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CHINA

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Foreword

This OECD report charts China's recent rapid progress in developing a regulatory framework for cross-border mergers and acquisitions (M&As). It examines the challenges that still face the Chinese government in its efforts to encourage inflows of foreign direct investment (FDI) by this route and draws on the experience of OECD member countries to offer a range of policy options to address these challenges.

China has become one of the world's leading destinations for FDI. However, while cross-border M&As have become the dominant form of global FDI flows, they remain a relatively small part of FDI flows into China.

Improving the regulatory framework for cross-border M&A can be of great benefit to domestic as well as foreign investment in China. Cross-border M&As can play an important part in the restructuring of state-owned industries, especially in the old industrial heartland in North East China. The Chinese government has enacted legislation to open the economy to cross-border M&A since the late 1990s, but there is still scope for the regulatory framework in this area to be rendered more open and transparent.

Cross-border M&A transactions could be facilitated by the relaxation of foreign ownership restrictions, greater regulatory transparency and the early enactment of a sound competition law. More also needs to be done to promote good corporate governance and disclosure so that investors considering mergers or acquisitions may conduct effective due diligence. Cross-border M&A can be made easier by further opening of China's capital markets to foreign investors.

This second investment policy review of China follows recommendations made in the first review, which was published in 2003. It forms part of the continuing programme of OECD-China co-operation on investment policies which began in 1995. This programme focuses on developing a mutually beneficial exchange of experience to promote an open and transparent policy framework for investment in China. A rules-based framework can encourage more and better foreign investment while maximising spill-over benefits to the domestic economy, stimulating economic growth and development.

Manfred Schekulin
Chair, OECD Investment Committee

Note by the Editor

This Review, a follow-up to the 2003 investment policy review of China, has been undertaken under the aegis of the OECD Investment Committee as a tool for furthering dialogue and co-operation between the OECD and the Chinese authorities in support of China's reform efforts in the field of international investment.

The Review, which is published under the responsibility of the Secretary-General of the OECD, has benefited from co-operation with the Ministry of Commerce of the People's Republic of China (MOFCOM) and other Chinese government agencies at national and local levels.

The Review also benefited from input from OECD member country governments, private-sector practitioners, and participants in three important events: the 21 February 2005 Changchun OECD-China Launch Conference for the North-East China Pilot Project on Open Policies towards Cross-Border Mergers and Acquisitions; the OECD-MOFCOM Seminar on Open Policies towards Cross-Border Mergers and Acquisitions at the 9th China International Fair for Investment and Trade held on 8 September 2005 in Xiamen; and, the 8-9 December 2005 OECD-China Symposium in Beijing on China's Policies towards Cross-Border Mergers and Acquisitions. It is based on a background study prepared by Kenneth Davies, Senior Economist in the Investment Division of the OECD's Directorate for Financial and Enterprise Affairs, with input from its Competition and Corporate Affairs Divisions.

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Executive Summary

China can benefit from more open policies on cross-border mergers and acquisitions (M&As)

China stands to benefit from more open policies towards cross-border M&As. While cross-border M&A has become the predominant form of FDI in the world, it forms a relatively small – though growing – proportion of China's FDI inflows. China's industrial heartland in the North-East has a high concentration of state-owned enterprises (SOEs) in need of restructuring and technological upgrading. Cross-border M&A can play a much larger part in the economic development of the North East, and the rest of China, alongside other forms of FDI.

The 2003 OECD Investment Policy Review and subsequent further opening to FDI in China

The 2003 *OECD Investment Policy Review of China: Progress and Reform Challenges* recommended a number of policy options to enable China to attract more and better FDI by developing a more open and transparent rules-based investment environment. These options included further relaxation of remaining foreign ownership restrictions, streamlining of foreign investment project approval procedures, better protection of intellectual property rights and stronger rule of law.

Since 2003 China has adopted some measures of further opening to FDI reflecting policy options recommended in the Review, particularly in the streamlining of project approval procedures. In 2003 China also promulgated landmark legislation on cross-border M&A.

Remaining obstacles to cross-border M&A

The OECD's preliminary findings on the investment climate in North-East China indicate that a number of obstacles to cross-border M&A persist in the region and in China as a whole. The regulatory framework for cross-border M&A remains fragmentary, over-complex and incomplete. The Chinese government continues to close off so-called "strategic assets" to cross-border M&A without specifying which sectors are defined as strategic, or why. Foreign ownership restrictions persist and are not wholly transparent; a recent revision of the

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Catalogue for Guidance of Foreign Investment Industries shows no significant liberalisation and additional sectoral restrictions not listed in the catalogues have been announced. Cross-border M&A approval procedures are cumbersome and time-consuming. There is a lack of transparency and disclosure in potential cross-border acquisition targets, reflecting poor corporate governance in Chinese enterprises, rendering effective due diligence difficult or impossible. Chinese methods of valuing a company differ significantly from OECD member common practice. The largely off-market ownership structure of Chinese listed enterprises and the closure of the A-share market to foreign investors have hitherto made takeovers difficult; recent measures have begun to address this problem. The competition framework within which M&A transactions are conducted is inadequate; there is no competition law providing for formal merger control and current merger review does not conform to international best practices in terms of substantive standards and review procedures.

Open policies towards cross-border M&A can benefit domestic as well as foreign investors

More open policies towards cross-border M&A can benefit foreign investors; they can also benefit domestic investors, who face many of the same problems. Domestic enterprises often seek merger or acquisition with a foreign partner to obtain new technology, management techniques, markets and debt cancellation. It is as much in their interests to complete the cross-border M&A transaction as it is in the interests of the foreign investor. Restrictions on foreign ownership which limit cross-border M&A can therefore also be a problem for such domestic enterprises. In addition, many generalised institutional obstacles affect all domestic enterprises just as much as foreign-invested enterprises, for example the widespread lack of corporate transparency.

Recommended policy responses

The Chinese authorities are invited to consider a number of policy responses to these challenges, including: further relaxation of foreign ownership restrictions; increased regulatory transparency; adopting internationally-standard and transparent merger notification procedures; further improving corporate governance; and fully opening capital markets to foreign investor participation. These policy responses may be facilitated by initially implementing them on a pilot basis and then spreading them to the rest of the country if and when they prove successful. North-East China may be an appropriate location for such pilot projects if cross-border M&As are considered an important element in the region's industrial revitalisation.

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Chapter 1

Background to the Review

The 2003 OECD Investment Policy Review of China *pointed out that although cross-border mergers and acquisitions (M&As) had become the main form of FDI flows between developed countries, such transactions remained a relatively small proportion of China's inward FDI.*

It noted that while laws had recently been enacted to enable cross-borde M&As in China, obstacles remained.

