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1200 New Targets: China's New Foreign Strategic Investments Rules

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## 1200 New Targets: China's New Foreign Strategic Investments Rules

For the first time, a broad group of non-Chinese investors can more freely acquire tradable shares of the 1200-plus listed companies with securities traded on the Shanghai and Shenzhen stock exchanges. This is the result of a joint policy announcement by the China Securities Regulatory Commission ("CSRC") and the Ministry of Commerce ("MOFCOM") in October 2005 and the ensuing *Measures on Strategic Investments in Listed Companies by Foreign Investors*, which became effective January 31, 2006 (the "2006 FSI Measures").

The 2006 FSI Measures are integral to China's plan to improve dramatically the efficiency of its stock markets, which have been plagued by two issues since their inception: (1) the poor corporate governance of listed companies and (2) the illiquidity of the large number of nontradable shares held by the state, which account for approximately two-thirds of the stock markets' aggregate value. To address these issues, China in 2005 began promoting a share conversion program under which listed companies are being restructured to convert almost all nontradable shares into freely tradable shares within two years. So far, almost 20% of the listed companies have completed this measure. The 2006 FSI Measures give foreign investors access to those tradable shares.

Key features of the new rules include:

- The 2006 FSI Measures apply to "mid- or long-term strategic acquisition investments" ("strategic investments") by foreign investors in listed companies that have completed the share conversion reform or in new listed companies that become public after the share conversion reform. Shares acquired through a strategic investment may not be transferred during a three-year period following the investment.

- Under the 2006 FSI Measures, foreign investors must be "financially sound, credible foreign legal persons or other entities with significant management experience," a requirement broad enough to include private equity funds. Foreign individuals, however, are excluded.

- A foreign investor must either own at least $100 million of assets or have at least $500 million of assets under management. It may rely on its parent to satisfy such requirements, but such parent must provide an "irrevocable undertaking" to the MOFCOM agreeing to be jointly and severally liable with the foreign investor for the investment. While the 2006 FSI Measures are not entirely clear on this point, the literal language requires the foreign investor to be wholly owned by its parent in order for it to rely on its parent to meet such assets tests. The term "parent" is not defined but presumably does not include an affiliate, i.e., an entity under common control with the foreign investor. Further clarification is needed from subsequent implementing rules or the actual implementing practice of the regulators as to whether an entity that indirectly wholly owns the foreign investor (i.e., a grandparent, great-grandparent, etc.) qualifies as a "parent."

- A foreign investor may either acquire shares from an existing shareholder or acquire newly issued shares from the company. A strategic investment may be made in installments. However, the foreign investor must acquire at least 10% of the outstanding shares of the listed company in the first installment unless otherwise permitted by law or approved by the relevant authority. The 2006 FSI Measures provide little guidance as to how soon the subsequent installment acquisitions must be made or how the three-year lock-up period is measured for an installment acquisition.

- The investor (or the listed company on its behalf) must submit to the MOFCOM an application, a strategic investment plan, the subscription agreement or share transfer agreement, relevant legal opinions, balance sheets for the past three years and other documents. In addition, the investor must undertake in writing to continue to hold the shares to be acquired for a specified period of time (presumably at least the three-year lock-up period). Absent "special circumstances" such as bankruptcy, liquidation or pledge of shares, the investor may not transfer its shares during such lock-up period.

- If the foreign investor acquires at least 25% of the shares of a single listed company and undertakes to maintain at least a 25% ownership of such company for 10 years, the listed company is recognized as a "foreign-invested joint-stock company" (as evidenced by a stamp to such effect on its foreign-invested enterprise ("FIE") approval certificate) and enjoys the preferential tax and other treatment available to FIEs. Presumably, if the foreign shareholding is below 25% (or if the foreign shareholder fails to make such an undertaking), the listed company is not entitled to the preferential FIE treatment, which is consistent with the laws and regulations governing FIEs (the "FIE laws")[1].

- The 2006 FSI Measures do not appear to allow aggregation of multiple foreign shareholders for purposes of the various ownership percentages (although the FIE laws do allow such aggregation). It is not clear whether this non-aggregation approach reflects legislative intent or merely an oversight in drafting which might attract further clarification.

