulgated the *Company Law* to legalize these strategic changes. Article 5 of the *Company Law* limits the role of the State to "macro-adjustment and control", allowing the state's ownership role more close to that of a shareholder. As long as a company conducts their business within the framework of law and government policy, it has the right to manage its own affairs independently.

[68] China's policy is to create a socialist market economy as distinguished from a market

SOE's poor performance continued to deteriorate.[69] To reduce the persistent pressure on its budget to balance the SOE losses and stimulate the SOEs to improve their efficiency, the Chinese government changed the method of outright subsiding SOEs and established four state-run banks to provide low-interest loans to the SOEs in need.[70] With the growing losses, however, the SOEs increasingly relied on bank loans as the primary source of their working and investment capital. Fearful of the potential social instability arising from the failing SOEs, the Chinese government instructed the banks to continue providing loans to the struggling SOEs, regardless of their creditworthiness.[71] By the mid-1990s, this practice resulted in enormous non-performing loans in the bank portfolios, jeopardizing the solvency of the China's banking system.[72]

At this stage, the SOEs started to form joint ventures with foreign investors as "strategy alliance" for the sake of product or market development. However the state assets were not easily acquirable and the SOEs generally exercised high asset control in the joint ventures. Another motive might be to service the considerable social welfare burdens placed on the SOEs. In this regard, the partnership in FIEs may yield regular cash flows that match better with SOEs'

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economy based on liberal capitalism which contemplates private ownership of property and the means of production. As long as China's political commitment to socialism remains firm, there will be limits on the private ownership of wealth and the state sector will continue to be a dominant portion of the economy. For instance, complete privatization of most SOEs will not be an option under the present approach. The state continues to own SOEs, in principle at least. In the view of China's rulers, the nation is undergoing economic, not political, reform. See D.C.K.Chow, The Legal System of the People's Republic of China, (St. Paul, MN: West Group, 2003) at 27.

[69] The SOEs' gross output share in China continued to decline from 65 percent in 1985 to 28 percent in 1998. Over 40 percent of the SOEs were loss makers in 1996, causing a net loss of RMB2.5 billion. See *supra* note 58.

[70] China's "Big Four" state-run banks are China Construction Bank, Bank of China, Industrial & Commercial Bank of China and the Agricultural Bank of China.

[71] *Supra* note 61.

[72] There was US$24 billion in outstanding loans when reforms began in 1978, equaling about half of that year's GDP. However, in 1995, outstanding loans were over US$600 billion, or equal to that year's GDP. Over the long term, government resources will not be enough to pay depositors and bond holders if SOEs refuse to service their debts. See "Heavy Burden for China's Financial Sector", China Business Review (U.S.), 1 January 1997. Some experts estimated that during 1991-1995, bad or non-performing debts increased by four times and total amount was more than RMB3Trillion (US$ 400 Billion). See T. Chan et al., "US$400 Billion Needed to Recapitalize China's Banks," *Standard & Poor's CreditWire*, 4 June 2001.

obligations than their operations.[73]

The third stage is from the initiation of the "grasp the large, release the small" policy to the present. China's present policy on the SOE reform was officially announced at the 15th CCPC in 1997. By allowing for diversified ownership forms, the new CCP policy removes the traditional ideological obstacles to the SOE reform and paves the way for SOE privatization.[74] Under the policy of "grasp the large, release the small", the State would only control large SOEs in those industries relating to national security, public utility and national monopolies, which will be consolidated into large conglomerates to compete internationally. Small- and medium-sized SOEs would be sold, merged or allowed bankrupt.[75] The Chinese government wants private investors, domestic and overseas, to participate in the acquisitions of SOEs, which is part of the economic restructuring plan.[76] The Chinese leaders expected to inject the foreign competition to stimulate the improvement of SOE operating efficiency.[77] As such, China's accession to the WTO would accelerate the restructuring of the SOEs.[78] However, it is unclear whether China's economy would be able to absorb the

[73] *Supra* note 33.

[74] See *Several Decisions of the CCP Central Committee on the Perfection of Socialist Market Economy*, adopted by the CCP Central Committee at its third plenum meeting on October 14, 2003. The Decisions explicitly permit private capital to invest in the areas of infrastructure, utilities and other industries so long as no laws prohibit its entry. The PRC Constitution was amended on 14 March 2004 to include protection of private property. See Article 13 of the revised Constitution.

[75] *Supra* note 61. At the Fifth Session of the Eighth National People's Congress in 1997, China's former premier Li Peng presented six reform measures for the SOEs. See "Reform Measures for State-owned Enterprises", online: TOM.COM <http://us.tom.com/english/168.htm> (date accessed: 13/12/2004). See also the *Decisions on Major Issues Concerning the Reform and Development of State-owned Enterprise* issued on the 4th Plenum of the 15th CPC Central Committee on 22 September 1999.

[76] Li Rongrong, director of the SASAC, made the remark at an M&A summit in Beijing on 9 November 2003. See *supra* note 33. "The problem of the structural low efficiency of China's SOEs cannot be solved by management approaches. SOEs should more engage in the international M&A to further vitalize the state-owned economy." said Chen Qingtai, deputy director of the Development Research Center under the State Council. See "China reforms state-owned enterprises through M&A", *People's Daily*, 9 December 2003.

[77] See Donald C. Clarke, "China's Legal System and the WTO: Prospects for Compliance", online: <http://www.law.gwu.edu/facweb/dclarke/pubs/wto_china.pdf> (date accessed: 7/1/2005).

[78] See S. X. Zhao et al.,"China's WTO Accession, State Enterprise Reform, and Spatial Economic Restructuring", *Journal of International Development* 14, 413-433 (2002).

onslaught of the foreign competition, especially after direct and non-direct aids to SOEs are phased out in accordance with its WTO commitments. In the short term, the WTO compliance may add more unemployment due to the large-scale economic restructuring, which may threat the social stability absent of a sound social security system in China.[79] During the transitional period, the Chinese leaders must reconcile the conflicts between economic efficiency and social stability. The Chinese government's concern in this regard is evident in the laws and regulations recently issued where a transaction's impact on employment will significantly influence its approvability.[80]

At this stage, the state assets become more acquirable. SOEs gradually lose the asset control to their foreign partners as the result of severe financial distress. Accordingly, the number of wholly foreign-owned enterprise and joint ventures with higher foreign control is rapidly increasing. M&As of the state assets become a prevalent form of establishing FIEs in China.[81]

Thus, as the Chinese government is actively seeking to reduce its shareholding in SOEs, a large number of potential targets are being made available for private investors to acquire, which particularly offers foreign investors unprecedented market entry options.[82] China's M&A market has a high potential for growth, as foreign investment in M&As accounts only for about 5 percent of the overall FDI in China.[83] Notably, the Chinese government has just issued a series of laws and regulations to facilitate the acquisitions of SOEs by foreign investors and an M&A regime is rapidly emerging in China.

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[79] Laid-off workers would not accept the impact of the reforms without a fight. There have been worker demonstrations in many cities that were occasionally reported in the international press – as well as for many others that are not reported. See *supra* note 61.
[80] *Ibid.*
[81] *Supra* note 39. See section 2.2, below, for more on this topic.
[82] "It is estimated that China will have 10,000 big merger deals in the coming five years and about 1.7 million Chinese SOEs will be restructured." See "10,000 big merger deals expected in five years in China", *People's Daily*, 20 November 2003.
[83] Supra note 33.

1.4. CHAPTER SUMMARY

M&As have already replaced greenfield investments as the dominant component of FDI in the world. Firms undertook M&As to pursue the efficiency and competitiveness on a global basis whereas cross-border M&As have double-edge implications for host countries. Globalization pushes foreign investors to shift their investment to Asia and China in particular, where cost advantages and new market opportunities are greater.

Since the adoption of the open door policy in 1978, China's economy has changed dramatically from a planned economy toward a market system. As a legacy of the planned economy, many SOEs are in severe financial distress and desperately require reform. By reviewing the evolution of the SOEs in China, we can see that restructuring the SOEs was not easy due to the ideological obstacle and the important role SOEs played in the past. Injection of foreign capital has become necessary and important to the success of SOE reform and to the development of Chinese market economy. Accordingly, M&As commonly used in mature economies are finding their new places in China as an instrument to rescue the distressed SOEs. China's WTO accession will no doubt accelerate the process.

As China is actively seeking to reduce its state shareholding in SOEs, a large number of potential targets are being made available for private investors to acquire, which particularly offers foreign investors unprecedented market entry options.

2. LEGAL FRAMEWORK GOVERNING M&A IN CHINA

In the context of its accession to the WTO and the restructuring of SOEs, China's M&A market appears to have a high potential for growth in the near future. However, the legal and regulatory frameworks governing M&As in China remains some of the obstacles to M&A transactions by foreign investors. Foreign investments through M&As in China are subject to restrictive rules and burdensome approval procedures. Dominant socialist ideology and state ownership also inject various political and social issues into many transactions. In an attempt to accelerate the restructuring of SOEs through the utilization of foreign investment, China is reforming its legal system rapidly and has recently issued a series of important regulations liberalizing the terms for M&As by foreign investors in China.

2.1. Overview Of Legal System In China

The Chinese legal system is generally classified under the Civil Law tradition, and virtually a mixture of informal and formal legal traditions.[84] China has a "unified political-legal system" as opposed to the separation of legislative, judicial and administrative powers in most western legal systems. Instead, China's legislative, administrative and judicial authorities all have the power to make laws within their respective jurisdictions.[85] Moreover, the legislative powers of the State are currently divided among different central and local legislative authorities.[86] At the national level, the National People's Congress (NPC), the NPC Standing Committee and the State Council have intrinsic power to enact national legislations. Ministries, commissions and other regulatory agencies under the

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[84] See H. P. Glenn, *Legal Traditions of the World: Sustainable Diversity in Law* (Oxford University Press, 2002), at 280.

[85] *Supra* note 68, at 142.

[86] See L. Li, "Theory and Practice of Division of Legislative Powers Between Central and Local Authorities in China", National Institute of Law, Chinese Academy of Social Science, online: <http://www.iolaw.org.cn/showarticle.asp?id=533> (date accessed: 31/12/2004).

State Council also have the power to enact departmental rules of general applicability within their respective jurisdictions. At the local level there exists a similar division of legislative powers provided that local legislation is in line with the higher level legislation. With the decentralized structure of the legislative powers, Chinese laws can be divided into six levels, i.e., the Constitution, laws enacted by the NPC and its Standing Committee, administrative regulations issued by the State Council, departmental rules by ministries and commissions under the State Council, local regulations, and legal interpretations.[87]

1) The Constitution and Laws

The *Constitution of the PRC* (Hereinafter referred to as the *Constitution*) is the highest and fundamental law of China.[88] The *Constitution* provides that "the legal superiority descends according to the level of legislative subjects".[89] In theory, the NPC – the supreme legislative authority – has the power to amend the *Constitution* and to enact and amend all basic laws relating to criminal offenses, civil affairs and the organization of state organs.[90] In practice, however, the NPC entrusts its Standing Committee with certain legislative powers when the NPC is not in session.[91]

2) Administrative Regulations

The State Council – the executive branch of the Chinese government – has the power to enact national administrative regulations, which carry the legal force under Chinese law.[92] While laws enacted by the NPC and its Standing Committee are usually general in nature, administrative regulations are required to facilitate

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87 See also Z. Huo & Y. Shi, "Overview of Legal Systems in the Asia-Pacific Region: People's Republic of China" (Cornell Law School LL.M. Papers Series, 2004), online: <http://lsr.nellco.org/cornell/lps/lsapr/5> (date accessed: 6/1/2005).

88 The Constitution was enacted in 1954 and amended in 1975, 1978 and 1982 respectively. See the English translation of the 1982 Constitution, online: <http://english.people.com.cn/constitution/constitution.html> (date accessed: 1/2/2005).

89 See Preamble of the 1982 Constitution.

90 *Ibid.* Articles 62 & 64. See also the *Legislation Law*, *infra* note 102, Article 7.

91 *Supra* note 89, Articles 67 (3). See also *infra* note 102, Article 7.

92 *Supra* note 89, Article 89.

the enforcement of the existing laws.[93] From the practical perspective, the administrative regulations are more comprehensive and important than the law itself. In some instances, the NPC and its Standing Committee can authorize the State Council to enact administrative regulations where no laws exist.[94] Such delegations not only meet the urgent need for regulation in certain areas that are undergoing dramatic changes, such as M&As, but also allow the NPC and its Standing Committee to eventually enact laws when time and conditions are appropriate.

3) Departmental Rules

Under the State Council, the ministries, commissions and other regulatory agencies are authorized to issue departmental rules within their respective jurisdictions and in accordance with the laws and the administrative regulations.[95] The departments issuing the rules are usually those who will primarily enforce the particular law. As departmental rules are detailed and technical in nature, they serve to implement or interpret the existing laws and administrative regulations. In some instances where the NPC and the State Council lack the expertise to legislate for a specific area such as M&As, the State Council can delegate its regulatory agencies to issue provisional departmental rules to meet the urgent need. There used to be no legal requirement that departmental rules be published so that some of them are regarded as "internal documents".[96] Along with administrative regulations, departmental rules account for the bulk of Chinese legislations and have significant impact on all aspects of the political, economic and social life in China.

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93 *Ibid.* Articles 68. See also *infra* note 102, Article 56.
94 *Supra* note 89, Article 89 (18). See also *infra* note 102, Article 56.
95 *Infra* note 102, Article 71.
96 *Supra* note 68 at 152. In accordance with China's WTO commitments, the State Council's Legislation Office recently announced that all of China's foreign trade related and foreign investment related laws, regulations, rules, and policy measures would be published. It further announced that China would use proper ways and means to help other WTO members and other pertinent individuals and enterprises understand those rules and regulations. See *supra* note 49.

4) Local Regulations and Rules

The economic reform policy brought initiatives to decentralize the legislative powers in order to facilitate the construction of socialist modernization.[97] Local authorities have a broad scope of legislative power in light of local conditions and specific needs of the respective administrative domains, provided that such regulations and rules are in accordance with higher level legislations.[98] People's congresses and their standing committees of "provinces, autonomous regions, major cities directly under central government, capital cities of provinces and autonomous regions, cities in special economic zones, and cities approved by the State Council" have the authority to enact local regulations, while the corresponding People's governments have the power to enact local departmental rules.[99]

5) Legal Interpretations

With a Civil Law tradition, China adopts the principle of legislative interpretation. The basis of legislative interpretation is that "those who make the law are in the best position to interpret it". According to this theory, legislative authorities also have the power to "interpret questions of law arising out of the concrete application of corresponding legal norms". This division of interpretive authority is consistent with that of legislative power under China's political-legal system.[100]

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97 *Supra* note 86.

98 *Supra* note 89, Article 100. See also *infra* note 102, Article 63. Chinese SOEs are divided into "central" and "local" enterprise. Local SOEs accounted for 54 percent of the industrial value added and 65 percent of the assets in the state sector. Local governments are extremely motivated to seek FDI for the sake of local interest. The competition for bigger share of FDI often prompts local governments to issue more generous FDI policies. See *supra* note 39.

99 *Supra* note 89, Article 116. See also *infra* note 102, Articles 63 & 73. For instance, pursuant to relevant State laws and policies on foreign investment, relevant regulations of the State Council and in light of the actual circumstances in Shanghai, the Shanghai Development and Reform Commission, the Shanghai Foreign Economic Relations and Trade Commission and the Shanghai Economic Commission jointly issued the *Guidelines of Shanghai Municipality for Foreign Investment in Industry Circular* on 15 September 2003. See "Issuing the Guidelines of Shanghai Municipality for Foreign Investment in Industry Circular", *China Law & Practice* (London: Nov 2003), at 1.

100 *Supra* note 68 at 168. On 10 June 1981, the NPC Standing Committee issued the

Since the initiation of open-door policy in 1978, numerous laws and regulations have been enacted to promote economic reforms. To establish the socialist market economy, the Chinese government accepted that "the market economy must be accompanied by a suitable legal system".[101] In particular, the enactment of the *Legislation Law* is a significant legal development since Chinese tradition used to recognize informal legal traditions such as morality and politics as having binding force.[102] The *Legislation Law* "draws a sharp distinction" between formal legal norms and informal legal norms so that only the norms that have been enacted in accordance with the *Legislation Law* qualify as legal norms accorded binding force.[103] With its accession to the WTO, China committed to the systemic reforms "through revising its existing laws and enacting new ones fully in compliance with the WTO Agreement", which would attract more foreign investment in the short term and strengthen the rule of law in the long run.[104]

2.2. China's Foreign Investment Regime

Over the past two decades, China has developed a complex system with preferential treatment policies to attract foreign investment. Most of the FDI in China are greenfield investments in the forms of the Equity Joint Venture (EJV),

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Resolution of the NPC Standing Committee on Strengthening the Work of Law Interpretation and authorized the Supreme People's Court and the Supreme People's Procuratorate to interpret questions of law arising out of specific applications of law in their sphere of work. Such judicial interpretations have binding force on all the courts and procuratorates in China and cover almost every aspect of the legal system.

[101] From 1979 to 1997, China has promulgated the 1982 Constitution and two amendments to the Constitution, 310 laws by the NPC and its Standing Committee, 800 administrative regulations by the State Council, 5000 local regulations and 30,000 departmental rules. See L. Lin, "Globalization and the Development of Legislation in China", National Institute of Law, Chinese Academy of Social Science, online: < http://www.iolaw.org.cn/showarticle.asp?id=532> (date accessed: 31/12/2004).

[102] The Legislation Law was adopted by the Third Session of the Ninth NPC on 15 March 2000. See the English translation of the Legislation Law, online: <http://www.cclaw.net/download/legislationlaw.asp> (date access: 12/12/2005).