In 2005 the OECD conducted a project in co-operation with China to study the development of China's policies towards cross-border M&A. This project took the form of a pilot study of the implementation of these policies in North-East China and culminated in an OECD-China Symposium on China's Policies towards Cross-Border M&As in Beijing in December 2005.

The 2006 Review is based on a background report that was developed during the project and discussed in detail at the December Symposium.

The *OECD Investment Policy Review of China: Progress and Reform Challenges* published in 2003[1] pointed out that although cross-border mergers and acquisitions (M&As) had become the main form of FDI flows between developed countries, cross-border M&A transactions remained a relatively small proportion both of China's FDI inflows and of total M&A transactions, including domestic M&As, in China.

The 2003 Review noted that the Chinese government welcomed cross-border M&As as a way of involving foreign investors in the reform of China's state-owned enterprises (SOEs) and that major laws and regulations enabling cross-border M&As had recently been passed.

Nevertheless, it concluded, several obstacles needed to be tackled to permit cross-border M&As to play a full part in China's economic development, including:

- An incomplete regulatory framework.
- Closure of the A share market to foreigners.
- Complex and unclear approval procedures.
- Protectionism at national and local levels.

It also noted progress and identified remaining problems in related policy implementation areas, including:

- Transparency and disclosure in Chinese enterprises, especially SOEs.
- Upgrading accounting systems and standards in line with international practice and eliminating inconsistencies between different standards and regulations.

A North-East China pilot project to study progress in developing and implementing the regulatory framework for cross-border M&As was launched at a conference in Changchun, in Jilin province, North-East China, on 21 February 2005. This was attended by 130 provincial government officials from North-East China and addressed by speakers from China's national and local government bodies, the OECD Secretariat, legal practitioners from OECD member countries experienced in cross-border M&A transactions in China and Chinese academics.

The OECD undertook a fact-finding mission to Beijing and to the three North-East China provincial capitals (Shenyang, Changchun and Harbin[2]) in April 2005. During this mission, interviews were held with representatives of

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Chinese local governments, OECD member country embassies and consulates, foreign investors and representatives of Chinese enterprises, both private and state-owned, and relevant publications were obtained (see Bibliography).

Following the February launch conference, the OECD established an external advisory group on China investment policies linked by an electronic discussion group. The group provides information and feedback for the current report and may continue to do so for future Investment Committee projects on China's investment policies. Members of the group are listed in Annex A.

A brief questionnaire on the experience of actual and potential foreign acquirers of Chinese enterprises was distributed in July 2005. Facts and opinions gleaned from responses to this survey have been incorporated in the body of this report. The questions are listed in Annex B.

China's policy towards cross-border mergers and acquisitions in relation to the revitalisation of the old industrial bases in North-East China was further discussed at a joint seminar between the Ministry of Commerce of the People's Republic of China (MOFCOM) and the OECD at the 9th China International Fair for Investment and Trade on 8 September 2005 in Xiamen. This seminar was addressed by high-level officials from both the OECD and the Chinese government, as well as by the World Bank and private practitioners.

This report was discussed at the OECD-China Symposium on China's Policies towards Cross-Border Mergers and Acquisitions held in Beijing on 8-9 December 2005. The Symposium brought together a wide variety of stakeholders, including the Chinese government, OECD member governments, the World Bank group, multinational enterprises based in OECD member countries, Chinese enterprises, Chinese and OECD business representative organisations, practitioners in cross-border M&As in China, Chinese academics and NGOs, and the OECD Secretariat. The report has been revised to take account of this discussion, summaries of which appear in relevant chapters below. The project was conducted under the aegis of the OECD's Investment Committee, which provided guidance and direction to the development of the report.

Notes

1. OECD (2003b).
2. The economic situation in these cities and the three provinces is outlined in Chapter 4.

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Chapter 2

The Case for Open Cross-border M&A Policy in China

Removing obstacles to cross-border mergers and acquisitions (M&As) can allow China to receive more and better FDI.

While cross-border M&A flows have become the predominant form of global foreign direct investment (FDI), they remain a relatively small component of FDI in China, though one that is now starting to grow.

China is also engaging in M&A activity in other countries. The acquisition by foreign investors of stakes in Chinese enterprises can greatly assist the latter in developing a presence abroad.

The type of FDI that is appropriate for a specific situation – greenfield or M&A – is best determined by market forces within a well-enforced and coherent regulatory framework. China can benefit from cross-border M&As as it already has benefited from other forms of FDI inflows.[1] Greenfield investment is common in developing countries, while M&A is the main mode of entry into transition economies.[2] China is both a developing country and a transition economy, so it is not inappropriate for it to receive both greenfield and M&A FDI. Removing obstacles to cross-border M&As can allow China to receive more and better FDI.

Most cross-border M&As occur between developed home and host countries with similar cultural and business practices.[3] Although China's business culture remains different from that in the OECD area, the immense change that it has undergone in the past quarter of a century of economic reform has considerably narrowed the gap and is continuing to do so rapidly. In the early years after the adoption of an "open door" economic policy in 1979, most of China's inward FDI came from Hong Kong and the Chinese diaspora, where cultural – including language – affinities played a major role in facilitating investment. As China's business environment has gradually begun to conform to internationally-recognised standards, FDI has come increasingly from other sources, especially OECD member countries, and cross-border M&As can be expected to contribute an increasing share of total inward FDI.

Cross-border M&A flows have become the predominant form of global FDI

Global cross-border M&A flows have been increasing rapidly since the 1980s. In 1982 they accounted for a negligible share of total FDI outflows. After peaking at over 80% of world FDI inflows in 2000, there were sharp falls in 2001-2002, but even in 2002-2003 cross-border M&A sales still represented over half of global FDI inflows.[4]

M&A flows have since the mid-1990s become the main form of FDI flow between developed countries. They have generally played a less important role in developing countries, but nevertheless in 2001 – a year when "megadeals" slowed abruptly in the developed world – the ratio of M&A inflows to GDP was actually higher in developing than in developed countries as developing countries, including those in Asia, have also been receiving increasing quantities of FDI in the form of M&A. A major reason for this increase is economic liberalisation in developing countries, which in the 1990s entailed large-scale sales of state-owned assets to reduce the role of the state in running the economy and cut the budget deficit.

