Conditional acceptance

Hubert Bazin and David Boitout of Gide Loyrette Nouel outlines how China is handling strategic foreign investment in PRC listed companies

The recent announcement of Chinese sovereign funds taking stakes in groups or banks listed in Europe and the US demonstrates the growing interest of Chinese authorities in the opportunities presented by western capital markets. In 2007 Chinese authorities have approved a few high-profile projects whereby foreign investors will directly acquire equity stakes in companies listed on the PRC stock markets. However, if trends show an increasing integration of China into the global world, investment conditions for foreign companies in PRC listed companies remain far removed from those enjoyed by Chinese companies on European or US stock markets.

The Administrative Measures for Strategic Investment by Foreign Investors in Listed Companies (the Strategic Investment Measures) were issued by the Ministry of Commerce (Mofcom), the China Securities and Regulatory Commission (CSRC) and various other administrative departments on December 31 2005 to reinforce Chinese capital markets that could have been weakened by the reform regarding non-tradable shares implemented in 2005. At that time, Chinese investors were concerned about the flow of newly tradable shares and their impact on stock prices, and Chinese authorities were considering investment by foreign strategic investors as a good way to both absorb part of the formerly non-tradable shares and to stabilize the stock markets. Less than a year after the issuance of the Strategic Investment Measures, the situation has changed, as the reform of Chinese non-tradable shares is already seen as a success, and stock prices have soared up to the unsustainable levels experienced at the end of the 1990s.

It is too early to assess the opening up of Chinese stock markets to foreign investors, but one can identify certain trends and issues that foreign enterprises face when contemplating the acquisition of shares in PRC listed companies. These are mainly related to various pieces of, sometimes inconsistent, regulations – each addressing particular issues arising from the structuring of these acquisition projects, and to a complex administrative approval process.

A complex regulatory framework

Besides the Strategic Investment Measures, various other regulations amended or issued within a few months will structure and implement the acquisition by foreign investors of equity stakes in PRC listed companies. These include: the Administrative Measures of the Share Desegregation Reform of Listed Companies, issued by the CSRC on September 5 2005, the amended PRC Securities Law, effective since January 1 2006, the revised Measures for the Administration of the Takeover of Listed Companies, issued on July 31 2006 by the CSRC and the Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors, issued on August 8 2006 by Mofcom, the CSRC and other administrations. As a result, the legal framework applicable to foreign investors is complex and the various regulations are not always consistent with each other, as some of them specifically address foreign-invested projects and include special approval requirements while others are generic rules for listed companies.

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Foreign companies have long tried to acquire equity stakes in listed companies but were often prevented from doing so by the particular features of Chinese stocks. Specifically, only the so-called B-shares of a few listed companies, denominated in foreign currencies, were officially available to non-Chinese individuals. And only a minority of the A-shares of a listed company were actually listed, around two-thirds of the total shares being non-tradable shares held by the founders of the listed company and/or by government-related companies.

The Chinese authorities invented non-tradable shares in the early 1990s to prevent the uncontrolled sale of state-owned enterprises to private investors. However, this system became a burden in the face of the growing need to develop efficient Chinese stock markets and the mergers and acquisitions market. At the same time the prospect of a big dilution resulting from the conversion of non-tradable shares into tradable shares also posed a threat to investors and affected the performances of the stock markets.

Several unsuccessful experiments to reform the structure of company shareholdings have been undertaken since 2000. In 2005, the CSRC eventually decided to address this issue, and launched its shares desegregation reform, aimed at converting non-tradable shares into ordinary A-shares.

A key feature of the 2005 reform was to impose a minimum 12-month lock-up period on former non-tradable shares, after their conversion into A-shares. Following this period, former non-tradable shareholders who hold more than 5% of the company's shares may only sell a limited number of shares on the market, representing not more than 5% of a company's total shares within 12 months, and not more than 10% within 24 months. In addition to these legal obligations, the holders of non-tradable shares have to negotiate the share desegregation plan at the company's shareholders' general meeting, which often results in free shares being granted to the floating shareholders and in further lock-up period commitments.