[103] *Supra* note 68, at 145.

[104] See X. H. Ma, "China's Commitment to Transparency Under WTO – Concepts of China's Law and Administrative Regulations", December 2001, online: <http://www.mofo.com/tools/print.asp?/mofo_dev/news/news/files/article622.html> (date accessed: 1/12/2005). See also World Trade Organization Ministerial Conference, Report of the Working Party on the Accession of China, WT/MIN(01)/3, Nov. 10, 2001, online: <http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm> (date accessed: 30/12/2004).

the Cooperative Joint Venture (also known as the "Contractual Joint Venture") (CJV), the Wholly Foreign-Owned Enterprise (WFOE), or Foreign-invested Company Limited by Shares (FCLS).

2.2.1. Types of Foreign-invested Enterprises in China

A foreign investor may not directly operate a business in China. It must do so through an FIE, which is an enterprise form specifically designed to accommodate foreign investment in China. Where the foreign party holds 25 percent or more of the registered capital, the FIE enjoys various tax and other preferential treatments at both national and local levels.[105] However, the preferential treatments currently awarded to an FIE may be phased out gradually subsequent to China's accession to the WTO.[106]

The establishment and operation of an FIE shall generally be subject to the *Company Law*[107], though the relevant provisions of the laws on foreign investment, if any, shall prevail.[108] In general, an FIE can take either of two corporate forms: Limited Liability Company (LLC) or Company Limited by Shares (CLS) (also known as Joint Stock Limited Company) as defined in the *Company Law*.[109] Nevertheless, the FIE's capital structure, governance structure and profit sharing scheme may be different from those of the LLC and CLS under

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[105] At the national level, an FIE enjoys two years' income tax exemption and three years' 50 percent tax reduction. Similar or better tax benefits are also given to FIEs at provincial and municipal levels. See generally C. Han & S. Qin, "FIE Status and the 25% Rule," China Law & Practice, December 2001/January 2002, 15(10), at 106. For instance, all corporations in China are taxed at the rate of 33 per cent; but, after various deductions, most foreign affiliates pay only around 15 per cent. In special economic zones, foreign affiliates have been enjoying an even lower rate." See "KPMG's Corporate Tax Rate Survey – January 2002", online: <http://www.kpmg.bg/dbfetch/52616e646f6d4956fefc52f7c01fc4dc9af95853c3c2815c/ctrs2002__final_.pdf> (date accessed: 6/1/2005).

[106] See R. Zhang, "Preferential Treatment and National Treatment: The Evolving Status of FIEs", *China Law & Practice* (London: Dec 2002) at 1. See also WIP 2000, *supra* note 4, at 55.

[107] *The Company Law of the People's Republic of China* [Hereinafter referred to as the *Company Law*] was adopted by the Standing Committee of the NPC on 29 December 1993, and effective as of 1 July 1994. See the English translation of the *Company Law*, online: <http://www.cclaw.net/download/companylaw.asp> (date accessed: 3/1/2005).

[108] *Ibid.* Article 18.

[109] *Ibid*, Chapters 2 & 3.

the *Company Law*.

2.2.1.1. Limited Liability Company

A foreign-invested LLC can take the form of an EJV, a CJV or a WFOE. Each type of FIE is subject to its own set of laws and regulations, among which are the *Sino-Foreign Equity Joint Venture law* of 1979 (revised 1990 & 2001), the *Sino-Foreign Contractual Joint Venture Law* of 1988 (revised 2000) and the *Wholly Foreign Owned Enterprise Law* of 1986 (revised 2000).[110] All these laws have been supplemented with various regulations.[111]

As discussed above, because of the political and legal restrictions during the early period of the economic reform, most FIEs in China were required to form Joint Ventures (JVs) with SOEs who generally exercised high asset control in the JVs. Meanwhile, JVs are traditionally favorite investment vehicles for foreign investors who are less familiar with Chinese investment environment and need a local partner with good government relationship to handle local issues.[112] An EJV must take the form of a LLC.[113] The share of profits and losses, as well as the managerial control, depends on each partner's proportionate capital contribution.[114] EJV is the most common FIE form, especially in the manufacturing sector. In contrast, a CJV offers more flexibility in that the share of profits and losses, as well as the managerial control can be determined in partners' discretion, rather than according to the percentage of capital contribution.[115] A

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110 See the full content of the Laws on Foreign Investment, online: <http://www.fdi.gov.cn/ltlawpackage/index.jsp?app=1&language=en&category=0140&currentPage=1> (date accessed: 5/1/2005).

111 Among them are the *Equity Joint Venture Law Implementing Rules* (1983, amended 1986 & 1987), the *Contractual Joint Venture Law Implementing Rules* (1995), and the *Wholly Foreign-Owned Enterprise Law Implementing Rules* (1990, revised 2001). See the Regulations on Foreign Investment, online: <http://www.fdi.gov.cn/ltlawpackage/index.jsp?currentPage=1&category=0150&app=1&language=en> (date accessed: 5/1/2005).

112 *Supra* note 50, at 3.

113 See Article 4 of the *Sino-Foreign Equity Joint Venture Law*.

114 *Ibid*, Article 8.

115 See Article 43 of the *Contractual Joint Venture Implementing Rules*.

CJV may take the form of a LLC, partnership or contractual relationship.[116] In practice, the majority of CJV take the form of a LLC.

A WFOE also takes the form of a LLC, where foreign investors contribute all registered capital, determine the management structure and assume responsibility for all profits and losses. Since wholly owned by a foreign investor(s), a WFOE would be subject to more stringent restrictions with respect to its establishment and business scope[117] Nevertheless, a WFOE can operate without the constraints of a local partner who may not share the same goals, expectations and values. Recently, WFOE has become a prevalent investment vehicle favored by the foreign investors who are more familiar with investment in China and quest for greater flexibility in terms of managerial control.[118] In 1997, the MOFTEC and the SAIC jointly issued the *Several Provisions on Changes in Equity Interest of Investors in Foreign Enterprises*, which provide the procedures of converting a JV into a WFOE. Thereafter, the growth of WFOEs exceeded that of JVs for the first time in 2000.[119]

2.2.1.2. Company Limited by Shares

While the LLC form was the basis for the FIE regime, the possibility of CLS was sought pursuant to the relevant provisions of the *Company Law*.[120] On 10 January 1995, the *Interim Provisions on Several Issues Concerning the Establishment of Foreign-invested Company Limited by Shares* (Hereinafter referred to as the *FCLS Provisions*) issued by the MOFTEC regarded Foreign Company Limited by Shares (FCLS) as a form of FIE. FCLS is essentially same as CLS as defined in

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[116] *Ibid*, Article 4.

[117] For the establishment of a WFOE, see Article 6 of the *Rules for the Implementation of the Foreign Enterprise Law* approved by the State Council. The approval of a WFOE application used to be contingent on its commitment to utilize advanced technology or export at least 50 percent of its products until the restrictions were eliminated in 2001. See Article 3 of the 2001 *Wholly Foreign-Owned Enterprise Law Implementing Rules*.

[118] *Supra* note 50, at 3.

[119] See "Investment Climate Statement for FY 2002", The American Embassy in China, online: <http://www.usembassy-china.org.cn/econ/ics2002.html> (date accessed: 3/1/2005).

[120] *Supra* note 107, Chapter 3.

the *Company Law*[121], except that an FCLS must have at least 25 percent of its shares held by foreign parties. Unlike JVs or WFOEs, the investors' interest in an FCLS takes the form of shares, similar to typical western-style corporations.[122] An FCLS can operate for an unlimited period and thus does not run the risk of re-negotiating among the partners and re-applying for government approval. According to the *Company Law*, all listed companies have to take the form of CLSs, so the FCLS form is a pre-condition for an FIE to be listed at the Chinese stock market.[123] It gives the foreign investors absolute control as long as they hold more than two-thirds of the shares. Such control enables the foreign investors to "conduct future capital increases, mergers and acquisitions, and divestments in a more flexible way".[124]

Under the *FCLS Provisions,* an FCLS may be newly established by Chinese and foreign investors. The establishment criteria of an FCLS are more stringent than those of JVs and WFOEs.[125] Alternatively, an FCLS may be converted into by existing FIEs, SOEs as well as CLSs. However, when an existing FIE is converted into an FCLS, the period of preferential treatment in terms of tax reduction and exemption shall not be reinstated subsequently.[126]

2.2.2. Other Investment Vehicles

2.2.2.1. Holding Company

The structure of a Holding Company (HC), also known as Foreign Investment Company, would enable foreign investors to seek the economies of scale and

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121 *Ibid.*
122 *Supra* note 50, at 3.
123 See Article 3 of the *FCLS Provisions*.
124 See M. G. Hu, "Company Limited by Shares (CLS): A Powerful Legal Vehicle for Group Restructuring", *China Law & Practice* (London: April 2004) at 1.
125 For instance, the sponsors of FCLSs are subject to "additional restrictions and qualification requirements"; in addition, an FCLS must have a minimum registered capital of RMB 30 million of which the foreign party must hold at least 25 percent interest; finally, the approval procedures are more "burdensome". See *supra* note 50, at 3. See also *supra* note 123, Articles 9, 11&12.
126 *Supra* note 123, Article 26.

efficiency by holding shares in subsidiary FIEs or providing centralized services for them.[127] Until 1995, however, there had been no formal rules governing the establishment and operation of HCs established by foreign investors. Though the *Company Law* gives a company the power to invest in other companies, the power to invest is generally limited to 50 percent of its net assets.[128]

To promote the foreign investment, the MOFTEC issued the *Interim Provisions on the Establishment of Foreign Investment Companies* (Hereinafter referred to as the *HC Provisions*) in 1995. In practice, however, few foreign companies can satisfy the high thresholds to establish a HC.[129] Although the MOFTEC has revised the *HC Provisions* several times, the *2004 HC Provisions* [130] still require the foreign investor seeking to establish a HC to have either: a) a total asset value of no less than US$400 million during the year before the application, one established FIE with paid-up registered capital of no less than US$10 million and at least three project proposals; or b) at least ten established FIEs with paid-up registered capital of no less than US$30 million. In establishing a HC by means of JV, the Chinese partner must have a total asset value of no less than RMB100 million during the year before the application. In addition, a HC must have a registered capital of no less than US$30 million.[131] A HC shall take the form of a LLC – either WFOE or JV.[132] The *2004 HC Provisions* made HCs more operative and add real value to group activities as the restrictions on their business scope were relaxed.[133]

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[127] *Infra* note 130, Articles 10, 13 & 14.

[128] *Supra* note 107, Article 12.

[129] To a large extent, only those among top 500 companies in the world can meet the conditions. By the end of 2004, foreign investors had established about 250 HCs in China. See Y.Y. Hu, "Foreign investors to have wider access", China Daily, 24 December 2004.

[130] See the *Provisions on the Establishment of Investment Companies by Foreign Investors* (Hereinafter referred to as the *2004 HC Provisions*) issued by MOFCOM on 17 November 2004, online <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC00000000000010443> (date accessed: 6/1/2005).

[131] *Ibid.* Article 3.

[132] *Ibid.* Article 2.

[133] HC's business scope has been expanded from the manufacturing sector to the wholesale, retail and franchise sectors. *Ibid.* Article 11.

2.2.2.2. Investment by FIEs

Without need to be qualified as a HC, an FIE is permitted to invest in Chinese entities under the *Tentative Provisions on Domestic Investment by Foreign-Invested Enterprises* jointly issued by the MOFTEC and the SAIC, effective on 1 September 2000 (Hereinafter referred to as the *FIE Investment Provisions*). Under the *FIE Investment Provisions,* an FIE can undertake certain investments without need to seek the approval from the foreign investment authorities. The entities invested by FIEs shall be established pursuant to the *Company Law* but their registration certificate shall include the notation "Investment by Foreign-Invested Enterprise".[134]

To be eligible under the *FIE Investment Provisions,* an FIE must have made full capital contributions, have operated profitably and have no record of illegal business activities.[135] However, the qualified FIEs exclude HCs and CJV without legal person status. In addition, identical to the provision of the *Company Law*, permissible investments under the *FIE Investment Provisions* may not cumulatively exceed 50 percent of an FIE's net assets.[136] Such restrictions effectively limit an operating FIE's ability to invest in China.

2.2.2.3. FIE with Foreign Ownership of Less Than 25 Percent

An FIE is a legal status originally given to a WFOE or a JV with foreign investors contributing at least 25 percent of the registered capital and entitled to the preferential treatments. In December 2002, the MOFTEC, the SAT, the SAFE, and the SAIC jointly issued the *Notice on Relevant Issues Concerning*

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[134] See "New Provisions on FIE Investment in China", a Publication of the American Chamber of Commerce – China, online: <http://www.amcham-china.org.cn/publications/brief/document/revisedLegalBrief12-00.htm> (date accessed: 23/12/2004).

[135] See P. M. Norton & H. Chao, "Mergers and Acquisitions in China", an O'Melveny & Myers' research report, April 2003, online: O'Melveny & Myers <http://www.omm.com/webcode/webdata/content/publications/Topics_2003_04.PDF> (date accessed: 9/12/2004).

[136] *Supra* note 134. See also *supra* note 107, Article 12.

Strengthening the Administration of Examination and Approval, Registration, Foreign Exchange and Taxation of Foreign Invested Enterprises (Hereinafter referred to as the *FIE Notice*), effective as of 1 January 2003. By enabling foreign investors to hold less than 25 percent of the registered capital in a domestic enterprise, the *FIE Notice* made a major breakthrough to create a new breed of FIE – FIEs with foreign ownership of less than 25 percent.

The *FIE Notice* provides that the JVs with foreign ownership of less than 25 percent are classified as FIEs and should follow the approval and registration procedures for FIEs. This rule is repeated in the *M&A Rules*[137]. The FIE approval certificate and business license will be issued with a notation "foreign investment proportion less than 25%".[138] FIEs with foreign ownership of less than 25 percent, however, are not entitled to the preferential treatments available to standard FIEs. Traditionally for the establishment of a standard FIE, foreign investors may make the capital contribution either "in one lump sum", or "by installments". However, foreign investors in FIEs with foreign ownership of less than 25 percent are required to make full capital contribution within three months in case of "contribution in cash", or within six months in case of "contribution in kind or in industrial property rights", from the issuance of the business license. [139]

2.2.3. Industry Policy For Foreign Investment

All foreign investments in China, whether greenfield investments or M&As, are subject to the industrial policies. Notably, the Chinese government set out the *Regulations for Guiding the Direction of Foreign Investment* (Hereinafter referred to as the *Investment Guidelines*)[140] and the *Catalog for the Guidance of Foreign*

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[137] See section 2.3.9, below, for more on the *M&A Rules*.
[138] See Article 5 of the *M&A Rules*.
[139] *Ibid*, Article 9.
[140] The recent Investment Guidelines was promulgated by the State Council on 11 February 2002, effective as of 1 April 2002. See the *Investment Guidelines* online: <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC00000000000003189&appId=1> (date accessed: 23/11/ 2004).

Investment in Industries (Hereinafter referred to as the *Catalog*)[141] to serve as general indications governing foreign investment in various industries. The *Investment Guidelines* divide all industries into four categories: encouraged, permitted, restricted and prohibited while the *Catalog* contains the detailed lists of sectoral items within each category. Such classification helps determine both the appropriate approval authority and the permitted percentage of foreign ownership in a certain sector. Such industrial policies are designed to integrate the foreign investment into China's national economy. Policies relating to the encouraged category channel FDI to the desired locations, sectors and activities where China could benefit from foreign capital and technology. Policies relating to the restricted and prohibited categories are designed to protect domestic industries for political, economic or national security reasons. While the *Catalog* in theory is for guidance, in practice it is mandatory. Before making any M&A moves, foreign investors must identify which category the target firm belongs to.

1) In the encouraged category, the *Catalog* permits the establishment of WFOEs in most industrial sectors. However, the category specifies a few sectors where foreign investors may only establish JVs and some sectors where JVs must be controlled or relatively controlled by Chinese investors. In addition, China has introduced new incentives for foreign investments in high-tech industries[142] and in the central and western areas[143] in order to stimulate the development in those less developed fields.

2) In the restricted category, the *Catalog* mandates majority ownership by

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[141] The latest Catalog was promulgated by the SDRC and the MOFCOM on 30 November 2004, effective as of 1 January 2005. See the full content of the *Catalog* online: Invest in China <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC00000000000010453> (date accessed: 3/1/2005).

[142] See the *Catalog of Encouraged Hi-tech Products by Foreign Investment* issued by the Ministry of Science and Technology and the MOFCOM on 2 June 2003, online: <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?appId=1&language=en&id=CENSOFT0000000009119> (date accessed: 3/1/2005).

[143] See the *Catalog for the Guidance of Foreign Investment in Industries in Central and Western Areas* issued by the SDRC and the MOFCOM, effective on 1 September 2004, online: <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC00000000000010114> (date accessed: 3/1/2005).

Chinese investors in some sectors. Even if some projects are allowed for WFOEs in certain sectors, they need undergo a more stringent approval process than that prescribed for the encouraged projects. In addition, the projects in this category are subject to approval from the authorities in charge of the relevant industries.

3) The *Catalog* bans foreign investment in the sectors falling within the prohibited category.

4) All sectors other than those listed in the *Catalog* belong to the permitted category. The permitted category also allows for WFOEs.