By contrast, cross-border M&As remain a relatively small component of FDI in China

In China, cross-border M&A sales have increased in recent years but remain a small proportion of total FDI inflows. In 2003, China became the largest recipient of FDI in the world, receiving an inflow of USD 53.5 billion.[5] This represented 9.6% of global inflows for that year totalling USD 559.6 billion. By contrast, cross-border M&A sales in China that year were only 1.3% of the global total. While cross-border M&A sales represented 53.1% of total FDI inflows worldwide, in China this proportion was 7.1%[6] (see Table 2.1).

Table 2.1. **Cross-border MA in China and the world**

	2000	2001	2002	2003
Cross-border M&A sales as % of world FDI inflows	82.4	72.6	54.5	53.1
Cross-border M&A sales as % of China FDI inflows	5.5	5.0	3.9	7.1
China's FDI inflows as % of world total	2.9	5.7	7.8	9.6
China's cross-border M&A sales as % of world total	0.2	0.4	0.6	1.3

Source: UNCTAD.

Cross-border M&A is starting to increase in China

This situation may, however, be rapidly changing. China's official FDI statistics do not routinely cover cross-border M&A transactions, so precise statistics are not available. Some private-sector analysts produce estimates based on surveys that may be incomplete but are likely to cover larger deals. One such source estimates that cross-border M&A deals in China (*i.e.* those involving foreign companies) totalled USD6 billion in 2003 and USD18 billion (*i.e.* nearly one-third of total FDI inflows) in 2004.[7] These statistics may exaggerate the trend, since they are likely to include assets which are not part of the acquisition transaction, but they nevertheless indicate that cross-border mergers and acquisitions are becoming a significant element in China's FDI inflows.

China is also engaging in M&A activity in other countries

At the same time, Chinese enterprises are becoming increasingly active in acquiring assets and equity overseas. In the 1990s, such activity largely took the form of purchases intended to secure supplies of raw materials for Chinese manufacturers. This situation is now changing: targets of overseas acquisitions by Chinese enterprises now increasingly involve manufacturers using more advanced technology than is already in use by the acquiring company, who can also use the acquisition to expand market share abroad. Prominent transactions in 2004 included the acquisition of ownership by Chinese enterprises in a number of prominent OECD member country enterprises, including Thomson, Alcatel, Ssangyong Motor, Global Crossing and Hynix Semiconductor. In December the Lenovo Group, China's largest computer manufacturer, purchased IBM's personal computer manufacturing business; this was the largest foreign acquisition by a Chinese enterprise to date (USD 1.75 billion, spread between cash payment, payment in Lenovo shares and the assumption of IBM liabilities to creditors). Statistics for China's outward FDI as a whole are incomplete[8] and regular statistics on outward M&As are not yet available. MOFCOM is understood to have instituted a reporting system for outward M&A deals in mid-2005 that will eventually lead to the publication of fuller data.

From January 1994 China's currency, the renminbi, was pegged to the US dollar at a rate of approximately CNY 8.3 = USD 1. On 21 July 2005 the People's Bank of China, China's central bank, announced that the peg had been abandoned in favour of a link to a basket of currencies of China's main trading partners.[9] Under the new exchange rate arrangement, the renminbi was initially set at CNY 8.11 = USD 1, representing a relatively modest appreciation, but with continuing high net inflows of foreign exchange it has already appreciated by more than this (by March 2006 the rate had reached CNY 8.04 = USD 1) and it is likely that it will rise further against major world currencies. This will lower the cost of acquisitions abroad for Chinese enterprises.

The acquisition by foreign investors of stakes in Chinese enterprises can greatly assist the latter in developing a presence abroad. Multinational enterprises outside China are generally more experienced in operating in those areas of the world that are the main targets of China's outward FDI. Cross-border M&A can therefore allow foreign investors to contribute to Chinese enterprises not just technology and management know-how but also a greater understanding of how to survive and prosper in a wide range of investment environments, including their home territories. They can also share their experience of co-ordinating the subordinate units of a global business to enhance its efficiency and profitability.

Notes

1. For evidence of the beneficial impact of FDI on China's economy, see OECD (2000a).
2. OECD (2001).
3. OECD (2001).

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4. OECD (2003a). The seminal article, *Trends and Recent Developments in Foreign Direct Investment*, in the OECD's *International Investment Perspectives 2003* is the main source for the statistics and analysis in this section.
5. Ministry of Commerce, People's Republic of China.
6. UNCTAD Web site *www.unctad.org*.
7. Dealogic, quoted on the Price, Waterhouse, Cooper Hong Kong Web site *www.pwchk.com*.
8. Existing data are summarised and analysed in OECD (2005b). Figures up to end-2004 appear in Annex C.
9. The largest weightings are for four currencies, the US dollar, the euro, the yen and the won. Other currencies in the basket include the Canadian, Australian and Singapore dollars, the Thai baht, the pound sterling and the Malaysian ringgit.

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Chapter 3

China's Regulatory Framework for Cross-border M&A

Legislation on cross-border M&A has developed rapidly in China in recent years, starting with regulations on the participation of foreign investors in the restructuring of state-owned enterprises (SOEs) in 1999 and culminating in landmark provisions on the merger and acquisition (M&A) of domestic enterprises by foreign investors in 2003.

Despite the enactment of this legislation, procedures by which foreign investors may merge with or acquire Chinese entities are still not wholly transparent. Approvals procedures remain based on those for foreign-invested enterprises (FIEs) in general and include the same elements of non-transparency. The competition framework remains inadequate. Institutional weaknesses, such as poor corporate governance and disclosure, constrain cross-border M&A activity.

Cross-border M&A is defined as a transaction in equity and/or assets that takes place between two entities belonging to different economies. The key test of whether a transaction is cross-border M&A is therefore whether it involves the transfer of ownership of equity or ownership of assets from one party to a party based in another economy. The acquisition of the equity of an existing domestic enterprise by a foreign-invested enterprise is clearly cross-border M&A. Purchase of equity may be by purchase of shares on a stock market or by private purchase, whether paid for in cash or in shares. Similarly, the acquisition of the assets of a domestic enterprise by a foreign-invested enterprise (FIE) is cross-border M&A. Another instance of cross-border M&A is the buying-out of the domestic partner's share of a joint venture to produce a wholly-foreign-owned enterprise (WFOE).

Mergers and acquisitions between partners which are both domestic enterprises, even when conducted outside China's economic jurisdiction, are not cross-border M&A, since these do not involve a cross-border transfer of ownership of equity or assets. Inclusion of such deals may inflate the cross-border M&A statistics quoted by some sources. Mergers between FIEs that do not involve domestic enterprises, such as the consolidation of wholly-foreign-owned-enterprises, are also not cross-border M&A. Consolidation of joint ventures is cross-border M&A if it involves the buying-out of one or more Chinese partners.