Prior to the 2006 FSI Measures, most foreign investors wishing to acquire an interest in a Chinese listed company could do so only by purchasing nontradable shares from the state.The only exception was the qualified foreign institutional investor ("QFII") program implemented in late 2002, which allows a small number of institutional investors to acquire tradable shares of Chinese listed companies under a quota system. A QFII, however, must satisfy stringent eligibility criteria, including having at least $10 billion of assets under management, and ownership of a listed company is capped at 10% for any single QFII shareholder and 20% in the aggregate. While the 2002 QFII rules remain in effect, the 2006 FSI Measures liberalize the elite 2002 QFII regime beyond recognition and do not impose any specific ownership caps, thus allowing a broad new group of foreign investors to invest more freely in China's stock markets.

[1] In the past, the vast majority of foreign investments in China have been made in the form of privately held equity joint ventures ("EJVs"), cooperative joint ventures ("CJVs") or wholly foreign owned enterprises ("WFOEs"). While EJVs, CJVs and WFOEs remain the primary focus of the FIE laws, China in the past decade began to allow other forms of foreign investment such as foreign-invested joint-stock companies and foreign-invested venture capital investment enterprises. The rules governing such new forms of foreign investment typically incorporate the FIE laws by reference to the extent the FIE laws are consistent with the new rules so as to ensure consistency in the basic treatment of foreign-invested entities created under different rules (e.g., the 25%-foreign-ownership-threshold for purposes of determining the eligibility of a foreign-invested entity as an FIE).

*David Patrick Eich is the senior partner in our Hong Kong office, scheduled to open in the fall of 2006, subject to regulatory approval. Dual qualified in the U.S. and the U.K., he currently resides in London where he focuses on complex private equity transactions in the U.S., Europe and Asia for global financial sponsors. He can be reached at: deich@kirkland.com. James Yong Wang, an attorney in our New York office, focuses on fund formation, private equity and mergers & acquisitions. With both a China and U.S. legal education, he also has extensive experience advising clients making investments with Asian implications. He can be reached at: ywang@kirkland.com. If you have any questions about this article, kindly contact either the Kirkland & Ellis attorneys with whom you normally speak or the authors.*

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## Asian Venture Forum: Tailoring an Asian Strategy to Suit Global Markets

**May 15-17, 2006**
**The Peninsula Hotel, Chicago**
**108 East Superior Street**
**Chicago, IL 60611, USA**

The Asian Venture Forum, organized by the Asian Venture Capital Journal, will address issues facing the region's private equity and venture capital markets. AVF events serve the dual purpose of encouraging an exchange of ideas on industry developments and trends and providing a meeting place for industry participants. Kirkland partner David Patrick Eich will moderate a panel discussion on "Accessing Asian Markets Through Buyouts and M&A."

## 2006 Global Asian Venture Forum: Global Perspective – Local Opportunities

**June 26-28, 2006**
**Grand Hyatt Hotel, Beijing**
**1 East Chang An Avenue,**
**Beijing, People's Republic of China 100738**

The 5th Annual Asian Private Equity & Venture Forum entitled *China: Bridge to a New Global Private Equity and Venture Model* will cover select topics including "China Links in with Global VC Firms: Engine for a New Model" and "GPS: Raising a New China Fund" and the Keynote address "Explaining Private Equity and Venture Capital: Does China Offer a New Global Model - Hyper-Growth and Strong Cash Flow." Kirkland partner David Patrick Eich will speak on the latest opportunities and challenges in Greater China private equity.

## Corporate Law for Intellectual Property Lawyers

**June 2, 2006**
**Gleacher Center**
**450 North Cityfront Plaza Drive**
**Chicago, Illinois 60611-4316**

Kirkland & Ellis is sponsoring the "Corporate Law for Intellectual Property Lawyers" seminar hosted by Law Seminars International. This seminar provides IP practitioners with an understanding of corporate law and other factors driving business transactions. Kirkland partner Neil S. Hirshman will present "Achieving Commercial Objectives While Protecting IP."

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