In undertaking its WTO commitments, China has amended the Catalog several times to relax the above restrictions with respect to most of the industrial or service sectors. The latest *Catalog* was promulgated by the SDRC and the MOFCOM on 30 November 2004 and effective on 1 January 2005 (Hereinafter referred to as the *New Catalog*).[144] The *New Catalog* adds more items to the encouraged category.[145] Further, certain sectors that used to be restricted or prohibited are now open to foreign investment under the *New Catalog*.[146] To cool down over-investment in certain sectors, some items which were originally included in the encouraged category are re-categorized under the permitted category.[147] Although the *New Catalog* continues the trend of opening more sectors to foreign investment, no major amendment was made to those service industries which are of more interest to foreign investors, such as the financial

144 See the full content of the New Catalog, online: <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC00000000000010453> (date accessed: 3/1/2005).

145 See *e.g.* "manufacture of key components of large screen color rear projection monitors", "production of ethylene glycol", "manufacture of automobile electronic devices", "manufacture of large scale cycle fluidized bed (CFB) boilers", and "production of read-only optical disks". *Ibid.*

146 See *e.g* "production and distribution of radio and television programs" and "production of motion pictures" are transferred from the prohibited category to the restricted category. *Ibid.*

147 See *e.g* "production of heavy plate", "production of galvanized plate, processing of scrap steel", and "manufacture of motorcycles and motorcycle engines". *Ibid.*

services, insurance, securities, wholesaling, retailing, transportation, information and consultancy services.

2.2.4. Government's Role in Foreign Investment Regime

To ensure full compliance with the industrial policies, the Chinese government takes the responsibility to examine and approve all the foreign investment projects. Though China is making effort to fulfill its promises relating to the WTO accession, the market opening commitments do not necessarily mean that the Chinese government will certainly approve any foreign investment project. Thus, understanding the government's role in the approval process is an important aspect of successfully concluding transactions in China.

In 10 March 2003, the NPC approved the reorganization plan for the State Council, under which the Ministry of Commerce (MOFCOM) and the State Owned Assets Supervision and Administration Commission (SASAC) were newly established. Currently, some primary governmental departments involved with foreign investment and their roles in the approval procedures are as follows:

- State Development and Reform Commission (SDRC):

  The SDRC, which has assumed the functions of the former State Development Planning Commission (SDPC)[148], is responsible for approving the feasibility study reports of foreign investment projects and supervising the restructuring of SOEs.[149]

- The Ministry of Commerce (MOFCOM):

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148 The SDPC once had important policymaking and industrial planning responsibilities in determining the general structure and scope of plans concerning long-term foreign trade and investment.

149 See main functions of the SDRC online: <http://www.sdpc.gov.cn> (date accessed: 2/2/2005).

The MOFCOM has undertaken certain functions of the former State Economic and Trade Commission (SETC)[150] and Ministry of Foreign Trade and Economic Cooperation (MOFTEC)[151]. Approvals from the MOFCOM are required in respect of (a) compliance with the *Catalog*, and (b) establishment of an FIE pursuant to foreign investments or M&A transactions.[152] In addition, the MOFCOM is responsible for antitrust review upon certain transactions by foreign investors.

- The State-owned Assets Supervisory & Administrative Commission (SASAC):

  The state asset administration function has been transferred from the Ministry of Finance (MOF)[153] to the SASAC. All M&As targeting SOEs are subject to SASAC approval. Whenever state-owned equity or assets are transferred pursuant to an M&A transaction, a mandatory appraisal is subject to SASAC approval.[154]

- State Administration of Foreign Exchange (SAFE):

  SAFE regulates foreign exchange controls and approves all foreign exchange expenditures and outward remittances. Upon receipt of the approval of MOFCOM and the SASAC, foreign investors shall register with SAFE in respect of the consideration for the transactions.[155]

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150 The SETC used to be responsible for formulating industrial policy and for determining the direction of future development of the economy and investment policy. The SETC once approved the application and feasibility study for a foreign investment project.

151 The MOFTEC used to be the primary regulator of foreign investment and have general supervision and approval authority over M&A transactions.

152 See main functions of the MOFCOM, online: <http://english.mofcom.gov.cn/mission/mission.html> (date accessed: 2/2/2005).

153 The MOF oversees China's financial activities, monitors revenues and expenditure, and prepares annual budgets and fiscal reports. See main functions of the MOF, online: <http://www.mof.gov.cn/wwwroot/C1-0020517181417291/index/index.jsp> (date accessed: 2/2/2005).

154 See main functions of the SASAC, online: <http://www.sasac.gov.cn/eng/zyzz.htm> (date accessed: 2/2/2005).

155 See main functions of the SAFE, online: <http://www.safe.gov.cn/0430/js_zyzn.htm> (date accessed: 2/2/2005).

- The China Securities Regulatory Commission (CSRC):

  The CSRC is responsible for monitoring and regulating China's securities markets. All information disclosures as well as other activities relating to the takeover of listed companies shall be subject to the CSRC's approval.[156]

- State Administration for Industry and Commerce (SAIC):

  The SAIC is responsible for the registration of FIEs and issuance of their business licenses.[157] In addition, the SAIC is responsible for antitrust review upon certain transactions by foreign investors.

- State Administration of Taxation (SAT):

  The SAT supervises all of China's taxation matters and formulates tax policies and enforces China's tax laws.[158] An FIE with foreign ownership of not less than 25 percent enjoys preferential tax treatment.

- Sector-specific Authorities:

  Particular industries are directly regulated by specific ministries or commissions, such as banking and insurance sectors. Foreign investments or M&A transactions targeting these sectors may require the approval of the authorities in charge.

- In addition to the national organizations, the corresponding provincial and local authorities regulate foreign business operations located in their jurisdictions.

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156 See main functions of the CSRC, online: <http://www.csrc.gov.cn/en/homepage/about_en.jsp> (date accessed: 2/2/2005).

157 See main functions of the SAIC, online: <http://www.saic.gov.cn/zhzjg/zhin.html> (date accessed: 2/2/2005).

158 See main functions of the SAT, online: <http://www.chinatax.gov.cn/function.jsp> (date accessed: 2/2/2005).

Proposed foreign investments that will result in FIEs usually go through a multi-level approval process. Project approvals and feasibility study reports are first prepared and approved by the SDRC. Depending on the amount of total investment and the types of business classified in the *Catalog*, the relevant approvals of the articles of association and of any joint venture contracts/shareholders' agreements are obtained from the MOFCOM.[159] The MOFCOM and the SDRC used to approve the projects with a total investment amount exceeding US$30 million and empower local government to approve other projects with less value. On 9 October 2004, the SDRC issued the *Administration of the Verification of Foreign-invested Projects Tentative Procedures* (Hereinafter referred to as the *Verification Procedures*) to simplify the approval procedures.[160] The *Verification Procedures* apply to the establishment of all FIEs, capital increases of existing FIEs and acquisitions of domestic enterprises by foreign investors.[161] Under the *Verification Procedures*, projects in the encouraged permitted categories with a total investment amount of US$100 million or more require the approval of the MOFCOM and the SDRC, while provincial governments can approve projects valued less than that amount. Projects in the restricted category with a total investment amount of US$50 million or more must receive the national level approval.[162] After receipt of the FIE Approval Certificates, the foreign investors shall register the approval with the SAIC in the appropriate jurisdiction, which will thereafter issue a FIE Business License. Subsequently, the foreign investors shall go through other registration procedures at the relevant government departments in charge of taxation, foreign exchange, etc. The government approvals required for an M&A transaction is similar to that for the establishment of an FIE. As far as the state-owned assets are concerned, the approval from the SASAC or its local counterpart is required.

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[159] Supra note 50, at 10.
[160] See J. Fu, "Investment procedures simplified", China Daily, 30 November 2004.
[161] See Article 2 of the *Verification Procedures*.
[162] *Ibid.* Articles 3 & 4.

Various governmental departments promulgate laws and regulations that set out policies with respect to foreign business operations, and they are empowered to enforce these policies. As noted below, the regulations governing M&A activities in China were issued by several governmental departments individually or collectively.[163] At the outset of a transaction, foreign investors should ascertain what governmental approvals are required. Due to different commercial and political interests, the support of one department does not necessarily imply the support of another, and the national and local authorities may hold divergent views on an issue because of local protectionism. The multi-level approval process could be a source of delay that can kill a deal. Thus, it is very important to monitor the entire process.[164]

2.3. China's M&A regime

With the absence of a uniform M&A law, the laws and regulations governing M&A activities in China have been issued on a piecemeal basis. While the *Company Law* provides general principles for mergers and divisions of companies, the *Securities Law* provides more specific rules regarding takeovers of listed companies.[165] In addition, M&A transactions by foreign investors are subject to the general foreign investment regime in China. Recently, various governmental departments have individually or collectively promulgated a series of regulations governing some specific aspects of the transactions.

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[163] See section 2.1 above, for more on the division of the legislative power in China. Please note that the laws and regulations quoted in this thesis still refer to their original regulators prior to the State Council restructuring.

[164] See "Merger and Acquisition Practice in China (2004)", Deacons, (Hong Kong: World Services Group, 28 November 2004), online: <http://www.worldservicesgroup.com/publicationspf.asp?id=443> (2/2/2005).

[165] *The Securities Law of the People's Republic of China* [Hereinafter referred to as the *Securities Law*] was adopted at the 6th Meeting of the Standing Committee of the Ninth NPC of the PRC on 29 December 1998, and effective as of 1 July 1999. See the English translation of the *Security Law* online: CSRC <http://www.csrc.gov.cn/en/jsp/detail.jsp?infoid=1061968202100&type=CMS.STD> (date accessed: 3/1/2005).

2.3.1. Merger Provision in Company Law

The Chapter VII of the *Company Law* sets out general principles for a merger between companies.[166] Generally, a merger must be approved by a resolution adopted at the shareholders' meeting.[167] As far as a CLS is concerned, the merger must also be approved by the original "department authorized by the State Council or the People's Government at the provincial level" which once approved the establishment of the CLS.[168]

The *Company Law* provides two forms of mergers: "merger by absorption" and merger by establishment. In a merger by absorption, one company absorbs another and "the company being absorbed" is dissolved. In a merger by establishment, two or more companies are consolidated into a newly established one and "the companies being consolidated" are dissolved.[169]

The companies to be merged must notify their creditors of the merger resolutions and make a public announcement accordingly. Generally, the absorbing company or the consolidating company shall assume the "creditor's rights and debtor's liabilities" of the companies to be merged. However, the creditors have the rights to require "full payment of the debts" or "provision of appropriate assurances" prior to the merger.[170] Such safeguard rules are designed to protect the interests of the domestic companies' creditors, which are usually the state-run banks or state asset management corporations.

The *Company Law* also requires that where the absorbed company is dissolved, the consolidating company is established, or the registered capital changes in connection with a merger, an application for the respective change to registration particulars should be filed with the "company registration authority"

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166 See Chapter VII of the *Company Law*: "Merger And Division Of Company", including Articles 182-188.
167 *Ibid*, Article 182.
168 *Ibid*, Articles 77 & 183.
169 *Ibid*, Article 184.
170 *Ibid*.

accordingly.[171]

2.3.2. Merger Provision in M&D Regulations

Pursuant to the *Company Law* and laws and regulations governing FIEs, the MOFTEC and the SAIC jointly promulgated the *Regulations on the Merger and Division of Foreign Invested Enterprises* (Hereinafter referred to as the *M&D Regulations*) on 10 October 1999, and amended on 22 November 2001.[172] The *M&D Regulations* offer foreign investors some effective vehicles to reorganize their investments in China.

The *M&D Regulations* apply to a merger: (a) between an EJV, CJV with legal person status, WFOE or FCLS; and (b) between FIEs and certain Chinese domestic enterprises.[173] To be eligible for a merger, an FIE must have made full capital contributions and "commenced production",[174] which effectively ban the establishment of a new FIE for the purpose of mergers only.

The most common vehicle under the *M&D Regulations* is consolidation of the legally independent FIEs. This kind of merger generally takes the form of a merger by establishment,[175] which enables the corporate reorganizations typical in western economies. In addition, EJV, CJV, WFOE and FCLS may merge with one another, and the surviving entity may take any of the various FIE forms.[176] This kind of merger generally takes the form of a merger by absorption,[177] which provides the dissolved FIE an exit strategy for its investment in China.

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171 *Ibid*, Article 188.

172 See the full text of the *M&D Regulations*, online: MOFCOM Beijing Chaoyang <http://www.google.ca/search?hl=en&q=%E5%A4%96%E5%95%86%E6%8A%95%E8%B5%84%E4%BC%81%E4%B8%9A%E5%90%88%E5%B9%B6%E4%B8%8E%E5%88%86%E7%AB%8B%E7%9A%84%E8%A7%84%E5%AE%9A&btnG=Google+Search&meta=> (date accessed: 1/2/2005).

173 *Ibid*, Article 2.

174 *Ibid*, Article 9.

175 *Ibid*, Article 3.

176 *Ibid*, Article 10.

177 *Ibid*, Article 3.

2.3.3. Takeover Provisions in Securities Law

Chapter IV of the *Securities Law* regulates "Takeover of Listed Companies" (Hereafter referred to as the *Takeover Provisions*),[178] which may be conducted by tender offer or by private agreement.[179]

In the case of takeover by tender offer, there is a 30-percent threshold for a mandatory offer rule: if an investor holds 30 percent of the outstanding shares of a listed company and intends to carry on the takeover, the investor is required to make a tender offer to all the shareholders of the target company unless exempted by the CSRC.[180] The takeover threshold, however, does not imply that an acquirer can trade shares freely before he holds 30 percent of the outstanding shares of a listed company. Within three days after the first 5 percent shareholding is reached, the acquirer should report his holding status to the CSRC and the stock exchange, notify the listed company and make a public announcement. Thereafter, such reporting and announcing obligations need to be performed with every shareholding fluctuation of 5 percent. During the reporting period and two days thereafter, the acquirer cannot continue to trade shares of the listed company.[181]

Before the mandatory offer is made, the acquirer must submit a report regarding the takeover to the CSRC and the stock exchange, including information on the purpose, terms of the takeover, fund availability, shares held and shares to be acquired. The offer period shall be "not less than 30 days or not more than 60 days", during which the acquirer cannot withdraw the offer.[182] Upon expiration of the offer period, if the acquirer's shareholding in the target company has reached "not less than 75 percent", the share listing and trading of the target company shall be terminated;[183] if the acquirer's shareholding has reached "not

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178 See Chapter IV of the *Securities Law*: "Takeover of Listed Companies", including Articles 78-94.
179 *Ibid.* Article 78.
180 *Ibid.* Article 81.
181 *Ibid.* Article 79.
182 *Ibid.* Articles 82 – 84.
183 *Ibid.* Article 86; see also the *Notice on Issues Relating to Listing Conditions of Companies Acquired by Tender Offer* issued by the CSRC on 20 May 2003. The Notice clarifies that if

less than 90 percent", the remaining shareholders of the target company shall be entitled to sell their shares to the acquirer on the same conditions of the offer.[184]

When a listed company is to be taken over by private agreement, the acquirer may "effect the equity transfer" by entering into a takeover agreement with the shareholders of the target company. Within three days thereafter, the acquirer must submit a written report on the private agreement to the CSRC and the stock exchange, and make a public announcement before the agreement can be performed.[185] Unfortunately, the *Takeover Provisions* fail to apply the mandatory offer rule to the takeover by private agreement. Without the obligation, the acquirer opts to negotiate with few controlling shareholders rather than with a great number of minority shareholders. Similar to the "two-tier tender offer" in western economies,[186] the minority shareholders would be falling in a discriminated position. In light of the fact that most shares of Chinese listed companies are non-tradable[187], the mandatory offer rule should be applicable when an investor seeks a controlling interest by acquiring non-tradable shares through private agreement.

2.3.4. Takeover Measures

Pursuant to the *Company Law,* the *Securities Law*, and other laws and regulations, the CSRC promulgated the *Administrative Measures of the Takeover of Listed Companies Procedures* (Hereinafter referred to as the *Takeover Measures*) on 28

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following the acquisition, the target company does not qualify for being listed according to the Company Law, but the acquirer does not attempt to de-list the stock of the acquired company, then the acquirer should formulate and implement plans to maintain the listing status of the target company and for complying with listing requirements again within one month after expiration of the tender offer. If the acquirer holds more than 90 percent of the total shares of the acquired company after closing, it should further apply to the securities exchange for suspension of listing.

[184] *Supra note 178*, Article 87.

[185] *Ibid*, Article 89.

[186] See "two-tier tender offer", *Dictionary of Finance and Banking*. Oxford University Press, 1997. *Oxford Reference Online*. Oxford University Press. McGill University (Nylink). Online: <http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t20.e3915> (date accessed: 12/12/2004).

[187] See section 3.2.1.1.1.2, below, for more on the non-tradable shares.

September 2002, and effective as of 1 December 2002.[188] The *Takeover Measures* stipulate the concrete rules and procedures governing the takeover of listed companies by means of private agreement, tender offer or "centralized trading at competing prices on a stock exchange".[189]

Built on the Takeover Provisions of the *Securities Law*, the mandatory offer rule with a general applicability has been further defined under the *Takeover Measures*. A mandatory offer rule shall apply to both takeover-by-offer and takeover-by-agreement as long as the acquirer's shareholding in the listed company exceeds 30 percent.[190]

Under certain circumstances, however, the acquirer may apply to the CSRC for a broad range of exemptions from the obligations related to the mandatory offer.[191] The acquire may apply for such exemptions in case of (a) transfer of shares "between different entities that are actually controlled by the same person", (b) takeover intended to rescue a listed company "facing serious financial difficulties", (c) issuance of new shares "according to the resolution of its shareholders' general meeting", or (d) transfer of shares "on the basis of a court ruling".[192] The relevant parties also may apply for an exemption in case of (a) a shareholding increase of an absolute controlling shareholder, (b) a decrease of listed company's share capital, (b) normal business activities of securities companies and banks, (c) "administrative transfer of state-owned shares" or (d) a "lawful succession".[193] In addition, it is in the CSRC's discretion to grant an exemption under other circumstances excluded therein.