The types of M&A transaction currently available to foreign investors are:

- **Direct acquisition.** An acquisition may, subject to prior approval, take place within China by the acquiring enterprise purchasing all or part of the non-listed equity interest of the domestic Chinese enterprise directly from one or more of the investors in the latter. Alternatively, an enterprise may be acquired by subscription to the requisite proportion of an increase in the target enterprise's capital. Foreign investors may also, from 1 January 2006, purchase A shares of listed companies which have undergone share segregation reform[1] through transfer by agreement or private placement, but trading in such shares by foreign investors remains subject to restrictions.
- **Indirect acquisition.** An acquisition may take place outside China by purchasing shares of the parent company of a Chinese enterprise listed on a stock exchange outside China's economic jurisdiction, typically Hong Kong (China).

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- **Asset purchase.** An existing or newly-created FIE may purchase some or all of the business assets of a domestic Chinese enterprise.
- **Debt-equity conversion.** Foreign investors may acquire domestic creditors' rights in an SOE, enabling them later to convert such debts into equity.
- **Merger.** Mergers may be by absorption, in which the absorbed enterprise is dissolved and its registered capital and assets merged into the new entity, or by new establishment, in which both enterprises are dissolved and a new company established incorporating registered capital and assets from them. The foreign party in such a merger must be an established FIE.

Legislation on cross-border M&A has developed rapidly in China in recent years

Legislation covering the acquisition of Chinese enterprises by foreign investors has developed rapidly in recent years. At the beginning of the economic reform period in 1978, the primary form of ownership of productive assets was public ownership in the form of state ownership of most of the urban economy, including industry and public utilities, and collective ownership (the rural people's communes) in the agricultural sector. The development of the private sector and of foreign-invested enterprises in the 1980s was accompanied by changes that resulted in the establishment by the late 1990s of an incomplete and not totally coherent legislative framework. The role of foreign investors within this framework was constrained within specific categories of foreign-invested enterprise, including contractual joint ventures, equity joint ventures and wholly-foreign-owned enterprises. At the same time, the Chinese authorities strove to develop bankruptcy laws and procedures as a core element in the restructuring of inefficient state-owned enterprises. By the late 1990s government policy had moved from a sole concentration on the use of foreign investment to create new enterprises, *i.e.* greenfield investment, towards acceptance of the acquisition of Chinese enterprises, or their assets, by foreign investors as part of the process of industrial restructuring. A major factor limiting this development was, however, the lack of a clear statement of policy and of a coherent body of laws and regulations governing cross-border M&A activity. Uncertainty surrounded not only the procedures for the acquisition of a Chinese enterprise by a foreign investor but also the procedures for merging or splitting foreign-invested enterprises within China.

Since the late 1990s, much has been done to fill the gap with legislation covering major areas of cross-border M&A activity.

1998: first regulations on participation of foreign investors in SOE restructuring

Provisional Regulations on the Use of Foreign Investment for the Asset Restructuring of State-Owned Enterprises (SOEs) were promulgated in September 1998. These regulations were limited in scope and could not therefore dispel uncertainty about the procedures for acquiring SOEs. Nevertheless, a significant number of acquisitions, mostly of small and medium-sized SOEs, did take place at local level as a result.

Regulations on merger and division of FIEs were first issued in 1999

In 1999 a set of Regulations on the Merger and Division of Foreign-Invested Enterprises[2] was issued jointly by the then Ministry of Foreign Trade and Economic Co-operation (MOFTEC, now the Ministry of Commerce, MOFCOM) and the State Administration of Industry and Commerce (SAIC); these regulations were amended and re-promulgated in 2001. These regulations specified procedures for merger and division of Sino-foreign joint equity ventures and Sino-foreign contractual enterprises with the status of a legal person, wholly-foreign-owned enterprises, and foreign capital companies limited by shares. An important feature was the stipulation that such mergers and divisions must not alter the effect of application of China's industry policy, *i.e.* the catalogues for guiding foreign investment, or the entitlement of either the target or the acquiring enterprise to benefit from FDI incentives.

The 2002 Takeover Code

The China Securities Regulatory Commission (CSRC) issued the Measures for Administration of the Takeover of Listed Companies (hereafter referred to as the Takeover Code) on 28 September 2002.[3] The Takeover Code came into effect on 1 December 2002. These Measures supplement Chapter 4 (on the takeover of listed companies) of the 1998 Securities Law.[4]

The Takeover Code governs the acquisition of shares in a PRC listed company actually or potentially giving the purchaser control over the company. Control is defined as having control over at least 30% of the issued shares of the company, including unlisted shares. The Takeover Code applies equally to domestic purchasers and foreign investors. Listed companies may be acquired by agreement, through a public offer or directly through the stock market. Consideration for such acquisition does not have to be paid in cash, so share swaps are possible. A party intending to purchase shares sufficient to give it a shareholding of over 30% of outstanding shares must make an offer to all shareholders, unless a waiver is granted by the CSRC.

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Foreign purchases of state-owned shares of listed companies

In November 2002 the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission (SETC) issued a Notice on Transfer to Foreign Investors of State-Owned Shares and Legal-Person Shares of Listed Companies.[5] This notice permits foreign acquisition of shares by open competitive bidding of public Chinese companies held by state-owned entities and other institutional investors not otherwise freely transferable under Chinese securities laws. Foreign investors may re-sell such shares 12 months after paying for them. No public company may become eligible for preferential treatment accorded to foreign-invested enterprises – such as tax incentives – as a result of such a purchase. In the same month, a notification on the transfer to foreign investors of state-owned shares and legal-person shares of listed companies was issued by MOFTEC (now MOFCOM), the Ministry of Finance, the State Assets Supervision and Administration Commission (SASAC) and the CSRC.

Qualified foreign institutional investors (QFIIs)

The position of foreign institutional investors was clarified to some extent by the promulgation of Tentative Rules on Administration of Investment in Domestic Securities by Qualified Foreign Institutional Investors[6] by the CSRC and the People's Bank of China (PBoC), also in November 2002. These rules established a new category of qualified foreign institutional investors (QFIIs), including fund management institutions, insurance companies, securities companies and commercial banks, who were allowed to invest in the domestic Chinese securities market from 1 December 2002. QFIIs must meet requirements regarding length of operation, size of assets under management, must invest at least 70% of their portfolios in stocks and each must appoint a Chinese commercial bank as its trustee and a domestic securities company to execute investment orders. More specifically, to attain QFII status:

- ***Fund management institutions*** must have conducted fund management business for over 5 years and their assets under management in the latest accounting year must be no less than USD 10 billion.
- ***Insurance companies*** must have conducted insurance business for over 30 years, with actually paid-in capital of no less than USD 1 billion and securities assets managed in the latest fiscal year must be no less than USD 10 billion.
- ***Securities firms*** must have conducted securities business for over 30 years, with actually paid-in capital of no less than USD 1 billion and securities assets managed in the latest fiscal year of must be no less than USD 10 billion.