Although the Measures on the Shares Desegregation Reform contain provisions for the transfer of commitments made by non-tradable shareholders to new

shareholders, the CSRC seems to have decided to freeze any transfer of such commitments, even if they have been duly approved by the shareholders' general meeting. As a result, investors (including foreign investors) willing to acquire formerly non-tradable shares will have access to a limited portion of the share capital of a listed company until completion of each company's share reform plan.

Structuring acquisition schemes

The Strategic Investment Measures provide that only those listed companies that have implemented the reform of their non-tradable shares may be invested in by foreign strategic investors.

To qualify as a strategic investor, a foreign company must have at least $100 million in tangible overseas assets, or at least $500 million in overseas assets under management. The rules specify that these requirements are satisfied if the investment is carried out by a wholly owned subsidiary of a company that meets these criteria and accepts to be jointly liable with its subsidiary. This possibility introduces a great deal of flexibility for a foreign investor to structure its investment. However, any subsequent sale of a subsidiary that has served as an acquisition vehicle will be subject to Mofcom approval.

To limit the access to the stock exchanges to reputable investors only, the Strategic Investment Measures also require the foreign investor to have a sound financial position, good credit rating and established management experience. The foreign investor must also have a sound governance structure and internal control systems, and not have incurred any sanctions in the past three years. Both foreign investment funds and industrial-type investors are able to comply with these requirements, although the purpose and duration of their investment is clearly different.

In any case, the Strategic Investment Measures provide that the foreign investor must agree to a three-year lock-up period and that its investment must represent at least 10% of the target company's shares. These conditions clearly reflect that, from the perspective of the Chinese authorities, any investment must be made with a view to establishing a long-term strategic partnership.

Only two routes are made available by the Strategic Investment Measures for carrying out a strategic investment in a listed company: the acquisition of existing shares in private transactions; or the subscription to new shares in a private placement. The purchase of shares by a foreign investor on the open market is prohibited at this stage, except through a tender offer if the foreign investor has acquired at least 30% of the share capital of the target company, as a tender offer will be mandatory in this case according the provisions of the Securities Law and unless a waiver is obtained.

Therefore, foreign investors interested in acquiring a minority interest in a Chinese listed company may negotiate private transactions directly with the holders of formerly non-tradable shares, or may be authorized to inject cash into the target company through a private placement.

Those foreign investors interested in becoming the controlling shareholder of the target company, and who have to go beyond the 30% share capital threshold, will be obliged to launch a tender offer, allowing all shareholders to sell their shares at the same price.

In this respect, the introduction of the *partial tender offer* system in the revised Securities Law represents a milestone. Without a partial offer system, an overly successful tender offer launched by a foreign investor could result in the delisting of a target company, which is not the purpose of the Strategic Investment Measures. By launching a partial offer if the investor has reached 30% of the share capital of a listed company, the foreign investor can limit the success of its offer to a certain percentage of the share capital and so guarantee that its investment will not trigger the delisting of the company.

A tender offer system obliges an investor to publicly announce that it will acquire at least 30% of the share capital of a company and to announce at the same time that it will launch a tender offer. The price of the tender offer should be the higher of the price a share paid by the foreign investor in a private transaction and the average of the daily average price recorded in the 30 trading days preceding the public announcement of the takeover. Although it is designed to protect the minority shareholders of the listed company, the

Author biographies

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Hubert Bazin has been a Gide Loyrette Nouel partner since 2001. He has spent almost 10 years of his career in China, and opened the firm's Shanghai office. His experience includes advising foreign investors in numerous transactions with Chinese enterprises and advising Chinese enterprises on their acquisition projects abroad. In the 1990s he was involved in the restructuring of certain Chinese state-owned enterprises. He recently advised a European group in a high-profile acquisition of a Chinese listed company. Bazin was admitted to the Paris Bar in 1991. He holds an Advanced Post-Graduate Degree in International Economic Law, a degree in Chinese language and is a graduate of the Institut d'Etudes Politiques de Paris.