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[188] See the English translation of the *Takeover Measures*, online: <http://proquest.umi.com/pqdlink?did=320617371&sid=3&Fmt=3&clientId=10843&RQT=309&VName=PQD> (date accessed: 11/11/2004).
[189] *Ibid*, Articles 1 & 3.
[190] *Ibid*, Articles 13 & 24.
[191] The acquirer may apply to the CSRC for "(1) exemption from the obligation to increase its shareholding by means of the takeover-by-offer method; (2) exemption from the obligation to issue a takeover offer to all shareholders of the target company; (3) exemption from the obligation to offer for all the shares of the target company". *Ibid*, Article 48.
[192] *Ibid*, Article 49.
[193] *Ibid*, Article 51.

For the purpose of preventing the loss of the state-own assets,[194] the *Takeover Measures* set forth the principles to determine minimum permissible price for the takeovers. The minimum price for tradable shares shall be the higher of (a) the highest price paid by the acquirer for such shares within the previous six months or (b) "90 percent of the daily weighted average prices" for such shares within the previous 30 days; the minimum price for tradable shares shall be the higher of (a) the highest price paid by the acquirer for such shares within the previous six months or (b) "target company's audited net asset value per share for the most recent period".[195] In addition, the *Takeover Measures* strengthen the fiduciary duty that "directors, supervisors and senior management of listed companies" owe to "the company they serve and the shareholders thereof",[196] which makes those business decision-makers more cautious and accountable in the course of the takeovers. Specifically, the board of directors and the independent directors of the target company are required to provide separate advice and opinion publicly upon the takeover offer.[197] To avoid "prejudicing the legitimate rights and interests" of its shareholders, the board of directors of the target company is restricted from taking any defense mechanisms typical in western economies for its own benefits.[198]

2.3.5. Disclosure Measures

Along with the *Takeover Measures*, the CSRC promulgated the *Administrative Measures of Disclosure of Information on the Change of Shareholdings in Listed Companies* (Hereinafter referred to as the *Disclosure Measures*) on 28 September 2002, and effective as of 1 December 2002.[199] To avoid the inside trading and

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194 In fact, majority of all Chinese listed companies are SOEs. See section 3.2.1.1.1, below, for more on the characteristics of China's securities market.
195 *Supra* note 188, Article 34.
196 *Ibid*, Article 9.
197 *Ibid*, Article 15.
198 *Ibid*, Article 33. For a brief of defense mechanism, see "Poison pills and other defense mechanisms", WIP 2000, *supra* note 4, at 104.
199 See the full text of the *Disclosure Measures* online: <http://www.rcfs.pku.edu.cn/resources/95D79E01EA01D5F0FFC3F08736D1E8885C527028

protect the interests of minority shareholders, the *Disclosure Measures* give more concrete provisions, than the *Securities Law*, on information disclosure regarding the shareholding change in listed companies.[200]

Built on Article 79 of the *Securities Law*, the *Disclosure Measures* have added the "expected change of shareholding"[201] to the circumstances where an acquirer shall perform the disclosure obligations:

(a) when he holds or controls 5 percent of the outstanding shares of a listed company;

(b) when he expects to hold or control more than 5 percent of the outstanding shares of a listed company.

(c) when his shareholding varies by every 5 percent after he has already held or controlled 5 percent of the outstanding shares of a listed company; or

(d) when his shareholding is expected to vary by more than 5 percent after he has already held or controlled 5 percent of the outstanding shares of a listed company.[202]

To perform his disclosure obligations, an acquirer shall submit a report on the changes in shareholdings to the stock exchange, concurrently report to the CSRC and its local agency where the listed company is located, notify the listed company and make a public announcement. The content and format of the Report of Changes in Shareholdings in Listed Companies shall be otherwise regulated by the CSRC.[203] There are two exceptions to the reporting and announcing obligations: (a) if a change of shareholding by less than 5 percent makes an investor's total shareholding in the listed company become less than 5 percent, his

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/16.htm> (date accessed: 2/2/2005).

[200] See Haworth & Lexon, "The legal frame of acquisition of listed companies has been basically formed", *Haworth & Lexon Law Newsletter*, No.10, 2002, 20 October 2002, online: <http://www.hllawyers.com/law-en-newsletter/2002/en-2002-10.htm> (date accessed: 2/2/2005).

[201] An "expected change of shareholding" includes the effect of "a share transfer agreement", "an administrative transfer of shares" or "a court ruling". See *supra* note 199, Articles 21 – 23.

[202] *Ibid*, Articles 15 – 18.

[203] *Ibid*, Article 12.

reporting obligation is exempted but the public announcement is still required;[204] and (b) if a decrease in the share capital of the listed company results in a change of shareholdings, the listed company is required to make a corresponding public announcement and the investor's disclosure obligations are exempted.[205]

Similar to the Takeover Provisions of the *Securities Law*, the investor may not continue to trade the shares of the listed company concerned for a certain period between the date when the disclosure obligations arise and two days following the public announcement.[206]

2.3.6. QFII Rules

On 5 November 2002, the CSRC and the People's Bank of China jointly promulgated the *Tentative Rules on the Administration of Investment in Domestic Securities by Qualified Foreign Institutional Investors* (Hereinafter referred to as the *QFII Rules*), effective as of 1 December 2002.[207] The *QFII Rules* set out a legal basis for the Qualified Foreign Institutional Investors (QFIIs) to access to the A-share market[208].

The QFIIs are referred to as "foreign fund management institution, insurance company, securities company or other asset management institution" approved by the CSRC to invest in China's securities market and approved by the SAFE for an investment quota.[209] However, the eligible threshold for a QFII is very high in terms of financial position, personnel qualification, corporate governance and asset values.[210]

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204 *Ibid*, Article 19.
205 *Ibid*, Article 26.
206 *Ibid*, Articles 15 – 18.
207 See the English translation of the *QFII Rules* online: <http://proquest.umi.com/pqdlink?did=320617891&sid=2&Fmt=3&clientId=10843&RQT=309&VName=PQD> (date accessed: 11/11/2004).
208 See section 3.2.1.1.1.1, below, for more on A-share market.
209 *Supra* note 207, Article 2.
210 *Ibid*, Articles 6 & 7.

A QFII can invest within the investment quota[211] in the RMB-denominated financial instruments, including A-shares, treasury bonds, convertible bonds and corporate bonds.[212] The investments made by QFIIs must comply with the *Catalog*.[213] There are also restrictions on the size and liquidity of such investments. Shareholding "by a single QFII in any one listed company" should not exceed 10 percent, and total shareholding "by all QFIIs in any one listed company" should not exceed 20 percent.[214] In addition, there is a lock-in period of one to three years for the investment quota principal remitted into China. Thereafter, a QFII may apply to the SAFE for the purchase of foreign exchange "in order to remit the principal out of China in installments".[215] Regardless of market performance and business judgment, such restrictions disable the *QFII Rules* to provide foreign investors the expected M&A opportunities via the open market in China.

2.3.7. State Shares Transfer Notice

On 1 November 2002, the CSRC, the MOF and the SETC jointly promulgated the *Notice on Relevant Issues Concerning the Transfer to Foreign Investors of State-Owned Shares and Legal Person Shares of Listed Company* (Hereinafter referred to as *State-Owned Shares Transfer Notice*), effective as of 1 January 2003.[216] The *State Shares Transfer Notice* allows the acquisition of state-owned shares and legal person shares, i.e. non-tradable shares[217] of Chinese listed companies by foreign investors.

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211 The minimum investment quota that a QFII may apply for is US$50 million, while the maximum is US$800 million. See the *Administration of Foreign Exchange for Securities Investments in the PRC by QFIIs Tentative Provisions* issued by the SAFE on 28 November 2002 and effective on 1 December 2002.

212 *Supra* note 207, Article 18.

213 *Ibid*, Article 21.

214 *Ibid*, Article 20.

215 *Ibid*, Article 26.

216 See the English translation of the *State-Owned Shares Transfer Notice*, online: <http://proquest.umi.com/pqdlink?did=320617931&sid=3&Fmt=3&clientId=10843&RQT=309&VName=PQD> (date accessed: 12/12/2004).

217 See section 3.2.1.1.1.2, below, for more on state-owned shares and legal person shares.

The transfer of such non-tradable shares must comply with the *Catalog*.[218] The SETC approval is required in respect of the "industrial policies and enterprise reorganization"[219]; the MOF is responsible for approving matters concerning "the management of state-owned shares";[220] "any major matters" shall be subject to the State Council approval. Without authorization, local governments cannot approve the transfer of non-tradable shares of the listed companies within local jurisdictions. The transfer of non-tradable shares in listed companies shall also comply with the *Takeover Measures* and *the Disclosure Measures*.[221]

To fulfill the principle of protecting state assets, [222] the *State Shares Transfer Notice* provides that the transfer of non-tradable shares shall be conducted "by the method of public bidding" [223], and the transferred shares cannot be legally registered in the name of the foreign investors until full payment for the transfers is made in a "freely convertible currency" or RMB profits from other investments in China. Following the full payment, there is a lock-in period of 12 months before the foreign investors can transfer such shares,[224] which reflects another principle under the *State-Owned Shares Transfer Notice* – "attract[ing] mid- and long-term investment, prevent short-term speculation and protect the order of the securities market".[225]

One of the most controversial provisions in the *State Shares Transfer Notice* is that the listed company after the transfers "shall continue to be governed by the original relevant policies and shall not enjoy treatment as [FIEs]",[226] regardless of the level of foreign ownership therein. This provision appears to contradict the

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218 *Supra* note 216, Article 2.
219 Please note that certain functions of SETC have been assumed by the MOFCOM. See section 2.2.4, above, for more on the restructuring of the State Council.
220 Please note that management of state-owned shares has been transferred from the MOF to the SASAC. *Ibid.*
221 *Supra* note 216, Article 4.
222 *Ibid*, Article 1.
223 *Ibid*, Article 3.
224 *Ibid*, Articles 5 & 7.
225 *Ibid*, Article 1(4).
226 *Ibid*, Article 9.

China's foreign investment regime.[227]

2.3.8. SOE Restructuring Provisions

On 8 November 2002, the SETC, the MOF, the SAIC and the SAFE jointly promulgated the *Tentative Provisions on the Restructuring of State-owned Enterprises Utilizing Foreign Investment* (Hereinafter referred to as the *SOE Restructuring Provisions)*, effective as of 1 January 2003.[228]

The *SOE Restructuring Provisions* set out a general framework for the use of foreign investment to restructure SOEs and their subsequent conversion into FIEs.[229] Except for those sectors prohibited under the *Catalog*, foreign investors are allowed to restructure the non-listed, non-financial SOEs by way of equity or asset acquisitions.[230] Specifically, foreign investors are authorized to participate in the following five types of SOE restructuring:[231]

(1) Foreign investors can restructure an SOE into an FIE by acquiring all or part of the "state-owned property rights" in the enterprise.[232] This provision applies to the SOEs that have not been organized as CLSs and the ownership interest will presumably be stated as a percentage of registered capital.[233]

(2) Foreign investors can restructure an SOE into an FIE by acquiring all or part

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[227] See section 2.2.1, above, for more on the FIE regime. With China's preferential treatment policies, foreign investors actually enjoy supra-national treatment over their Chinese competitors. Recently, China seems to have taken a serious look at its preferential treatment policies. For foreign investors, preferential treatment is not a paramount consideration any longer as they are anxious to be real players in the Chinese market. See *supra* note 106.

[228] See the English translation of the *SOE Restructuring Provisions,* online: <http://proquest.umi.com/pqdlink?did=320618011&sid=6&Fmt=3&cl%20ientId=10843&RQT=309&VName=PQD> (date accessed: 20/12/2004).

[229] *Ibid.* Article 2.

[230] The scope of application expressly excludes listed companies and financial enterprises. *Ibid*, Articles 2, 3 & 6(2).

[231] *Ibid*, Article 3.

[232] *Ibid*, Article 3(1).

[233] *Supra* note 135.

of the "state-owned equity" of the enterprise.[234] This provision permits the transfer of the state-owned shares of non-listed SOEs organized as CLSs.[235]

(3) Domestic creditors can transfer their claims in an SOE to foreign investors and the enterprise is restructured into an FIE.[236] This provision appears intended to permit foreign investors to acquire "non-performing loans" from state-run banks or state asset management corporations and convert such creditors' rights into the equity of the SOE.[237]

(4) Foreign investors can acquire "all or main assets" of an SOE and contribute such assets to establish an FIE alone or jointly with the SOE selling the assets.[238]

(5) An SOE can invite foreign investment to "increase its capital and its shares".[239]

The foreign investor selected should have "the business qualifications and technology level" needed by the SOE to be restructured, "a fine business reputation and management capabilities", and "a solid financial position and economic strengths".[240] The foreign investor is also required to make a restructuring plan, which is part of the restructuring application submitted to the MOFCOM or its local agencies.[241] To improve the "corporate governance" structure and "promote the sustained growth" of the SOE to be restructured, the restructuring plan should include "the development of new products, technical transformation and a related investment plan, measures to strengthen corporate management".[242]

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234 *Supra* note 228, Article 3(2).
235 *Supra* note 135.
236 *Supra* note 228, Article 3(3).
237 *Supra* note 135.
238 *Supra* note 228, Article 3(4).
239 *Ibid*, Article 3(5).
240 *Ibid*, Article 5.
241 *Ibid*, Article 9(1).
242 *Ibid*, Article 5.

One of the principles under the *SOE Restructuring Provisions* is "not prejudicing the lawful rights and interests" of the employees in connection with the restructuring.[243] Where the "controlling interests" or major assets of the restructured SOE are transferred to foreign investors, the parties to the transaction should "formulate an appropriate plan" for employee settlement that should be approved by the employee representative congress of the restructured SOE. Such a plan is also part of "the assignment agreement" to be submitted for government approval. Specifically, for employees laid off in connection with the restructuring, economic compensation should be paid to such employees and required contributions to such employees' social insurance fund should be paid in full to "the social insurance authority".[244] These provisions arise from the government's concern about the "social stability" issue resulting from unemployment in connection with M&A transactions by foreign investors. They appear to give the employees a say over the restructuring and "ensure that employee costs and terms will be a central feature of any privatization investment".[245] However, it is uncertain to what extent the opinion of such an employee representative congress would have a material effect.

2.3.9. M&A Rules

On 7 March 2003, the MOFTEC, the SAFE, the SAIC and the SAT jointly promulgated the *Provisional Rules for Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors* (Hereinafter referred to as the *M&A Rules*), effective as of 12 April 2003.[246] The *M&A Rules* consolidate previous laws and regulations governing the acquisitions of Chinese domestic enterprises by foreign investors and add some new requirements.

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[243] *Ibid*, Article 6(5).
[244] *Ibid*, Article 8.
[245] *Supra* note 135.
[246] See the English translation of *M&A Rules* online: <http://www.helplinelaw.com/law/china/merger-acquisition/index.php> (date accessed: 5/1/2005).

The *M&A Rules* regulate the acquisitions of "domestic enterprise with no foreign investment (Hereinafter referred to as the 'Domestic Company')" by foreign investors. The acquisitions defined in the *M&A Rules* constitute "equity acquisitions" and "asset acquisitions". Equity acquisitions are made either through (a) the acquisition of "equity interest from shareholders of the Domestic Company" by agreement and its subsequent conversion into an FIE; or (b) the subscription to "the increase in the registered capital of the Domestic Company" and its subsequent conversion into an FIE. Asset acquisitions are made either through (a) the establishment of an FIE to acquire and operate the assets of the Domestic Company; or (b) the acquisition of the assets of the Domestic Company and the subsequent contribution of such assets to "establish an FIE to operate such assets".[247]

Besides the acquisitions are subject to the various government approval procedures under the foreign investment regime,[248] the *M&A Rules* also stipulate the required corporate approvals from the stakeholders. In case of equity acquisition, if the target is a LLC, the shareholders must unanimously adopt a resolution approving the equity acquisition; if the target is a CLS, the shareholders' meeting must adopt a resolution approving the equity acquisition.[249] In case of asset acquisition, "the property rights holders or the agency of authority of the domestic enterprise" must adopt a resolution approving the asset acquisition.[250] In addition, as a special requirement for both acquisitions, a plan for the resettlement of employees must be formulated.[251]

The parties to the acquisitions are not entirely free to set the transaction price. The *M&A Rules* require that the transaction price shall be based on the valuation conducted by an asset valuation institution in China agreed on by the parties,

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[247] *Ibid.* Article 2. Despite use of the term "mergers" and "acquisitions", the *M&A Rules* are confined to acquisitions only, and remain silent on mergers.
[248] *Ibid.* Article 6.
[249] *Ibid.* Article 12 (1).
[250] *Ibid.* Article 15 (1).
[251] *Ibid.* Articles 12 (9) & 15(8).

which makes the aggressively low pricing difficult. [252] In practice, however, it is one of foreign investors' concerns whether Chinese asset valuation institutions will and are able to follow the "internationally recognized valuation methods". The most common valuation method in western economies is the "discounted cash flow" technique,[253] whereas valuation method based on "replacement cost less depreciation" is adopted in China.[254] Transaction price "obviously lower than the evaluation result" is expressly prohibited. As far as state-owned equity or assets are concerned, a mandatory valuation is required.[255] This rule repeats Article 13 of the *State Property Rights Transfer Measures* where, if the "state-owned assets and equity transaction price is lower than 90% of the results of a valuation", approval must be obtained from the SASAC before the transaction can proceed.[256]

The *M&A Rules* require that the "full consideration" should be paid within three months after the issuance of the business license. Only under "special circumstances" which are up to the approval authorities' discretion, a first installment of "60% or more of total consideration" should be paid within six months and the balance payable within one year after the issuance of the business license. Although subject to the SAFE approval, a foreign investor could "use any stock it has the right to dispose of" other than cash as "the instruments of payment".[257]

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[252] *Ibid.* Article 8.