- ***Commercial banks*** must have total assets that rank among the top 100 in the world in the latest fiscal year and securities assets managed must be no less than USD 10 billion.

2002 regulations on using foreign investment to restructure SOEs

On 8 November 2002 Tentative Regulations on Using Foreign Investment to Restructure State-Owned Enterprises[7] were issued by SETC, MoF, SAIC and the State Administration of Foreign Exchange (SAFE). These regulations are more explicit and precise than the preceding set issued in 1998. They elaborate procedures for the transfer to foreign investors, from 1 January 2003, of shares, assets or other rights held by SOEs by open competitive bidding. Under these regulations, restructuring plans must be examined and approved by the SETC and transfer agreements examined and approved by the MoF. Foreign transferees may use legitimate renminbi income from other investments in China or other property rights to pay the transfer price, subject to SAFE approval. The foreign investor may establish a foreign-invested enterprise (FIE) by acquiring: all or part of the state interest in an SOE; all or part of the state shares in a company with state interests; debt owed by an SOE to domestic creditors; all or the majority of the assets of an SOE; or an equity stake in an SOE. To qualify for participation in the restructuring of an SOE, the foreign investor must: possess the business qualifications and technical expertise required by the SOE; be in the same line of business as the SOE being restructured; have a sound business reputation and management capabilities; have a solid financial position; possess advanced technology and management expertise; and must be capable of introducing sound corporate governance practices.

A partial landmark: the 2003 Interim Provisions

By end-2002, the above-mentioned regulations formed a fragmentary legislative patchwork for the acquisition of Chinese businesses, mainly SOEs, by foreign investors. What was lacking was an overall framework. An attempt to provide such a framework was made on 7 March 2003, when MOFTEC (now MOFCOM), the State Administration of Taxation (SAT) and SAIC jointly issued the Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.[8] These rules, effective from 12 April 2003, set out requirements and procedures for the acquisition of domestic enterprises (not just SOEs) by foreign investors. As already set out in the rules for the merger and division of FIEs in 1999, the rules specified that industrial policy applies, in the form of the foreign investment catalogues. The capital contribution of the foreign investor is normally at least 25% after acquisition, but the authorities now have the power to approve a new FIE with less than 25% foreign ownership (such an enterprise must specifically registered as a "FIE with less than 25% foreign equity" and does not qualify for favourable tax treatment). This marks a major departure from the stipulation in the 1979 Equity Joint Venture Law that an FIE must have at least 25% foreign investment. The new FIE inherits obligations to creditors of the target domestic enterprise. Transaction prices must, according to the new rules, be determined by assets appraisal agencies. The acquisition must normally be paid for in full within 3 months, although under some conditions this limit may be extended to 6 months. The rules also stipulate a maximum amount of total investment in each FIE acquisition.

The 2003 Interim Provisions represent a legislative landmark in the regulatory framework for cross-border M&A in China. They clarify many issues that had previously been uncertain and reduce the scope for discretionary powers. However, since they only cover a limited subset of issues governing such transactions, they do not provide a comprehensive regulatory framework.

Anti-trust provisions

Under the 2003 Interim Provisions, mergers or acquisitions affecting Chinese markets must be reported to MOFTEC (now MOFCOM) and SAIC if either party to the transaction has annual revenue in China exceeding CNY 1.5 billion (approximately USD180 million at the current exchange rate), if either party has acquired cumulatively 10 enterprises in related industries in the previous year, if either party has a market share of over 20% in China, if the combined market share of the parties would exceed 25% in China or if a competitor requests a review and the transaction would affect competition. As discussed below, such market-share thresholds may not provide objectively quantifiable criteria and are therefore not wholly transparent.

Transactions that may have a negative impact on competition may be subject to an anti-trust hearing within 90 days of notification. A party to an M&A transaction may apply to MOFCOM and SAIC for exemption from the requirements of the anti-trust regime if:

- The proposed M&A transaction can improve the conditions for fair market competition.
- It involves the reorganisation of loss-making enterprises and helps to increase or maintain employment.
- It will improve the competitive edge of enterprises in the international market place by introducing advanced technology and management.

  or if

- It will improve the environment.

One of the thresholds for reporting a proposed merger includes overseas mergers that do not involve the direct transfer of any equity interest, shares or assets of a company established in China. The criterion that as a result of the transaction a party will directly or indirectly hold an equity interest in more than 15 foreign-invested enterprises may not provide a consistent indicator of possible over-concentration in all sectors of the economy. In sectors such as retailing and restaurants, where enterprises tend to be small and numerous, this criterion appears unlikely to be a sufficient indicator that a proposed merger or acquisition is likely to cause excessive concentration in the domestic market, impair competition or harm domestic consumers. These thresholds appear to discriminate against foreign investors.

M&A antitrust reviews are reportedly suspended pending finalisation of the new competition law (see below). Filings are being made and data gathered, but no follow-up action is yet being taken.

Tax treatment of cross-border M&As

The State Administration of Taxation (SAT) in May 2003 issued a Circular on Tax Matters Related to Merger or Acquisition of a Domestic Enterprise by a Foreign Investor.[9] The circular grants rights to favourable tax treatment to new FIEs formed after such M&A, provided the post-acquisition foreign equity is at least 25% of the total.

Purchase of A shares by foreign investors permitted from 2006

On 31 December 2005, MOFCOM, CSRC, SAT, SAIC and SAFE issued Administrative Measures regarding Strategic Investment in Listed Companies by Foreign Investors, effective from 31 January 2006. These measures allow foreign investors to purchase the A shares of listed companies which have completed share segregation reform or of companies which listed after share segregation reform. Purchase shall be through transfer by agreement or private placement. Trading of A shares by foreign investors is still subject to restrictions, such as a three-year lock-up period after the completion of a strategic investment. However, when a foreign investor is required to make the acquisition by way of general offer in accordance with the Securities Law, it can purchase A shares offered by other shareholders during the offer period.

Challenges for further policy development and implementation

Despite the enactment of the legislation described above, procedures by which foreign investors may merge with or acquire Chinese entities are still not totally transparent.

The approvals process for new FIEs formed by merger with or acquisition of a Chinese company, whether it is an SOE or a private enterprise, as set out in the 2003 M&A rules, remains based on the procedure for approving and registering an FIE and therefore shares the same elements of non-transparency. Although there are time limits for approval, it is nevertheless possible for local authorities, who may have a direct financial interest in domestic enterprises that fear competition from the FIE that would result from the proposed merger or acquisition, to delay it until the last minute.