David Boitout
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David Boitout has been the managing partner of GLN's Shanghai office since January 2004. He was a member of the mergers and acquisitions department of the Paris office from 1996 to 2000, before joining the Shanghai office, where he has been based since the end of 2000. Boitout's practice focuses on international mergers and acquisitions, including cross-border acquisitions, joint ventures and corporate restructurings. He has been involved in foreign direct investments and acquisitions in China by prominent European groups from several industries including catering services and the automotive, distribution, manufacturing and chemical industries. His experience within the firm in Paris and in Shanghai has enabled him to develop specific expertise in all matters relating to acquisitions by either share deals or asset deals, in the context of China's rapidly changing regulatory environment. Boitout is recommended by the *Asia Pacific Legal 500*. He was admitted to the Paris Bar in 1998. He holds a postgraduate degree (DEA) in private law (1996) and an honours degree (Maîtrise) in business law (1995).

timing of a tender offer may not be consistent with the schedule of administrative approvals provided for under the Strategic Investment Measures.

The administrative approval process

The Strategic Investment Measures provide that the strategic investment must first be approved by the board of directors of the target company and then by its shareholders' general meeting. After this, the foreign investor must file an application with Mofcom to obtain a preliminary approval for the transaction, which is normally delivered in 30 days. However, Mofcom's review takes longer than this 30-day period. If the seller holds state-owned shares, it has to go through the appraisal and approval process applicable to state assets.

Mofcom's policy is not only to review the principle of foreign investment in a given company or the qualification of the foreign investor pursuant to the criteria set out in the Strategic Investment Measures, but also to carry out an official or unofficial merger control review at this stage of the procedure. As a result, Mofcom may analyze the impact of the contemplated acquisition on the relevant market, and request the opinion of the suppliers, clients or competitors of the target company.

Once it has obtained approval in principle from Mofcom, which is valid for six months, the foreign investor may proceed with the purchase of the shares and their registration with a securities depository and clearinghouse. If the acquisition is structured through a private placement, the target company has to apply for the approval of the CSRC for the private placement. This decision rests with the Public Offering Committee of the CSRC, which is composed of five independent members, who assess how the target company has used the funds raised from its initial public offering, how the investment projects to be financed with the proceeds of the private placement can justify the dilution of the minority shareholders and how the subscriber of the new shares will be prevented from competing with the target company. In this respect, the Public Offering Committee of the CSRC will not consider the acquisition project a strategic investment, but will only focus on checking the compliance of the private placement with CSRC's tight rules, purported to protect minority shareholders.

Should the foreign investor reach 30% of the share capital through the purchase of shares or a private placement, it must apply to the Listed Company Department of the CSRC for a non-objection letter to the tender offer triggered by this situation. The non-objection letter to the tender offer will be issued after review by the CSRC of a tender offer acquisition report, which contains all the necessary details to inform the floating shareholders about the investor, its projects and the way it intends to manage the listed company in the case of a successful tender offer.

The final stage in this process is applying to Mofcom for a final certificate of approval. This complex administrative approval process can take months, and does not always match the particulars of this type of transaction. In addition, administrative authorities reviewing or approving the various documents submitted by the strategic investor or the target company might require amendments, clarifications or additional commitments whatever the previous agreements between the selling shareholder and the foreign acquirer or the resolutions voted by the shareholders' general meeting of the target company.

Sensitive issue

The acquisition by foreign investors of equity stakes in Chinese listed companies remains a sensitive issue, not only for Chinese administrative authorities, but also for the general public, which can express dissatisfaction or even merely oppose the principle of foreign investment in what they consider to be the listed jewels of Chinese industry. The priorities of Chinese authorities may also change according to changes in the political climate and due to the need to attract or to control the flow of foreign capital. Contrary to most previous expectations, bullish stock markets in Shenzhen and Shanghai have followed the reform of non-tradable shares and, as a result, the attraction of foreign capital to the market is no longer an economic priority.

However, the presence of foreign investors in the capital of Chinese listed companies will remain necessary to improve the governance of Chinese listed companies and to contribute to the maturing of Chinese stock exchanges. In any case, foreign groups will probably remain interested in investing in listed companies and future deals might even include exchanges of equity stakes or more sophisticated arrangements. For this reason if for no other, further clarification of the regulatory environment will be necessary sooner or later.