[253] See "Business Valuation", *Puget Sound Business Journal* (17 November 1995), online: <http://www.windcap.com/bussinesvaluepress.htm> (date accessed: 2/2/2005).

[254] See "Mergers and Acquisitions in China", *China Update, Squire, Sanders & Dempsey L.L.P.*, May 2003, online: <http://www.ssd.com/files/tbl_s29Publications%5CFileUpload5689%5C8499%5Cchina_update-05-2003.pdf> (3/2/2005).

[255] *Supra* note 246, Article 8.

[256] On 31 December 2003, the SASAC and the MOF issued the *Tentative Administrative Measures of the Transfer of Enterprise State-owned Property Rights* (Hereinafter referred to as the *State Property Rights Transfer Measures*), effective on 1 February 2004. See the full text of the State Property Rights Transfer Measures, online: <http://new.suaee.com/suaee/portal/info/content.jsp?infoid=60669930-4333-11d9-a406-1db87f000001&typeid=6d813540-28bb-11d9-b68d-5a97c0020381> (date accessed: 3/2/2005).

[257] *Supra* note 246, Article 9.

Similar to the provisions of the *Company Law*, the *M&A Rules* have a safeguard provision for the benefits of the target's creditors. The Domestic Company selling assets shall "gives notice to its creditors and makes a public announcement", and the creditors may requests the Domestic Company to provide the appropriate assurance. "Any agreement on the disposition of the creditor's rights and liabilities" reached among foreign investors, the Domestic Company and its creditors shall be submitted to the approval authority.[258] Such strict rules are intended to protect the interests of the creditors which are usually the state-run banks or state asset management corporations.

Most interestingly, the *M&A Rules* incorporate the provisions regarding the pre-merger notification and merger review,[259] which are typically governed by the antitrust law in western jurisdictions. However, there are some critical issues arising from those antitrust provisions, which will be discussed below in detail.

2.4. CHAPTER SUMMARY

China has a "unified political-legal system" where China's legislative, administrative and judicial authorities all have the power to make laws within their respective jurisdictions. With the decentralized structure of the legislative powers, Chinese laws can be divided into the Constitution, laws, administrative regulations, departmental rules, local regulations, and legal interpretations.

Over the last two decades, China has developed a complex system to promote foreign investment. Most of the foreign investments are Greenfield investments in the forms of the EJV, the CJV, the WFOE, or the FCLS. Foreign investors, upon satisfying certain criteria, can use HC or operating FIE to invest in other Chinese entities.

All foreign investments in China, whether Greenfield investments or M&As, are

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[258] *Ibid*, Article 7.
[259] *Ibid*, Article 21.

subject to the industrial policies - the *Investment Guidelines* and the *Catalog,* which divide all industries into four categories: encouraged, permitted, restricted and prohibited.

To ensure full compliance with the industrial policies, the Chinese government takes the responsibility to examine and approve all the foreign investment projects. Proposed foreign investments that will result in FIEs usually go through a multi-level approval process.

With the absence of a uniform M&A law, the laws and regulations governing M&A activities in China have been issued on a piecemeal basis. While the *Company Law* provides general principles for mergers and divisions of companies, the *Securities Law* provides more specific rules regarding takeovers of listed companies. Recently, a series of important regulations with regard to some specific aspects of the M&A transactions have been issued to facilitate the acquisitions of domestic enterprises by foreign investors.

The *M&D Regulations* offer foreign investors a merging vehicle to reorganize their investments in China. The *Takeover Measures* standardize the M&As involving Chinese listed companies and broaden the applicability of the mandatory offer rule. To avoid the inside trading and protect the interests of minority shareholders, the *Disclosure Measures* give concrete provisions on information disclosure regarding the shareholding change in listed companies. The *QFII Rules* for the first time allow the Qualified Foreign Institutional Investors to access to the A-share market. The *State Shares Transfer Notice* allows foreign investors to acquire the state-owned shares and legal person shares of Chinese listed companies. The *SOE Restructuring Provisions* set out a general framework for the use of foreign investment to restructure non-listed SOEs and their subsequent conversion into FIEs. The *M&A Rules* consolidate previous laws and regulations governing the acquisitions of Chinese domestic enterprises by foreign investors and add some new requirements.

3. STRUCTURING M&A TRANSACTIONS

The regulatory developments governing M&A transactions have broadened both the range of targets and acquisition methods. In light of the M&A regime in China, foreign investors can structure the transactions targeting domestic enterprises, i.e. SOEs in most cases, through a merger, an equity acquisition and an asset acquisition.[260]

3.1. Mergers

As mentioned above, Chinese law recognizes two types of merger transactions: "merger by absorption" and "merger by establishment".[261] Following the merger, "the creditor's rights and debtor's liabilities" of the merged entities shall be assumed by the surviving entity or the established post-merger entity.[262] Chinese law does not permit a foreign entity to merge directly with a Chinese domestic entity unless the foreign investor has established a registered presence in form of an FIE in China.[263] To be eligible for a merger, the FIE must have made full capital contributions and have commenced operations.[264] In principle, the merger should comply with the *Catalog* and the post-merger FIEs should also comply with Chinese foreign investment regime.[265]

A merger between an FIE and a Chinese domestic enterprise have been governed by the laws and regulations applicable to mergers between domestic companies since an FIE, established under Chinese law, is itself a Chinese legal entity. In addition, the *M&D Regulations* are also applicable to a merger between an FIE

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[260] For a summary of the deal structure, see *supra* note 135.
[261] See section 2.3.1, above, for more on this topic.
[262] *Supra* note 107, Article 184. See also *supra* note 172, Article 25.
[263] *Supra* note 172, Article 2.
[264] *Ibid*, Article 9.
[265] *Ibid*, Article 5.

and certain Chinese domestic enterprises.[266] By including domestic enterprises in the *M&D Regulations*, the Chinese government may intend to invite foreign investors to use this merging vehicle to restructure the inefficient SOEs, which account for significant portion of Chinese domestic enterprises.[267]

To be eligible for a merger with an FIE, the Chinese domestic enterprise must be organized as an LLC, or a CLS pursuant to the *Company Law*. The parties to a merger must make "full employment" or "proper resettlement" for the original employees of the enterprises to be merged according to the *M&D Regulations*.[268] In the pursuit of preferential treatment, the foreign investors have to hold at least 25 percent of registered capital of the post-merger FIE, though it is relaxed by the *FIE Notice*.[269] The merger is also subject to the *FIE Investment Provisions.*[270]

3.2. Acquisitions

3.2.1. Acquisition of Equity

Baker & McKenzie classifies equity acquisitions into direct and indirect acquisitions, where an acquirer may directly or indirectly acquire the shares or registered capital of a target company.[271] Generally speaking, the foreign investor in an equity acquisition will assume "the creditor's rights and liabilities" of the target company in proportion to its shareholding therein.[272]

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[266] *Ibid*, Article 9.
[267] See P. M. Norton & N. Groffman, "Reorganizing Foreign Invested Enterprises in China: the New Merger and Division Regulations", *Topics in Chinese Law*, O'Melveny & Myers LLP, April 2000, online: <http://www.omm.com/webcode/webdata/content/publications/APRIL_2000.PDF> (date accessed: 1/2/2005).
[268] *Supra* note 172, Article 17.
[269] See section 2.2.2.3, above, for more on FIE with foreign ownership of less than 25%.
[270] *Supra* note 172, Article 19. See also section 2.2.2.2, above, for more on the *FIE Investment Provisions*.
[271] *Supra* note 50 at 5.
[272] *Supra* note 246, Article 7.

3.2.1.1. Direct Equity Acquisition

In a direct equity acquisition, also known as onshore acquisition, the acquirer may acquire shares directly from the existing shareholders of the target company, or acquire newly issued shares directly from the target company. Direct equity acquisitions will be subject to the full approval of the Chinese authorities.[273] If the acquisition results in the injection of foreign capital into a domestic enterprise, the approval for conversion of the target company into an FIE will be required. The target domestic company may be a listed or unlisted SOE.

3.2.1.1.1. Investing in Listed SOEs

Some features of Chinese securities markets should be noted before an assessment of the feasibility of foreign investment in listed SOEs. First, China's stock market was initially launched as an effort to finance the ailing SOEs and improve their performance through public listing.[274] Indeed, 95 percent of all listed domestic companies at the Shanghai and Shenzhen stock exchanges are SOEs.[275] Moreover, China's stock market has been very fragmented as a result of both the inconvertibility of the Chinese currency RMB and the socialist ideology of state ownership. Majority stake of the listed SOEs are non-tradable shares directly or indirectly held by the state, with the rest tradable at the stock exchanges. This complex share ownership system provides limited share acquisition opportunities to private investors.

However, recent regulatory changes have expanded the range of permissible share acquisitions by foreign investors. Acquisitions of shares in listed SOEs are regulated with reference to the types of the shares acquired.

3.2.1.1.1.1. Acquisition of Tradable Shares

[273] *Supra* note 50 at 6.
[274] See OECD, *China in the World Economy* (Paris: OECD, 2003), at 497.
[275] *Supra* note 135.

Tradable shares constitute only about one third of the outstanding shares of the listed SOEs, including A-shares and B-shares. A-shares can be freely traded at two stock exchanges, denominated, subscribed for and traded in RMB. A-shares could be issued to domestic investors only prior to the *QFII Rules*. B-shares are domestically listed foreign capital common shares on two stock exchanges, denominated in RMB, but are subscribed for and traded in foreign currency.[276] B-shares could be issued to foreign investors only.[277] B-share market has been separated from A-share market because of not only the political policy to safeguard the state ownership, but also the technical problem of inconvertibility of RMB.[278]

In fact, B-share market has been significantly marginalized in terms of number of list companies and market capitalization.[279] Traditionally, foreign investment in listed SOEs has taken the form of negotiated minority stakes, and has been for the purpose of establishing a strategic relationship or making a portfolio investment rather than for obtaining the operating control. China does not permit hostile takeovers of listed SOEs through open market purchases or tender offers without the consent of the CSRC.[280]

The *Takeover Measures* and the *QFII Rules* set out, for the first time, the conditions under which foreign investors may acquire the tradable shares of the listed SOEs. Under the *Takeover Measures*, the foreign investors may take over

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[276] See Article 2 of the *Regulations of the State Council on Domestically listed Foreign Capital Shares of Stock Companies* promulgated by the State Council on 25 December 1995.

[277] *Ibid*, Article 4. Chinese investors have been able to subscribe B-shares still in foreign currency since 21 February 2001. See Article 2 of the *Circular of the China Securities Regulatory Commission and the State Administration of Foreign Exchange on Questions Regarding Investment in the B Shares Market by Chinese Residents* issued by the CSRC and SAFE.

[278] See O. Tang, "Certain Issues Concerning Foreign Mergers and Acquisition of Listed Companies in China", *Xianggang Jingji Daobao* (31 August 1998), pp.32-33.

[279] See the Statistical information at the CSRC website: <http://www.csrc.gov.cn/en/statinfo/index1_en.jsp?path=ROOT>EN>Statistical%20Information>Listed> (date accessed: 3/1/2005).

[280] *Supra* note 165, Articles 82 & 89. Note that most listed Chinese companies are SOEs in which the state has retained a controlling interest by holding the non-tradable shares. In such cases, acquisition of all the tradable shares would still not convey control.

Chinese listed companies by agreement, public tender offer or centralized trading on the stock exchange. In addition to respecting the *Disclosure Measures*, a mandatory offer to all shareholders is required beyond the 30-percent shareholding threshold though the CSRC may waive such obligations under certain circumstances.[281] The *QFII Rules* historically provides the legal ground for foreign investors' accession to the A-share market, but there are restrictions on both the size and liquidity of such investments. QFIIs are not permitted to hold more than 10 percent individually or 20 percent collectively of the outstanding shares of any listed company.[282] Considering both that the tradable shares account for at most one-third of total outstanding shares of any listed SOE and that the takeover threshold is 30 percent, those restrictions would limit foreign investors' ability to take over a listed SOE entirely at the open market.

3.2.1.1.1.2. Acquisition of Non-Tradable Shares

Approximately two third of the outstanding shares of the listed SOEs are non-tradable, i.e. shares that cannot be traded on the open market and can be transferred only by private agreement with the CSRC and SASAC's approval. Non-tradable shares include state shares held "by central governmental departments, local government, or authorized institutions on behalf of the State", and legal person shares held by the state authorized entities with a "legal person status"[283]. This rigid separation is designed to prevent state ownership from being lost.[284] Consequently, the state has absolutely retained a controlling interest in all of the listed SOEs.

Foreign investors had been prohibited from acquiring the non-tradable shares in

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281 See section 2.3.4, above, for more on the *Takeover Measures*.

282 See section 2.3.6, above, for more on the *QFII Rules*.

283 See J. Y. Wang, "Dancing with the Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market", online: <http://www.hawaii.edu/aplpj/pdfs/v5-01-Wang.pdf.> (date accessed: 3/2/2005), at 16.

284 See Legal Department of the CSRC, *Zhengquan Shichang Zhuanjia Tan* [Expert Forum on the Securities Market], (Beijing: China University of Political Science & Law Press, 1994), at 24.

the listed SOEs since the State Council Securities Commission issued the *Suspension of Handling Applications for Transfer of State-owned Shares and Legal Persons Shares in Listed Companies to Foreign Investors Circular* in June 1995. However, the ban was relaxed in 2003 pursuant to the *State Shares Transfer Notice*. As a necessary complement to the *QFII Rules*, the *State Shares Transfer Notice* enables foreign investors to effectively take over listed SOEs by acquiring a controlling interest therein. Also, the transfer of non-tradable shares in listed companies must comply with the *Takeover Measures* and the *Disclosure Measures*.

Currently, there are no policies issued regarding under what circumstances non-tradable shares acquired by foreign investors may become tradable in China. Since the potential pressure upon the domestic securities market may be dangerous, the authorities would not approve such conversions in the near future.[285] Consequently, such uncertainty would limit foreign investors' exit options.

3.2.1.1.2. Investing in Non-Listed SOEs

Most of non-listed SOEs are non-major enterprises and small-and-medium enterprises that have not yet finished the establishment of the "modern corporate system" to become listed companies. A significant number of them are operating inefficiently and financially distressed. The tough problems can not be easily solved due to the tight budget of the government.[286] Though the government encourages the adoption of various means to activate the SOEs, it is hard for most of this kind of SOEs to be really privatized or revitalized due to their insufficient net assets against the huge creditors' liabilities and employees' compensation.

In light of such fact, the *SOE Restructuring Provisions* set out a comprehensive

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[285] See H.P. Shi, "Discussion on the Reduction of State Shares Holdings", *Securities Daily*, 24 December 2002. See also Y. Yu, "Li Rongrong Expressed No Proposal for the Tradability of State Shares", *Securities Daily,* 12 November 2003.

[286] Supra note 59.

framework to accommodate different scenarios in restructuring the non-listed SOEs with foreign investment. An acquisition of the equity in a non-listed SOE can be effected through (a) an assignment of the "state-owned property rights" in the SOE to the foreign investors, (b) a sale of "state-owned shares" of the non-listed SOE to the foreign investors, (c) an "increase in the registered capital" to be subscribed by the foreign investors, (d) an issuance of new shares to be subscribed by the foreign investors, or (e) a "transfer of the domestic creditors' rights" in the SOE to the foreign investors for subsequent conversion into an equity interest.[287]

The *M&A Rules* also apply to acquisitions of the equity in non-listed SOEs "with no foreign investment". A foreign investor may either acquire the shareholders' equity by agreement, or subscribe to an increase in the registered capital of a non-listed SOE.[288] In addition, the *M&A Rules* appear to set out the examination and approval procedures for FIEs resulting from the restructuring as required by the *SOE Restructuring Provisions.*[289]

3.2.1.2. Indirect Equity Acquisition

In an indirect equity acquisition, also known as offshore acquisition, the foreign investor acquires the equity of the target company offshore from the target's foreign parent companies. "[N]either the equity holding structure nor the assets of the target company would be directly affected".[290] An indirect equity acquisition would be a viable option when the target business in China is held through an offshore company, but it would apply only in the case of equity acquisitions.[291]

An indirect equity acquisition may be the simplest transaction structure which carries the least administrative burdens in respect of the approval procedures. The

[287] *Supra* note 228, Article 3.
[288] *Supra* note 246, Article 2.
[289] *Supra* note 228, Article 9(3).
[290] *Supra* note 50, at 6.
[291] Asset acquisitions must be made by an established FIE in China and cannot be conducted offshore. See section 3.2.2, below, for more on this topic.

transaction would be conducted in the jurisdiction of incorporation of the offshore parent company and generally not subject to the M&A regime in China except that the *M&A Rules* require pre-merger notification under certain circumstances.[292] If the offshore target is a listed company, the transaction may also be conducted through a foreign stock exchange. Thus, the documentation for an indirect equity acquisition would be consistent with the international M&A practice in western jurisdictions. In addition, corporate approvals may not be required from Chinese joint venture partners or the board of directors of the target company.[293] To avoid China's burdensome regulatory requirements, many foreign investors use offshore holding companies as a special vehicle to facilitate any possible subsequent restructuring of their holdings in China.[294]

3.2.2. Acquisition of Assets

In an asset acquisition, the acquirer acquires selected assets of the target company, which maintains its separate legal existence. Generally speaking, this approach can effectively reduce the foreign investor's risks because the domestic enterprise selling assets shall assume all its original creditor's rights and liabilities[295]. However, an asset acquisition may be more complicated than an equity acquisition since the transaction may involve the transfer of different categories of assets of the target company, "each carrying separate statutory formality requirements". Moreover, transfers of assets may be taxable in China.[296]

Until recently, there has not been much foreign investment made in SOEs in the form of equity acquisitions, because most foreign investors were not interested in taking over SOEs, many of which suffer from high levels of debt, a surplus of employees and onerous social welfare burdens. Instead they would rather form

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[292] *Supra* note 50, at 6. Since 12 April 2003, if certain thresholds are met, indirect acquisitions shall be reviewed by the MOFCOM/SAIC for possible antitrust effects in China. See s*upra* note 246, Article 21.