The competition framework within which cross-border M&As are conducted in China remains inadequate. There is no competition law, current substantive standards for merger review do not conform to internationally-recognised standards, and review procedures are not transparent or consistent with good practice in countries that employ formal merger review. One example of this is that the 2003 M&A rules contain a notification requirement for anti-trust purposes that may not be wholly transparent. One of the thresholds for notification is based on the market share of the acquiring investor, the target company or their combined market share, yet the rules do not specify how market share is to be defined and measured.

The stipulation that an actual or potential competitor may obtain an anti-trust review of a proposed merger or acquisition even if it does not meet the notification thresholds is open to abuse in the context of the dependence of many local governments on local enterprises for revenue to fund both budgeted and off-budget expenditures.[10]

It remains to be determined to what extent the new competition law will resolve these issues.

Even if legislation regarding cross-border M&A is rendered more coherent, foreign investors will still be constrained in their M&A activity in China by persistent institutional weaknesses that the government is trying to address, in particular inadequately enforced standards of corporate governance. Such weaknesses are also an obstacle to the development of domestic Chinese enterprises, both because domestic enterprises often seek merger or acquisition by a foreign investor as a solution to their problems and because their activities are constrained by obstacles such as lack of corporate transparency when they engage in domestic M&A activity.

Before taking a final decision to merge with or acquire an enterprise, an investor needs full financial and other information on which to base that decision. Such information is normally obtained from due diligence conducted by an appropriate agency. A particular problem in China is the lack of transparency in most companies, in particular with regard to financial information and ownership structures.[11] SOEs are the inheritors of the political traditions of the command economy of which they were originally a component, and may still value secrecy as an indispensable weapon of policy. Enterprises based in OECD countries could seek security before engaging in an

M&A transaction by proposing an indemnification arrangement to insure against damage to their interests from this lack of transparency. But such arrangements are not common in China and may not be fully understood, let alone accepted, by transaction partners, and are therefore unlikely to be included in an internationally standard purchase and sale agreement, except in cases involving larger Chinese enterprises with more experience of international business practices. Foreign investors are therefore not assured of a proper allocation of risk and liability between seller and purchaser.

A fuller evaluation of remaining obstacles to cross-border mergers and acquisitions in China is presented in Chapter 5.

Notes

1. On 23 August 2005 the CSRC issued Measures for the Administration of Share Capital Segregation Reform of Listed Companies, which effectively force state-owned enterprises (SOEs) to release their non-tradeable shares.
2. Ministry of Foreign Trade and Economic Co-operation (1999).
3. China Securities Regulatory Commission (2002b).
4. People's Republic of China (1998b).
5. China Securities Regulatory Commission (2002a).
6. China Securities Regulatory Commission (2002c).
7. State Economic and Trade Commission (2002).
8. Ministry of Foreign Trade and Economic Co-operation (2003).
9. State Administration of Taxation (2003).
10. OECD (2005) *Governance in China* explains how China has become increasingly dependent on using extra-budgetary resources (including arbitrary fees and levies and commercial incomes) to finance government, especially at the sub-national levels.
11. See *OECD Investment Policy Review of China: Progress and Reform Challenges*, in particular Chapter 5, Section 5 on Corporate Governance and Chapter 5, Section 6 on Accounting Standards.

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Chapter 4

Lessons from North-East China Experience

North-East China has developed as a centre of heavy industry, now under intensive restructuring. Unemployment in the region is well above the national average. North-East China is the focus of the Chinese government's current regional policy.

Measures to attract foreign direct investment (FDI) to North-East China have been concentrated on cross-border mergers and acquisitions (M&As). The region is in a good position to benefit from cross-border M&As, of which is has some experience. Enterprises there seeking foreign investment by way of M&A tend to be loss-making state-owned enterprises (SOEs) that are heavily indebted and need new technology and overseas markets.

North-East China has been selected for special consideration in the 2006 OECD Review because the Chinese government has identified it as needing foreign investment as part of the process of revitalisation of China's old industrial bases and cross-border mergers and acquisitions are being actively sought by state-owned enterprises (SOEs) and the local governments that oversee them there. Several cross-border acquisitions have already taken place in the region. Further liberalisation of China's policies towards cross-border mergers and acquisitions can benefit North-East China by widening the range of options for enterprise restructuring. At the same time, policies that the government may find difficult to implement rapidly on a national scale might well be considered suitable for trying out as pilot projects in North-East China before spreading nationwide.

North-East China has developed as a centre of heavy industry, now under restructuring

North-East China, which consists of the three provinces of Jilin, Liaoning and Heilongjiang, occupies an area of 788,000 square kilometres, 8.2% of China's total land area,[1] containing a population of 107.3 million people at end-2003, 8.4% of the national population total. Its GDP reached CNY 1 295.5 billion (USD 156.3 billion) in 2003, 9.6% of national GDP. Per capita GDP in 2003 was CNY 12 078 (USD 1 457.55) 32.7% above the national average of CNY 9 101 (USD 1 098.29). Living standards above the national average are also reflected by retail sales of consumer goods, which totalled CNY 481 750 million (USD 58 137 million), 10.1% of the national total, in 2003. Education and healthcare indicators are also above the national average.

These three provinces constitute the original heavy industry base of China. Industry was developed in the region during its occupation by Japan between 1931 and 1945 and then during the industrialisation drive embodied in the first five-year plan initiated by Communist government in 1953. The region is referred to as the "eldest son of the republic" (*gongheguo de zhangzi*), originally indicating its backbone role in the country's economic development. One of China's main steel production bases at Anshan was restored and expanded in the 1950s; it now produces 10 million tonnes of steel per year. The First Automotive Works produced its first automobile in 1956 and is now a major automobile and automobile component factory. Shenyang was established as the country's main centre for machine tool production, mainly

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handled by the Shenyang No. 1 Machine Tool Works, China's largest producer of complex lathes and the national centre for CNC technology. [2]

The government's formulation of a development plan for North-East China as a project of "rejuvenation of the old industrial base in the North-East" is based on the conception of the region as the "eldest son" which has been the mainstay of the national economy for a long period but has grown old before the rest of the country and now needs help to regain its former strength. Local authorities in the region, habituated to central planning, have therefore tended to view the main task of this project as breathing new life into existing state-owned enterprises, largely to protect the living standards of those employed in them. As a result, foreign investors have been invited to invest in such enterprises to enable them to divest themselves of large debt burdens. Such inflows also help to reduce non-performing loans in the state-owned banking system.