[293] *Supra* note 50, at 8.

[294] *Supra* note 267.

[295] *Supra* note 246, Article 7.

[296] *Supra* note 50, at 8. Though taxation is a significant consideration in any M&A transaction, it is not a topic covered by this thesis.

joint ventures with SOEs contributing assets useful for the operations. In light of the fact, the *SOE Restructuring Provisions* provide that the restructuring of SOEs using foreign investment includes the sale of all or primary assets of SOEs to foreign investors, who subsequently contribute such assets to establish an FIE.[297] Prior to the *SOE Restructuring Provisions*, it was difficult for an SOE to sell its assets to a foreign investor directly for cash though it was relatively easy to contribute such assets into a joint venture for an equity interest.

The *M&A Rules* has a broader application over asset acquisitions. The Article 2 provides for two methods of asset acquisition of a domestic enterprise by a foreign investor. The first method is that the foreign investor establishes an FIE to acquire the operating assets of the domestic enterprise. The second one is that the foreign investor acquires the assets of the domestic enterprise and then contributes the acquired assets into a newly established FIE.[298] Chinese law generally does not permit the acquisition of domestic assets by a foreign entity unless the foreign acquirer has established "a registered presence in form of an FIE" in China.[299] As the acquiring vehicle, the FIE may be established simultaneously with the asset acquisition. The capital contributions made to the new FIE can be used to acquire the assets directly from the target company.

Although establishment of an FIE for the purpose of asset acquisitions is subject to the approval of the MOFCOM, the acquisition of assets itself is deemed a normal commercial transaction between two Chinese entities and needs no government approval from the perspective of the general foreign investment regime. Some special approvals, however, are required for any transfer of the state-owned assets. Where an SOE transfers its assets, "the State-authorized Investment Institution or the department authorized by the State" is authorized to "undertake the procedures for examination and approval, and the transfer of

[297] *Supra* note 228, Article 3.
[298] *Supra* note 246, Article 2.
[299] *Supra* note 50, at 8.

property rights".[300] In addition, if the price of any state-owned asset is lower than 90 percent of the value assessed by an authorized asset valuation institute in China, the approval from the SASAC or its local agency is required before the transaction proceeds.[301]

3.3. CHAPTER SUMMARY

The regulatory developments governing M&A transactions have broadened both the range of targets and acquisition methods. In light of the M&A regime in China, foreign investors can structure the transactions targeting domestic enterprises, i.e. SOEs in most cases, through a merger, an equity acquisition and an asset acquisition.

Chinese law does not permit a foreign entity to merge directly with a Chinese domestic entity unless the foreign investor has an established FIE in China. A merger between an FIE and a Chinese domestic enterprise have been governed by the laws and regulations applicable to mergers between domestic companies, as well as the *M&D Regulations*.

In an equity acquisition, an acquirer may directly or indirectly acquire the equity of a target company. In a direct equity acquisition, the target domestic company may be a listed or unlisted SOE. Acquisitions of shares in listed SOEs are regulated with reference to the types of the shares acquired. The *Takeover Measures* and the *QFII Rules* set out, for the first time, the conditions under which foreign investors may acquire the tradable shares of the listed SOEs. The *State Shares Transfer Notice* provides opportunities for foreign investors to acquire a controlling interest in the listed SOEs and is a necessary complement to the *QFII Rules*. The *SOE Restructuring Provisions* set out a comprehensive framework to accommodate different scenarios in restructuring the non-listed SOEs with foreign investment while the *M&A Rules* also apply to acquisitions of

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300 *Supra* note 107, Article 71.
301 *Supra* note 256, Article 13.

the equity in non-listed SOEs "with no foreign investment". An indirect equity acquisition may be the simplest transaction structure because the transaction would be conducted in the jurisdiction of incorporation of the target's offshore parent company and generally not subject to the M&A regime in China.

In an asset acquisition, the acquirer acquires selected assets of the target company, while the target shall assume all its original creditor's rights and liabilities. Chinese law does not permit the acquisition of domestic assets by a foreign entity unless the foreign acquirer has established an FIE in China. The *SOE Restructuring Provisions* provide that the restructuring of SOEs using foreign investment includes the sale of all or primary assets of SOEs to foreign investors, who subsequently contribute such assets to establish an FIE. The *M&A Rules* also provides for two methods of asset acquisition of a domestic enterprise by a foreign investor.

4. ANTITRUST ISSUE ARISING FROM M&A IN CHINA

Though China has systematically maintained control over the foreign investments through various FDI laws and regulations, many foreign firms have effectively increased their market shares in China especially since the WTO accession relaxes the large-scale acquisitions of SOEs. As such M&As usually target the established SOEs that play a leading role in their respective industries, foreign firms can rapidly obtain a dominant position in the relevant industry. However, following the M&As, the involved industry generally has fewer competitors, which can harm its competitive structure and "confer monopolistic power upon the surviving firms".[302] Thus, with the concern over the increasing foreign acquisitions of domestic firms that result in market dominance and restrictive practices of some Multinational Companies (MNCs), the Chinese government is stepping up efforts to establish its own antitrust regime.[303]

4.1. MNCs Alleged Competition-restrictive Practices

In May 2004, the Fair Trade Bureau of SAIC published a research report - "The Competition-inhibiting Practices of Multinational Companies in China and Countermeasures" (Hereinafter referred to as the "SAIC Report"), which was submitted by Prof. Jiemin Sheng, Director of the Economic Law Research Institute of Beijing University.[304] The research examined domestic and foreign enterprises from more than six industries including "software, photosensitive material, mobile phones, cameras, tires and soft packaging" in Beijing, Shanghai

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302 See K. J. Hamner, "The Globalization of Law: International Merger Control and Competition Law in the United States, the European Union, Latin American and China", *J. Transnational Law & Policy*, Vol. 11:2, Spring, 2002, online: <http://www.globalpolicy.org/globaliz/law/intllaw/2002/2002intlcomplaw.pdf > (date accessed: 28/10/2004).

303 See also P. S. Mehta, "Competition Policy in Developing Countries: an Asia-Pacific Perspective", *Bulletin on Asia-Pacific Perspectives 2002/03,* online: <http://www.unescap.org/pdd/publications/bulletin2002/ch7.pdf> (date accessed: 8/10/2004).

304 See X. Q. Hu, "Out Comes the Anti-Monopoly Investigation Result", *Xin Jing Bao* [New Capital Daily], 19 May 2004.

and Guangdong province. According to the SAIC Report, some MNCs have taken advantage of the "technology, brand recognition, capital and management" to lessen competition and even abuse their monopolistic power in the involved industries.[305] Some MNCs have exploited the absence of an antitrust law to conduct large-scale horizontal M&As to eliminate competition in the domestic market.[306] The SAIC Report presents several examples of restrictive practices of specific MNCs. Microsoft's personal computer operating system and Tetra Pak's soft drink packaging material each hold a market share of 95 percent in China and were alleged to abuse their dominant positions.[307] Eastman Kodak has rapidly obtained 70 percent share of Chinese photo film market through acquisition of almost all domestic competitors in the late 1990s,[308] and will further consolidate its dominant position after the acquisition of "20 percent of the only major Chinese competitor, Lucky Film Corp".[309]

With China's accession to the WTO, Chinese policymakers are increasingly concerned whether domestic enterprises are able to compete with foreign rivals and many fledging domestic industries can even survive. Most Chinese enterprises are too small in scale and vulnerable to foreign competition. Even some large Chinese companies are relatively small comparing with the global competitors. In 2004, China at best had only 16 firms listed in the *Fortune's Global 500*,[310] most of which have operated in the protected industries, enjoyed preferential treatment as large SOEs and prospered as monopolies or oligopolies.[311] Therefore, while Chinese policymakers have counted on foreign

305 See X. Y. Wang, "Report: Anti-monopoly law vital", *China Daily*, 22 August 2004.
306 *Infra* note 373. See also *Ibid.*
307 *Supra* note 305.
308 See "Perspectives of Mergers of Chinese Firms by Foreign Investors", MOFTEC working Paper, online: <http://www.moftec.gov.cn/article/200302/20030200071550_1.xml> (date accessed: 1/5/2004).
309 See W. Peng et al., "Which MNCs are Suspected of the Monopolization in China", *Xin Jing Bao* [New Capital Daily], 19 May 2004. See also supra note 305.
310 See "The 2004 Global 500", *Fortune*, online: <http://www.fortune.com/fortune/global500/0,15119,1,00.html > (date accessed: 1/4/2005).
311 See P. Nolan & J. Zhang, "The Challenge of Globalization for Large Chinese Firms", UNCTD Discussion Paper, July 2002, online: <http://www.unctad.org/en/docs//dp_162.en.pdf > (date accessed: 1/4/2005).

competition to improve the performance of domestic firms and boost economic growth, they are also concerned that foreign firms may expand too rapidly and gain market powers before domestic firms are well established.

The SAIC Report proposes that the relevant authorities: "(a) make the best of existing laws and regulations to restrain and sanction such restrictive practices; (b) issue new regulations specifically targeted at monopolistic practices by MNCs; and (c) accelerate the promulgation of the *Antitrust Law* (also known as the Anti-monopoly Law)".[312] The widely understood urgency to prevent expansion of foreign investment into dominance is a real spur to China's antitrust legislation. The *M&A Rules* was issued to target foreign enterprises seeking to increase market shares in China through M&As, with specific thresholds triggering pre-merger notification and additional government scrutiny. Many MNCs feared that they would become the law's first targets, since they have consummated and contemplate M&A transactions exceeding the triggering thresholds.[313]

4.2. Antitrust Provisions in M&A Rules

One of the breakthroughs of the *M&A Rules* was introducing China's first antitrust provisions governing M&As (Hereinafter referred to as the *Antitrust Provisions*)[314], generally stating that M&As "shall not create excessive concentration, eliminate or hinder competition, disturb the social economic order or harm the societal public interests".[315] The MOFCOM and the SAIC are authorized to receive the pre-merger notification and review certain transactions for antitrust considerations.

Both onshore and offshore transactions, upon satisfying certain thresholds requirements, are subject to the *Antitrust Provisions*.[316] However, the *Antitrust*

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[312] See Z. Y. Tang, J. Chen & S. Hua, "Towards an Anti-monopoly Law: China Vows to Upgrade its Competition Safeguards", *China Law & Practice* (London: July 2004), at 1.
[313] See R. Buchman, "China Hurries Antitrust Law," *Wall Street Journal*, 11 June 2004.
[314] The *Antitrust Provisions* constitute of Articles 19 – 22 of the *M&A Rules*.
[315] *Ibid.* Article 3.
[316] For the scope of application, see *Ibid.* Articles 2 & 21.

Provisions apply only when there are foreign investors involved in an M&A transaction and even when the foreign investor is not the controlling shareholder following the transaction. As such, the *Antitrust Provisions* virtually provide the Chinese government with a mechanism to protect its SOEs and other domestic firms from the increasing foreign competition as mentioned above.

4.2.1. Pre-merger Notification

The *Antitrust Provisions* distinguish between onshore and offshore transactions and impose different thresholds on each to trigger the reporting obligation and possible antitrust review. If any of the triggering thresholds is reached, the foreign investor is required to submit a report on the proposed transaction to the MOFCOM and/or the SAIC.

Onshore Transactions

Article 19 provides four independent thresholds requiring mandatory notification and review of onshore transactions:

(1) the revenue of a party to the merger or acquisition in the domestic market for the current year exceeds RMB1.5 billion;

(2) the foreign investors have merged with or acquired more than 10 domestic enterprises in aggregate engaging in the related businesses within one year;

(3) the market share of a party to the merger or acquisition in the domestic market has reached 20%; or

(4) the market share of a party to the merger or acquisition in the domestic market will reach 25% as a result of the merger or acquisition.[317]

[317] *Ibid* Article 19.

The aforementioned thresholds look quite straightforward, but they are difficult to measure without definitions for terms such as "market share".[318] As the US and European experiences in merger review suggest, analyzing market definition and market concentration would raise highly sophisticated issues of law and economics.[319] It should be also noted that transaction size itself is not relevant to the mandatory notification thresholds for onshore transactions. Thus, this provision would enable the antitrust authorities to capture even small deals in an economically insignificant industry as long as the parties' combined market share exceeds 25 percent. Moreover, if any of the four thresholds is deemed to independently trigger antitrust review, the MOFCOM and/or the SAIC may review any transaction involving any party with large revenues "regardless of the significance of the market shares or anti-competitive effects involved".[320] Both practices might waste the scarce resources unnecessarily.

Even if the triggering thresholds are not met, the MOFCOM and/or the SAIC may engage in discretionary review of an onshore transaction, at the request of "any competing domestic enterprise, relevant functional department or industrial association", if the enforcement agencies find that the transaction will "involve a huge market share, or if there is any other material aspect of the merger or acquisition which might severely affect market competition, national economy or people's livelihood and national economic security".[321] These broad terms vest the enforcement agencies with enormous discretionary power to check anticompetitive practices, so this provision is criticized for creating the

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[318] *Infra* note 322. Lawyers in China have expressed concern that, because China does not have a developed system for defining relevant market, it is difficult to predict what the market share thresholds will mean in practice. See "Add a Line to the Premerger Notification Checklist: China to Require Notification of Some Acquisitions", *Fried Frank Antitrust and Competition Law Alert* ™, 22 November 2002, online: <http://www.ffhsj.com/antitrust/pdf/alert_021122v2.pdf> (date accessed: 28/10/2004).

[319] See "China Introduces Antitrust Review for Cross-Border M&A", Clifford Chance, July 2003.

[320] See "Anti-Trust Rules Governing M&A in PRC", *China Legal Report*, February 2004, Wenger Vieli Belser Beijing Office, online: <www.ffhsj.com/practice_groups/antitrust.htm> (date accessed: 27/9/2004).

[321] *Supra* note 246, Article 19. Please note that there is no similar discretionary reporting mechanism for offshore transactions.

unpredictability and non-transparency.[322] Nevertheless, another view supports the enforcement agency to be discretionary in their approach and holds that "removing discretionary power through more *per se* provisions could be even worse". [323]

Offshore Transactions

Granting the antitrust authorities extraterritorial jurisdiction, Article 21 provides five separate thresholds for mandatory reporting of offshore transactions:

(1) the assets owned by a party to the offshore merger and acquisition within China exceed RMB 3 billion;

(2) the sales of a party to the offshore merger or acquisition in the domestic market for the current year have exceeded RMB 1.5 billion;

(3) the aggregate market share in the domestic market by a party to the offshore merger or acquisition and its affiliated enterprises has reached 20%;

(4) the aggregate market share in the domestic market by a party to the offshore merger or acquisition and all of its affiliated enterprises in the domestic market will reach 25% as a result of the offshore merger or acquisition; or

(5) as a result of the offshore merger or acquisition, a party to the offshore merger or acquisition will hold, directly or indirectly, equity of more than 15 foreign investment enterprises engaging in the related businesses within China.[324]

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[322] See J. Z. Tao, "China's Emerging Antitrust Regime", *China Business Review*, May-June 2004.

[323] The "*per se* rule" is a judicial principle that an act or practice violates legal provisions simply if the act or practice occurs regardless of whether it is harmful or not. In contrast, the "rule of reason" refers to the judicial doctrine that whether an act or practice violates legal provisions is determined on the basis of its impact and/or other factors. See *supra* note 303.

[324] *Supra* note 246, Article 21.

Meeting any of these thresholds subjects a foreign investor to report the offshore transaction to the MOFCOM and/or the SAIC, either before publicly announcing the transaction plan or simultaneously when submitting the plan to the regulatory authorities in the country where it is located.[325] The scope of potential reporting obligations is even broader for offshore transactions: the pre-merger notification may be still required even if an offshore transaction has "no competitive effect in China", as long as either party has a significant presence in China in terms of market share, sales or assets which exceed the triggering thresholds.[326] Nevertheless, without the corresponding procedural rules applicable to offshore transactions as prescribed in Article 19, the merger control over offshore transactions is virtually unenforceable.

Exemption

Under Article 22, a transaction may be eligible for exemption from the mandatory reporting obligation under any of the following circumstances:

(1) the merger or acquisition may improve the conditions for fair competition in the domestic market;

(2) the merger or acquisition will restructure the enterprise running at a loss and ensure employment;

(3) the merger or acquisition will absorb advanced technologies and management professionals and enhance the international competitiveness of the domestic enterprise; or

(4) the merger or acquisition will improve the environment.[327]

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[325] *Ibid.*
[326] See P. J. Wang & C. Wang, "Chinese Merger Control", *The Asia Pacific Antitrust Review 2004*, online: <http://www.globalcompetitionreview.com/apar/prc_merger_control.cfm> (date accessed: 1/12/2004).
[327] *Supra* note 246, Article 22.

The drafters of the *Antitrust Provisions* seem to ignore an exemption to the "passive minority investments" where the investors would not be interested in exerting control over the acquired entity.[328] Moreover, all the exemptions require the approval from the MOFCOM and/or the SAIC and thus may be subject to substantial administrative discretion.

4.2.2. Antitrust Review Process

The provisions on the antitrust review process appear to apply to onshore transactions only. If any of the triggering thresholds is met and the MOFCOM and/or the SAIC find that the transaction might lead to "over-concentration, impair fair competition or damage consumers' interests", the enforcement agencies will separately or jointly call together "the relevant departments, organizations, enterprises and other related parties" for a hearing within 90 days of the date of receipt of all requisite documents.[329] As the starting point for the 90-day period cannot be ascertained without a clear definition of "all the documents", the hearing dates could be postponed indefinitely. Virtually, the antitrust authorities may decide whether to hold a hearing at their discretion.

Even if a hearing is held, it is not clear whether foreign investors would have the adequate opportunity to defend themselves, as the *Antitrust Provisions* fails to specify the procedures of the hearing as well as the relevant appeal mechanism.[330] After the hearing, the MOFCOM and/or the SAIC will "decide according to law whether to approve the application for the merger or acquisition". This provision is stricter than that in mature economies where the obligation is to notify rather than to apply for approval. Instead, a common practice is to impose a waiting period after which the transaction can proceed absent of objection from the

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[328] *Supra* note 320.

[329] *Supra* note 246, Article 20, but the provisions fail to provide how the MOFCOM/SAIC makes the preliminary determination that the transaction is of competitive concern.

[330] *Supra* note 322. The *Administrative Litigation Law of PRC* "permits a party wrongfully denied approval to seek review either through administrative appeal or by filing an administrative suit" before the People's Court with the appropriate jurisdiction, See *supra* note 326. But Chinese courts may have very limited authority to resolve the disputes involving antitrust matters. See *infra* note 331.

antitrust authorities.[331] Moreover, the *Antitrust Provisions* do not specify what legal principles and analytical methods the MOFCOM and/or the SAIC will consider, so the enforcement agencies would have enormous discretion to examine and review the transactions on an *ad hoc* basis until the birth of an official *Antitrust Law*.[332]

4.3. Rationale of Merger Control

With the absence of an *Antitrust Law* in China, existing laws and regulations have been issued on a piecemeal basis to prevent the most anticompetitive activities found in the transitional economy, but a strong theoretical foundation for the competitive mechanism is currently lacking. Neither the *Antitrust Provisions* nor other Chinese laws currently provide any additional insight into how the enforcement agencies will conduct their antitrust analysis. In order to make sound antitrust policies for China, it is helpful to understand the rationale of merger control.[333]

4.3.1. Basics of Antitrust Analysis

One distinctive feature of the antitrust policy in mature economies is that it is established on the basis of strict economic analysis. Theoretically, an antitrust analysis would assess the structure of the market concerned: in a competitive market, there are many competing firms who cannot "influence the market price individually"; in an oligopolistic market, there are a few competing firms whose power over the market price are constrained by each other; and in a monopolistic

[331] In the US, Hart-Scott-Rodino Act (Clayton Act, 15 U.S.C. § 18a (1994)) requires a transaction be delayed for 30 days (or 15 days in the case of cash tender offer). If antitrust agencies take no action, the transaction can be consummated when the waiting period has expired. See Y. J. Jung & H. Qian, "The New Economic Constitution In China: A Third Way for Competition Regime", Northwestern Journal of International Law & Business, 24:xx (2003), online: (date accessed: 3/11/2004).

[332] *Supra* note 322.

[333] Under the Competition Act of Canada, the "merger" is defined as "… the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase of or lease of shares or assets, by amalgamation or by combination or otherwise of control over or significant interest in the whole or part of a business of a competitor, supplier, customer or other person." See P. S. Crampton, *Mergers and the Competition Act* (Toronto: Carswell, 1990), at 573.

market, there is only one firm who can set the price unilaterally.[334] With the increased concentration of market structures, one or several firms obtain the market power to "raise prices profitably above the levels that would be charged in a competitive market". Abuse of market power usually leads to "higher prices, reduced outputs and poor quality products" at the expense of consumers and should be restricted.[335] A common way to gain market power is through M&As,[336] so it is better to block mergers that would create significant market power than to control market power after mergers are consummated.[337]

"[M]ost mergers do not harm competition seriously and are themselves part of the competitive process"[338] while some mergers would seriously harm competition by significantly increasing the probability of abusing market power. In this regard, horizontal mergers are the most anticompetitive since they directly eliminate the number of competitors in a market;[339] vertical mergers are "less likely to result in a loss of competition" since they do not immediately reduce the number of competing firms in a specific market;[340] conglomerate mergers are considered to pose the least threat to competition because they have "neither horizontal nor

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[334] *Infra* note 337. The use of competitive market processes has proven an effective way to improve economic efficiency, the objective of antitrust law. See, Owen, Sun & Zheng, *infra* note 370, at 21.

[335] See S. Sun, "Antitrust Analysis and Its Enforcement in the United States", *Perspectives*, Vol. 2, No. 3, online: <http://www.oycf.org/Perspectives/9_123100/Contents.htm> (date accessed: 28/10/2004).

[336] *Ibid.* For a discussion of the Market Power Theory explaining the nature of FDI, see Soontiens & Haemputchayakul, *supra* note 7.

[337] See P. Bamford et al., "Chapter 4 Merger", *A Framework for the Design and Implementation of Competition Law and Policy*, (Washington: The World Bank/OECD, 1998), at 41.

[338] The mergers may be procompetitive if they reduce the costs of the merging firms, permitting them to lower prices to consumers. See D. Smith & S. Sun, "Introducing Competition Policy into China", online: <http://www.econs.ecel.uwa.edu.au/economics/Links/papers/aces_sun_su.pdf> (date accessed: 6/6/2004).

[339] *Supra* note 337, at 41 – 42.

[340] However, a vertical merger may enhance a dominant firm's position by increasing the difficulty of entering its market. Such a vertical merger may immediately harm consumers if the potential competition from outside firms was constraining the pricing of the dominant firm. See s*upra* note 337, at 44. The current trend worldwide is to move away from vertical antitrust laws, which is appropriate for a more unified and mature market. But China should establish antitrust laws to supervise vertical restraints strictly, because China's market structure is more fragmented. See *infra* note 366.

vertical components". [341]

"Most merger control laws require pre-merger notification",[342] which provides the opportunity for the antitrust authorities to analyze the impact of a merger on competition before the merger is consummated. Experience has shown that usually only larger mergers pose significant threat to competition, so the law should set a threshold beyond which mergers need be reported.[343] There are two basic stages in merger review. The first is to determine whether the merger raises any competitive concerns. This determination can be achieved without a full analysis, and in most cases the antitrust authorities will not take further action. But if the possibility of competitive harm is identified, a more complete examination is required.[344]

"Most merger control laws are written generally" with the details and definitions left to the antitrust authorities.[345] Some antitrust authorities issue merger guidelines describing how they conduct the antitrust analysis. The U.S. Department of Justice and Federal Trade Commission *Horizontal Merger Guidelines* serve such purposes, elaborating a "five-step process": (1) Market definition; (2) Measurement and concentration; (3) Potential adverse competitive effects of mergers; (4) Entry analysis; and (5) Efficiencies.[346]

4.3.2. Chinese Approach

Antitrust laws differ across countries in terms of their coverage and content,

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[341] *Supra* note 337, at 45.
[342] *Ibid*, at 56.
[343] This does not mean, however, that mergers below the threshold are not subject to the merger control law. The antitrust authorities should retain the power to challenge such mergers, breaking them up after consummation if necessary or preventing their consummation if it learns about them in advance other than through pre-merger notification. *Ibid.* Article 19 of the *M&A Rules* also allows the antitrust authorities to conduct the discretionary review.
[344] *Supra* note 337, at 45.
[345] *Ibid*, at 46.
[346] *Ibid.* See also the Horizontal Merger Guidelines (Issued: 2 April 1992; Revised: 8 April 1997), online: <http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html > (date accessed: 1/4/2005).

reflecting different social, political, cultural and legal traditions.[347] "Every country needs to tailor its [antitrust] law to its own specific set of needs and conditions."[348]

Legal borrowing has obvious attractions for China to develop its antitrust regime.[349] With long history and rich precedents, the U.S. antitrust policy and enforcement experiences are good references for China; with civil law tradition and similar market structure, China also follows the EU antitrust law model "in terms of its basic structure and legal setting"; and with "paramount concerns over administrative monopoly", the Chinese draft antitrust law has much in common with those of Korea and Japan.[350] However, it is unlikely for China to accept any foreign model of antitrust law as its own. With an adaptive legal borrowing, China will develop its antitrust law on the basis of its own needs and traditions.[351]

Effective legal borrowing is not easy because it extracts concepts and institutions from the context in which they are originally used.[352] In order to have a better understanding of the legal mechanisms of a certain country, one must consider its traditions and cultural elements that are "the values and attitudes which bind the system together, and which determines the place of the legal system in the culture of the society as a whole".[353] With an affirmative view of how to achieve a

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347 See P. Lin, "Competition Policy in East Asia: The Cases of Japan, People's Republic of China, and Hong Kong", Working Paper Series, No. 133 (17/02) CAPS, Center for Asian Pacific Studies, December 2003, online: <http://www.ln.edu.hk/econ/staff/plin/2%20Lin-revised.pdf> (date accessed: 8/10/2004).

348 *Supra* note 303.

349 *Infra* note 352. See also Pitman B. Potter, *Globalization and Economic Regulation in China: Selective Adaptation of Globalized Norms and Practices*, Washington University Global Studies Law Review, Vol. 2:119 (2003).

350 *Supra* note 331.

351 The Draft has borrowed experiences from various economies' antitrust laws, and is basically compatible with international practice, according to Yang Wang, Section Chief, Department of Treaty and Law, MOFCOM. See Y. Wang, "The Status Quo of China's Antimonopoly Legislation and the Necessity of International Cooperation", online: <http://www2.jftc.go.jp/eacpf/01/hanoi_seminor.pdf > (date accessed: 8/10/2004).

352 See D. J. Gerber, "Constructing Competition Law in China: the Potential Value of European and U.S. Experience" (2004) 3 Washington University Global Studies Law Review 315.

353 See "Comparative Law: A General Perspective", *Complex Legal Transaction I Course*

well-ordered society, the Chinese tradition has evolved as nearly the polar opposite of the Western individual, rights-based reliance on the rule of law.[354]

Current U.S. law has reduced the legitimate objectives of antitrust law to economic efficiency, whereas such a goal "does not correspond to the political expectations supporting the drive" for an antitrust law in China.[355] "Laws adapted to the market economy must regulate, restrain and safeguard the socialist market economy."[356] The goal of socialist market economy is to develop a market economy, but also to emphasize that "it serves societal needs, securing political and community support for market activities". Issues of economic justice and distributive fairness are politically important in China.[357] In addition to competition elements, the inclusion of socioeconomic considerations in merger review symbolizes Chinese policymakers' intention to balance the market system with collective values.[358]

Given China's political environment and governmental structures, ignoring the political dimension of competition policy would be naïve in the extreme. In China, the administrative bureaucracy has high social status and extensive political power. It would be politically difficult for China to move from an administratively-centered regime to a U.S. court-oriented system. The administrative bureaucracy would tend to hold up the introduction of an antitrust law if that is seen to threaten its power and prestige.[359] Moreover, antitrust law is

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Package, John Saywell, Esq. (ed.), 2004, McGill University.

[354] For more about Chinese tradition and other traditions, see generally Glenn, *supra* note 84.

[355] *Supra* note 352.

[356] See X. Y. Wang, "The Prospect of Anti-Monopoly Legislation in China", *Washington University Global Studies Review*, Vol. 1:201 (2002), at 201-02.

[357] For discussion of contemporary Chinese thinking about antitrust law and prospects for the enactment of an antitrust law, see also *Ibid.*

[358] The antitrust authority shall not grant an approval if a proposed M&A would (1) eliminate or hinder competition; (2) disturb social and economic order; or (3) harm social and public interests. See *supra* note 246, Article 3. Virtually, "every country that has competition policy also has non-efficiency objectives" "as part of the political compromises necessary to maintain stability and consensus among its component interests". See Owen, Sun & Zheng, *infra* note 370, at 21.

[359] *Supra* note 352.

a developing subject in China. These bureaucratic officials would need time and experience to develop their expertise and confidence in the antitrust law system, which allows for a Chinese-style gradual approach.

4.4. China's Antitrust Legislation

4.4.1. The "Long March" Legislation

As part of China's policy of transforming the planned economy into a market system, a mechanism to obtain an efficient allocation of economic resources is a key policy goal, which would be achieved with adequate competition policy and laws.[360] With the absence of an *Antitrust Law*, existing laws and regulations have been issued on a piecemeal basis to address the need to safeguard market competition.[361] Since the proposed *Antitrust Law* was first listed in the legislative plan of the Eighth Standing Committee of the NPC in 1994, more than ten years have passed.[362] With China's accession to the WTO and its economic restructuring in progress, the process of building an effective antitrust law should be accelerated.

As the proposed antitrust enforcement agency will be able to bring antitrust enforcement against government departments of the same or even higher rank, such an institutional arrangement will inevitably "set off power struggles" among different ministries and commissions. Actually, this issue is believed to hold up the promulgation of the antitrust law.[363]

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[360] The main objective of competition policy and law is to preserve and promote competition as a means of ensuring the efficient allocation of resources in an economy. See *supra* note 303. See also Owen, Sun & Zheng, *infra* note 370, at 21.

[361] For a summary of China's emerging legislation on competition, see generally P. Neumann & J. Guo, "The Slow Boat to Antitrust Law in China", online: <http://www.faegre.com/articles/article_1220.aspx> (date accessed: 20/7/2004).

[362] The antitrust law has been again listed on the legislative agenda at the Tenth NPC in its five-year tenure, which ends in March 2008. See *supra* note 305.

[363] Recently, the SDRC joined the MOFCOM and the SAIC to state the responsibility to accelerate the promulgation of the Antitrust Law, but it is difficult to make clear who lead the legislation. See *infra* note 394. See also Owen, Sun & Zheng, *infra* note 370.

The 1993 *Anti-Unfair Competition Law* was China's first competition law.[364] However, the antitrust issues relating to M&As, which are important areas covered by competition laws,[365] are virtually ignored in the *Anti-Unfair Competition Law*. One of the reasons for the absence is that Chinese economy mainly consists of small- and medium-sized firms in the fragmented regional markets and is characterized by a low level of industrial concentration.[366] In order to increase the industry competitiveness and breaks up the market fragmentation, the Chinese government has promoted a national champion policy to create several conglomerates in each pillar industry through directed M&As among SOEs since the 1980s.[367] Mergers as a whole currently do not pose a major anticompetitive threat in China, and the benefits from economies of scale and efficiency gains outweigh the potentially anticompetitive effects of market concentration. In this regard, the introduction of an antitrust law would work against the market integration policy.[368]

Concerns over the treatment of state monopolies and the restructuring of the SOEs may also delay the introduction of an antitrust law. All of China's production used to be undertaken by SOEs, effectively resulting in no competition in most sectors of the domestic market. Over the last two decades, economic reforms pushing China toward a market economy have led to greater effective competition, but SOEs continue to dominate key industrial sectors and enjoy monopolistic or

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[364] The *Anti-Unfair Competition Law* was adopted at the Third Session of the Standing Committee of the Eighth National People's Congress and promulgated on 2 September 1993.
[365] See UNCTAD, *Model Law on Competition*, (Geneva: UNCTAD 2000). According to the Model Law on Competition, competition law covers three main areas: restrictive agreements or arrangements, the abuse of market power, and mergers and acquisitions.
[366] See C. L. Liu, "Competition Laws in A Different Context: Managing Vertical Restraints in The Chinese Transitional Economy", a paper presented at The 5th Annual Conference of the Society of New Institutional Economics at University of California, Berkeley, 15-17 September 2001, online: <http://www.isnie.org/ISNIE01/Papers01/liu.pdf> (date accessed: 17/10/2004).
[367] See *Provisions of the State Council on Several Issues Concerning Further Promoting Horizontal Economic Combinations* issued by the State Council on 23 March 1986; *Guidelines of the Industry Structure Adjustment for the Tenth Five-Year Plan* issued by the State Economic & Trade Commission in October 2001.
[368] See *supra* note 347.

oligopolistic power in the market.[369] Another concern relevant to SOEs may be the "impact of competition on the survival of SOEs" that used to provide the social welfares to their employees.[370] Prior to the establishment of a sound social security system, failing SOEs due to the increasing competition would definitely threaten the social stability.

It may take some time before a consensus is reached among the stakeholders about the best time to introduce an antitrust law. With China's accession to the WTO and the declining dominance of the SOEs in the economy, the attitudes towards antitrust law are changing as well. On the one hand, "Chinese policymakers have recognized the problems created by administrative monopoly" and the challenges posed by foreign acquisitions of domestic firms;[371] on the other hand, the policymakers intend to make China's legal system market-compatible and further attract foreign investment. Thus, promulgation of an antitrust law has become a legislative priority.[372]

4.4.2. The Forthcoming Antitrust Law

Although revised many times during the past decade, the draft *Antitrust Law* has yet to become a law. In March 2004 the MOFCOM submitted another draft

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369 *Supra* note 302. See also Bing Song, "Competition Policy in a Transitional Economy: The Case of China", *Stanford Journal of International Law* Vol.31:387 (1995), at 402.

370 See B.M. Owen, S. Sun & W. T. Zheng, "Antitrust in China: The Problem of Incentive Compatibility", AEI-Brookings Joint Center for Regulatory Studies, September 2004, at 23, online: <http://www.aei-brookings.org/publications/abstract.php?pid=843 > (date accessed: 19/4/2004).