The North-East possesses geographical advantages comparable with those of the Pearl River and Yangzi River deltas in that it has ports, including Dalian, that provide access to overseas markets, is situated near countries with which it has trade and investment links (Japan, Korea, Russia) and enjoys good and improving communications with the rest of China. However, geopolitical realities have so far prevented it from realising its full potential as a centre for international business at the heart of North-East Asia.

The move from central planning to market economy has thrown into sharp relief the inefficient structure of the state-owned industries that dominate the economy of NE China.[3] In 2002 the North East was home to 10.2% of state-owned enterprises producing 14.9% of national SOE gross output value,[4] indicating both that there was a rather higher ratio of SOEs to population in the region than in the rest of the country and that the average size of an SOE there was far larger than the national average. These SOEs generated 21.9% of national SOE profits and paid 15.4% of the VAT collected from SOEs.[5] Overall labour productivity in North-East China's SOEs, measured in CNY per person per year, was 91.8% of the national average in Liaoning, 92.1% in Jilin and 123.8% in Heilongjiang. In Guangdong, which had a relatively low proportion of SOEs (6.2% of the number of SOEs in China – roughly the same as its share of national population – and 7% of national SOE gross output value), their productivity was 207.7% of the national average; in Shanghai, with just under 1.3% of national population,[6] 5.2% of SOEs and 4.9% of SOE gross output, productivity was 213.3% of the national average.[7]

Unemployment in North-East China's urban areas is well above the national average

In 2003, registered urban employed in the three North-Eastern provinces totalled 1 354 000.[8] This represented 19.5% of total national urban

Box 4.1. **North-East China's three provinces: basic data**

Heilongjiang

Capital city: Harbin (Haerbin), population 9.5 million (end-2003)

Land area: 454 000 sq. km

Population: 38.2 million (end-2003)

Jilin

Capital city: Changchun, population 7.2 million (end-2003)

Land area: 187 400 sq. km

Population: 27.0 million (end-2003)

Liaoning

Capital city: Shenyang, population 6.9 million (end-2003)

Other major city: Dalian, population 5.6 million (end-2003)

Land area: 147 500 sq. km

Population: 42.1 million (end-2003)

Abundant mineral resources

The North-East contains China's main reserves of natural resources: 29.8% of the country's iron ore (mostly in Liaoning), 38.1% of its crude oil (largely in Heilongjiang, though the other two provinces are also important producers), 81.2% of its magnesite (all in Liaoning) and 21.5% of its glass silicon materials (mostly in Liaoning). It possesses significant quantities of other mineral reserves, including copper (6.7% of the national total), manganese (5.4%), coal (4.8%), natural gas (3.9%), and pyrite (2.2%).

Major centre for China's heavy and energy industries

The three provinces play a major role in several of China's key heavy and energy industries. For example, in 2003 the region produced 39.2% of the country's crude oil, 12.5% of its steel, 11% of its coal and generated 8.7% of its electricity. By contrast, only 1.8% of national cloth output was made in the North East in 2003. Despite its relatively cold climate, the region is a major agricultural centre, providing 14.6% of China's grain production and 5.8% of its oil-bearing crops in 2003.

Relatively poor performance in international trade

Despite its coastal location and possession of the country's seventh largest port, Dalian,* facing the Pacific Ocean, the North East appears to be performing below potential in international trade. In 2003 the region's exports were 4.5% and imports 4.4% of national totals, well below its share of major domestic economy indicators such as GDP and population.

* In terms of freight tonnage handled per year, which reached 126 million tonnes in Dalian in 2003.

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unemployment, more than double the region's 8.3% share of national population at the end of 2003. By end-2003, the region contained 958 000 beneficiaries of unemployment insurance, 23.1% of the national total. Liaoning province had the highest rate of registered urban unemployment in China, 6.5% in 2003, while Heilongjiang had 4.9%; only Jilin, at 3.6%, was below the national figure of 4.3%. Official unemployment figures exclude categories of unemployment normally included in OECD countries, so both the national and regional figures understate the problem. It is likely that the official figure has failed to capture fully the rise in unemployment resulting from the closure of many SOEs in the North-East. An indication that local government finances in the three North-Eastern provinces are under strain from social security demands stemming from high unemployment is the relatively high 21.4% proportion of central government spending on subsidy to social security programmes that went to the region in 2003.[9]

The economy of the region has developed rapidly during the past quarter of a century of economic reform and is continuing to do so. In 2003, the combined production-based GDP of the three North-Eastern provinces was CNY 1.3 trillion (USD 157 billion), compared to CNY 87.3 billion in 1999.

North-East China is the focus of the Chinese government's current regional policy

The regional development priorities of the Chinese government have changed during the reform period. The earliest emphasis was on testing foreign investment and market economy in the Special Economic Zones (SEZs) of Guangdong and Fujian provinces, far from the capital, during the 1980s. A subsidiary aim was to help reconstruct the industrial base that had been removed from these coastal provinces for reasons of military strategy in earlier decades, so the establishment of SEZs contained an element of regional policy. In the first half of the 1990s, the emphasis switched to Shanghai, partly because it was a major economic centre that was perceived as having fallen behind the SEZs and therefore needing to catch up with the reform trend, and partly because its leaders had become the leaders of China. From 1993 onward, the government, worried about growing income disparities and the harm they might to do social stability, also paid attention to sharing the benefits of economic reform and expansion with China's hinterland, the Central and Western regions. Such concerns intensified following government changes in 2003, in which year a new aim was added to the portfolio of regional projects: the rejuvenation of the old industrial base in North-East China. This was initially embodied in a document entitled Several Opinions Regarding the Rejuvenation of the Old Industrial Bases in North-East China produced by the Central Committee of the Chinese Communist Party. In August 2005 the State Council issued Implementation Measures for Further

Deepening the Reform of the Old Industrial Bases in North-East China, which specifically encourage the involvement of foreign capital in the reorganisation of state-owned enterprises (SOEs) in North-East China.