371 *Ibid.*

372 See "Vice Minister Yu Guangzhou: Anti-monopoly Law to be Out in 2005", Network Center of MOFCOM, 26 January 2005, online: <http://yuguangzhou2.mofcom.gov.cn/aarticle/speech/200501/20050100015523.html > (date accessed: 2/2/2005). See also "Antitrust Law in Legislative Pipeline", China Daily, 2 February 2005. But according to the author of the SAIC Report, Prof. Sheng, there is little possibility to pass the Antitrust Law by the end of 2005. On the one hand, the earliest approval by the NPC will be possible in June; on the other hand, the independent antitrust authority is still lacking. See *infra* note 394. According to the *Legislation Law*, the legislative process of the NPC includes the initiation of a bill for legislation, submission of the bill, drafting of the law, examination and review of the draft law by the NPC in session, vote and approval of the law, and publication of the law by an order of the President of the PRC.

Antitrust Law to the State Council to accelerate the promulgation.[373]

Owen, Sun and Zheng discussed and characterized the draft *Antitrust Law* of 2004, to which they had access.[374] Following a "European-style competition regime"[375], the draft *Antitrust Law* is intended to prohibit the competition-restraining practices in the form of all "agreements among enterprises" unless exempted otherwise, the "abuse of dominant position" by enterprises and the "administrative monopoly" particularly relevant to the Chinese economy. However, it fails to "focus on economic efficiency as the primary goal" of the antitrust law.[376]

The draft *Antitrust Law* also includes a chapter regarding merger control, addressing a broader range of antitrust issues than do the *M&A Rules*.[377]

1. The future *Antitrust Law* would probably extend the limited applicability of merger control under the *M&A rules* generally to domestic enterprises.

"A competitive environment, underpinned by sound competition law and policy, is an essential characteristic of a successful market economy."[378] However, given Chinese economy's fragmented structure and low industry concentration, China has not been particularly active in the area of antitrust. Instead, during the long process of negotiating for the WTO entry, the Chinese government has initiated a market integration policy through administrative M&As among SOEs in order to

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373 See "China – Draft Anti-Monopoly Law Submitted to the State Council for Review", *Antitrust & Trade Regulation Update*, July 2004, Squire, Sanders & Dempsey L.L. P., online: <http://www.ssd.com/files/tbl_s29Publications%5CFileUpload5689%5C9042%5CAntitrust%20Update%20072004.pdf> (date accessed: 16/2/2005).

374 An unofficial draft was widely circulated outside China in 2003 and was the subject of a public commentary by the American Bar Association. The 2004 draft was said to have some slightly changes in terms of the enforcement agency. See Owen, Sun & Zheng, *supra* note 370, at 28. See also "Joint Submission of the American Bar Association's Sections of Antitrust Law and International Law and Practice on the Proposed Anti-Monopoly Law of the People's Republic of China", 15 July 2003, online: <http://www.abanet.org/intlaw/divisions/regulation/chin715II.pdf>

375 *Supra* note 370, at 23.

376 *Ibid.* at 28.

377 *Supra* note 326.

378 *Supra* note 303.

increase the international competitiveness of Chinese enterprises.[379] Without sound competition policy and law, however, such mergers would only erect higher barriers to entry against market competition.[380] In this regard, introduction of the *Antitrust Provisions* virtually serves another barrier against the increased foreign competition arising from China's accession to the WTO. Such a competition policy protects the individual competitors unable to compete rather than the competitive process,[381] which will misallocate economic resources and harm the health of the emerging market economy.

The White & Case states that "[t]he WTO, in particular the Trade-Related Investment Measure Agreement, requires that the principles of national treatment and transparency be applied to investment measures put in place by member countries".[382] China's WTO accession should result in a level playing field for both domestic and foreign players, and any rules should apply equally to both domestic and foreign enterprises. As such, it is contrary to the spirit of WTO principles in Article III of the GATT and in the TRIMS for the antitrust provisions under the *M&A Rules* to apply only to the M&As involving foreign investors.[383] Instead, a number of mergers would be justifiable with the WTO

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379 *Supra* note 367.
380 *Supra* note 335.
381 See Thomas B. Leary, "The Economic Roots of Antitrust", a presentation at the International Seminar on Antitrust Law and Economic Development at the Chinese Academy of Social Sciences Institute of Law, Beijing, 1 July 2004, online: <http://www.ftc.gov/speeches/leary/040706rootsofantitrust.pdf> (date accessed: 27/9/2004).
382 See "New Antitrust Rules for Mergers in China", *China Law Bulletin*, November 2002, The White & Case China Practice Group, online: <http://www.whitecase.com/files/tbl_s47Details/FileUpload265/268/china_law_bulletin_11_2002.pdf>, (date accessed: 11/11/2004).
383 GATT requires that WTO Members provide national treatment to all other Members. See Article III of the *General Agreement on Tariffs and Trade (GATT) 1994*, online: <http://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_02_e.htm#articleIII > (date accessed: 16/5/2005). TRIMS also require that "no Member shall apply any TRIM that is inconsistent with the provisions of Article III ... of GATT 1994" though the TRIMs applies to investment measures related to trade in goods only. See Articles 1 & 2 of the *Agreement on Trade-Related Investment Measures (TRIMS)*, online: <http://www.wto.org/english/res_e/booksp_e/analytic_index_e/trims_01_e.htm#article2> (date accessed: 16/5/2005).

accession because "[i]mports can provide an additional layer of competition" even if the merging firms "control a large portion of domestic production".[384]

Moreover, the underlying reason for economic and legal reform in China is to create systems that attract foreign investment and provide "a framework of greater competition to convince foreign investors of China's potential for stable economic growth".[385] Since it is evident that M&As have become a major vehicle for FDI, China cannot afford any policy change that could substantively undermine its current attraction as a destination for foreign investment.[386] Thus, the *M&A Rules* need to be improved in a way that they will serve as an incentive for foreign investors to participate in M&As of domestic enterprises; a modern *Antitrust Law* is urgently needed to ensure fair competition on a national level, without discriminatory effect against foreign investors.

2. The test for merger review in the future *Antitrust Law* will be based on socioeconomic considerations other than anticompetitive effects.

The antitrust authority shall not grant an approval if a proposed transaction would "eliminat[e] competition", "hinder[...] the healthy development of the national economy" or damage the "public interests".[387] As Owen, Sun and Zheng argue, the test criteria are "too vague" and based on non-competition policy factors except for the first element. The proposed test for merger review is actually not consistent with the general antitrust law idea of substantial lessening of competition. However, it is politically difficult for China to move to a policy that will review M&As only for anticompetitive effects. As discussed in the above section, the laws in China must safeguard the socialist market economy, whose goal emphasizes that "it serves societal needs, securing political and community

384 *Supra* note 338.
385 See World Bank, *China 2020 – China Engaged: Integration with the Global Economy* (1997), at 19-21.
386 *Supra* note 320.
387 *Supra* note 370, at 26.

support for market activities". [388] The inclusion of socioeconomic considerations other than anticompetitive effects in merger review symbolizes the intention of China's policymakers to balance the market system with the collective values of Chinese tradition.

3. The adoption of an *Antitrust Law* does not guarantee an effective antitrust regime. "If the enforcement agency is seen as being incapable of discharging its role, people may lose faith in the effectiveness of antitrust law as a whole".[389]

The future *Antitrust Law* would rely on "administrative rather than judicial machinery as its primary enforcement mechanism". [390] The effectiveness of enforcement "depends on the extent to which the enforcement agency is able to act without being constrained or unduly influenced by political forces that might have conflicting objectives".[391] Under the *M&A Rules*, the MOFCOM and the SAIC both have jurisdiction to examine and control the anticompetitive aspects of the M&As. As the two enforcement agencies are in charge of approval and registration of FIEs, an M&A transaction cannot be legally consummated without their approval. From the perspective of enforcement alone, this arrangement is much more effective since an independent enforcement agency does not have the same leverage and power on the M&A participants. Nevertheless, there is no clarity with respect to the division of the responsibilities of the MOFCOM and the SAIC in the *M&A Rules* or any implementation rules.[392] Such institutional

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[388] Supra note 356.
[389] *Supra* note 320.
[390] *Supra* note 370, at 21. The Draft Antitrust Law confers on the enforcement agency a variety of responsibilities, including: issue antitrust policies and rules; investigate matters relating to antitrust provisions under the antitrust law; resolve all matters requiring its approval provisions under this law; investigate market competition conditions; investigate and dispose cases which violate the antitrust law; maintain reports of offenses etc. See *supra* note 331.
[391] *Supra* note 347.
[392] The MOFCOM would presumably deal with enterprises' mergers and administrative monopolies, and the SAIC would be experienced with preventing agreements between firms to create monopolies. See "Country fighting against monopolies", *China Business Weekly*, 5 December 2004.

arrangement would invites confusion in the enforcement process due to different commercial and political interests. The MOFCOM's submission of the draft *Antitrust Law* implies that the antitrust enforcement agency would be housed therein though the draft has not specified so. As the result of government restructuring in 2002, the MOFCOM combines several ministry-level agencies and is generally considered a powerful ministry with jurisdiction over domestic and international trade. Such an institutional arrangement may give the antitrust enforcement agency considerable power and legitimacy. The MOFCOM is one of the drafters and set up an Antitrust Investigation Office in September 2004.[393] Another drafter – the SAIC – also established an Antitrust Section under its Fair Trade Bureau ten years ago. However, in an economy with significant state ownership and administrative monopoly at many levels of government, antitrust enforcement would raise the question of fundamental conflicts of interest. To give it sufficient power and independence, it is better to create a new independent agency directly under the State Council than affiliate itself with any ministry and commission.[394]

4. Another interesting question is how the antitrust provisions in the *M&A Rules* will interact with the future *Antitrust Law*.

The *M&A Rules* aim at regulating the M&As by foreign investors only whereas the forthcoming *Antitrust Law* is designed to create a level playing field for all players. Moreover, the *M&A Rules* is a Department Rule issued by the ministries and commissions whereas the *Antitrust Law* will be adopted by the NPC. According to the legislative hierarchy in China, the antitrust provisions under the *M&A Rules* are only temporary provisions and shall be subordinate to the future *Antitrust Law*. Moreover, the merger control regime under the future *Antitrust Law* would address a broader range of antitrust issues than those under the *M&A*

[393] See "Ministry sets up anti-monopoly office", *China Daily*, 17 September 2004.
[394] See L. M. Zhang, "Struggles for Legislative Power of Antitrust Law among Three Ministries and Commissions Hold up the Promulgation", Beijing Morning Post, 11 January 2005.

Rules. Thus, the *M&A Rules* would be redundant, in terms of antitrust provisions, of the future *Antitrust Law* but it can exist after the enactment of the *Antitrust Law*, except that the antitrust provisions shall be repealed expressly in the *Antitrust Law*. Alternatively, the *M&A Rules* may be revised to delete "any consideration of competition factors" in the antitrust provisions, which should be conducted only under the *Antitrust Law*.[395]

4.5. CHAPTER SUMMARY

Since their entry into the Chinese market, MNCs have rapidly obtained considerable market power through M&As in their respective industries. With the concern over the increasing M&As by foreign investors that result in market dominance and restrictive practices, the Chinese government is stepping up efforts to establish its own antitrust regime.

The *M&A Rules* introduced the first Chinese antitrust provisions applicable to the M&A transactions involving foreign investors. Both onshore and offshore transactions, upon satisfying certain thresholds requirements, are subject to pre-merger notification and possible antitrust review. The antitrust authorities have substantial discretion to review some transactions below the thresholds and exempt others beyond the thresholds. One of the central issues is the limited applicability of the antitrust provisions to the foreign related transactions only, which does not respect the spirit of the WTO national treatment principle. In order to make sound antitrust policies for China, it is helpful to understand the rationale of merger control prevailing in the mature economies, and particularly how the enforcement agencies will conduct their antitrust analysis. Although there are basic principles that are useful to follow when developing a new antitrust law, the specific context of China should be taken into account. Because of some economic and political factors, the promulgation of an antitrust law has been delayed for over a decade. With China's accession to the WTO and its economic restructuring in progress, the process of building an effective antitrust law should

[395] *Supra* note 320.

be accelerated. The merger control regime under the future antitrust law would address a broader range of antitrust issues than those under the *M&A Rules*, but an effective antitrust regime needs more considerations.

5. CONCLUSION

This thesis characterizes and analyzes the evolving Chinese legal regime governing M&As in the context of China's economic reform and the restructuring of SOEs in particular.

M&As are commonly used in mature economies for the purpose of seeking efficiency and competitiveness, and are finding their places in China as a solution to save ailing SOEs. In an attempt to accelerate SOE reform through the utilization of foreign investment, China has made considerable advances during a short period of time in developing a legal framework that standardizes how foreign investors acquire interests in such SOEs. The recent regulatory development has broadened the range of M&A targets and methods. In particular, the *M&A Rules* consolidate the previous regulations applicable to M&As, though some critical issues need further clarity. Unfortunately, its applicability, which is confined to acquisitions involving foreign investors, has limited reach in regulating all M&A transactions and does not respect the spirit of the WTO national treatment principle. Since it is evident that M&As have become a major mode of FDI entry, the *M&A Rules* need to be improved towards serving as an incentive to attract foreign investors to participate in the economic reform in China.

With the accelerating M&A development in China after its accession to the WTO, the Chinese government has recognized the antitrust issues arising from the increasing M&A activities by foreign investors that result in market dominance and restrictive practices. China has taken a big step forward in establishing a modern merger control and antitrust system when it set up the first pre-merger notification system in the *M&A Rules*. Nevertheless, China's merger control regime is still at the infant stage from the antitrust perspective. With the absence of the implementation rules or other guidelines, many issues remain to be clarified, which invite many opportunities for extra-competitive concerns and administrative discretion into the review and decision processes. Until the promulgation of the proposed *Antitrust Law*, there remain many fundamental problems limiting the effectiveness of the current antitrust regime in China.

While its proposed *Antitrust Law* is likely to be promulgated in the near future, China has not yet had a uniform *M&A Law*. As discussed upon the legal system in China, the existing M&A regulations were issued by various departments to meet the urgent need for regulating the emerging subject of M&As, where no *M&A Law* exists. Such legislative delegations allow the NPC and its Standing Committee eventually enact an *M&A Law* when time and conditions are appropriate. The current M&A regime aims at regulating M&As involving foreign investors rather than creating a level playing field for both domestic and foreign actors. In addition, the M&A regulations issued on a piecemeal basis remain a maze even to experienced Chinese legal professions. Thus, a uniform *M&A Law* is required to simplify and clarify the procedures for M&A transactions involving either of domestic or foreign entities. Also expected to be included in the *M&A Law* are some innovative transaction structures legitimately available in mature economies, such as leverage buyout and management buyout. In addition, the *M&A Law* is expected to provide detailed rules with regard to employment settlement, tax arrangement, accounting standard and other practical issues involved in M&As.

Foreign investors undertake M&As in order to enter the Chinese market or expand their business more rapidly and efficiently than Greenfield investments. The mode of entry by way of M&As can be effective only if transactions can be consummated quickly and through reliable and transparent procedures. Unfortunately, China's burdensome multi-agency approval processes and complex industry policies regulating foreign investment remain a major source of delay and uncertainty to the consummation of the M&A transactions. Nevertheless, the need for more foreign investment and the WTO accession commitments will push China to change its legal and regulatory frameworks to accommodate the international business. In this regard, the most significant impact of China's WTO accession may be the relaxation of restrictions on foreign investment in many economic sectors and service sector in particular, which will effectively broaden the range of M&A targets and methods. In addition, a single government agency will be needed to enforce the future *M&A Law*, replacing the current multi-tier government approval process. A larger M&A market would result from simplifying, clarifying and accelerating the M&A approval and screening processes.

Over the past few years, it is fair to say that the Chinese government has made great efforts to honor its WTO commitments. Though a comprehensive market-oriented legal system is yet to be completed, foreign investors now can observe a major difference in the investment environment compared with that prior to China's WTO accession. In the long run, the WTO membership would substantially improve the rule of law and the investment environment in China. With a reliable and transparent legal and regulatory environment where firms with different ownership can compete on a level playing field under fair competition rules, the Chinese market will become even more attractive. Therefore, the recent regulatory development just signals the beginning of a viable framework for M&As in China. It can be expected that as China completes the post-WTO transitional period and its economy becomes further integrated into the world economy, its M&A regime will indeed come closer to international standards and practices, whereupon M&A activities in China will enter a new era.

LIST OF ABBREVIATIONS

CCP	Chinese Communist Party
CCPC	Chinese Communist Party Congress
CJV	Cooperative Joint Venture
CLS	Company Limited by Share
CSRC	China Securities Regulatory Commission
EJV	Equity Joint Venture
FCLS	Foreign-invested Company Limited by Share
FDI	Foreign Direct Investment
FIE	Foreign Investment Enterprise
GATT	General Agreement on Tariffs and Trade
HC	Holding Company
JV	Joint Venture
LLC	Limited Liability Company
M&A	Merger & Acquisition
MNC	Multinational Company
MOFCOM	Ministry of Commerce
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
MOF	Ministry of Finance
NPC	National People's Congress
PRC	People's Republic of China
QFII	Qualified Foreign Institutional Investor
RMB	Ren Min Bi (Chinese Currency)
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SASAC	State-owned Assets Supervisory & Administrative Commission
SAT	State Administration of Taxation
SDRC	State Development and Reform Commission
SDPC	State Development Planning Commission
SETC	State Economic and Trade Commission

SOE	State-owned Enterprise
TRIMs	Agreement on Trade-Related Investment Measures
UNCTAD	United Nations Conference on Trade and Development
WFOE	Wholly Foreign-Owned Enterprise
WIP	World Investment Report
WTO	World Trade Organization

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