Measures to attract FDI to North-East China have been concentrated on cross-border M&A

North-East China has attracted its fair share of FDI

In terms of FDI attraction, the North-East region has done modestly, but not spectacularly, well by national standards. By end-2001, the three North-East provinces, which then jointly accounted for 10.9% of China's current-price GDP[10] and 8.4% of its population at the last national population census in 2000,[11] had together received 6.2% of cumulative realised FDI and had registered 9.1% of the total number of FDI contracts worth 7.3% of total contracted FDI value.[12] By end-2002, North East China was home to 8.8% of all foreign-invested enterprises (FIEs) in the country, accounting for 9.6% of the registered capital of FIEs nationwide;[13] these figures also indicate that the average size of FDI projects in the region was somewhat larger than the national average, though the percentage of capital invested by foreign partners, at 8.4%, suggested that foreign contribution to each project was actually slightly smaller on average. FIEs in North-East China generated 7.2% of total national FIE profits and 7.1% of national FIE VAT payments in 2002.[14] This ratio of FDI indicators to population compares favourably with the vast Western Region, which had received a mere 4.1% of China's total FDI inflows in 2001,[15] compared to its 28.8% share of national population,[16] less favourably with Guangdong, which had 6.1% of China's population in 2000[17] and 24% of the country's FIEs and 24.4% of the registered capital of all FIEs at end-2002.[18]

Development of open policies at national level promote local FDI attraction

The Chinese government attaches great importance to attracting FDI to North-East China to assist the process of restructuring the inefficient SOE sector. As with the regional policy designed to promote catching-up of the economies of China's Central and Western regions, there has been some use of local fiscal incentives to attract all kinds of FDI,[19] and there have also been significant infrastructure improvements which contribute to cost and risk reductions for investment in the region. However, the main policy emphasis has been on the development of more open policies nationwide towards cross-border M&A in order to attract foreign investment in the revitalisation of SOEs in the region. This marks a step forward in that the Chinese authorities appear to be moving from reliance on localised attraction policies based on fiscal

Box 4.2. **FDI in Jilin province**[1]

Jilin province started attracting FDI later than many other Chinese provinces, but FDI inflows have since accelerated comparatively rapidly. FDI is now a major driver of economic development in the province. In 2004, more than 110 000 people were directly employed in FIEs, which achieved sales of CNY 150 billion and provided one quarter of the province's tax revenue.

By end-2004 Jilin province had approved the establishment of 7 300 FIEs with total investment of USD 21.1 billion, including USD 9.3 billion in contracted FDI and USD 5 billion in actually utilised FDI. FDI in Jilin has come from 53 countries and territories, the top eight being: Hong Kong (China), Germany, Korea, British Virgin Islands, the United States, Japan, Chinese Taipei and Singapore. In 2004, six OECD member countries (Germany, Korea, the United States, Japan, the United Kingdom and the Netherlands) ranked in the top ten of the 26 countries and territories that invested in Jilin province. Of the 36 of the 500 top world MNEs that have established 47 FIEs in Jilin province, the overwhelming majority are from OECD member countries, including 9 from the United States, 8 from Japan, 5 from Germany, 3 from the United Kingdom, 2 from Korea, 2 from France and 1 from Canada.

FDI in Jilin province has mainly been in transport equipment manufacturing, food processing and manufacturing, chemical raw materials and chemical products manufacturing, textiles, wood processing, pharmaceuticals manufacturing and photoelectrics.

FDI has played a major part in boosting the province's foreign trade. In 2004 FIEs accounted for 30% of Jilin's exports and 60% of its imports. (In China as a whole, FIEs now account for well over half of both exports and imports[2].) The relatively large share of imports resulted from imports of automobile components worth over USD 1 billion during the year.

The Jilin provincial government affirms that FDI has helped to restructure and improve industry in the province and to enhance the development, transformation, quality improvement and rational utilisation of the province's natural resources. Over a quarter of FDI in Jilin province is in transport equipment manufacturing, so a relevant example is the expansion of the No. 1 Automobile Works to an output capacity of 660 000 automobiles by 2007 in co-operation with OECD-based automobile companies. This will entail a corresponding expansion of automobile component manufacturers in Jilin province. Among component manufacturers there are already over 100 FIEs. Other examples of expanded output capacity resulting from FDI include the food processing and manufacturing, raw chemicals and chemical products manufacturing, textiles and wood processing industries.

However, in quantitative terms the Jilin provincial government considers that it still does not attract an appropriate share of FDI – for example, it claims to have so far received only 0.74% of total national actually utilised FDI, well below its 2% share of national output.

In 2005, Jilin province was seeking to involve foreign investors in the restructuring of major state-owned enterprises and to deepen its relationship with the major investing countries, most of whom are OECD members.

1. Information in this box is taken from the presentation by Jia Hongbo, Director of Jilin province Department of Commerce to the China-OECD Symposium on Cross-Border Mergers and Acquisitions in the Rejuvenation of the Old Industrial Base in North-East China in Changchun on 21 February 2005 entitled *Strengthen Co-operation and Attract Capital on a Win-Win Basis to Rejuvenate the Old Industrial Base in Jilin* [in Chinese].
2. In 2005, FIEs accounted for 58.5% of the total value of two-way trade, *i.e.* 58.3% of exports and 58.7% of imports by value. FIEs were clearly a driver of trade growth: two-way FIE trade grew 25.4% over 2004 while total two-way trade increased by 23.2% [Source: *www.fdi.gov.cn*.]

incentives to an approach that is based on a nationally consistent and coherent application of a more open policy towards foreign investment.

North-East China is in a good position to benefit from cross-border M&A

North-East China can benefit significantly from cross-border M&A as it contains a concentration of industrial SOEs, many of which have strong investment in both physical and human capital coupled with chronic management problems. There is therefore a high potential for efficiency gains following merger or acquisition and subsequent rationalisation of such enterprises. The region possesses a comprehensive industrial base, good communications, proximity to the coast and to the capital, Beijing, a large, well-qualified workforce, a well-developed educational system with notable strengths in technical and vocational education and training, and a developing consumer market.

North-East China has experience of cross-border M&As

Foreign investment has been an important factor in NE China, largely in the form of joint ventures with domestic Chinese enterprises. The largest investor in the region has so far been Hong Kong (China), which has invested mainly in hotels, tourism and manufacturing, but there have also been significant investments by OECD-based MNEs such as the joint ventures with the First Auto Works (FAW) in Changchun, China's largest automobile SOE, which operates a joint venture with Volkswagen and co-operative production with Toyota.

A few large cross-border M&A transactions have taken place, notably the acquisition of a 44.4% stake in the Hualin Tyre Company in Heilongjiang by a unit of GT Tyres of Singapore (the first acquisition of an SOE by a foreign investor in China under 2003 Provisional Regulations) and the takeover of Harbin Breweries by Anheuser Busch in 2004. The precise extent of such activity to date remains to be determined.

Enterprises seeking foreign investment in Jilin province

An example of the type of enterprise selected by local governments in North-East China as potential acquisition targets for foreign-invested enterprises is provided by the list of 100 key projects for foreign investment published by the Department of Commerce of Jilin Province in 2005.[20] The total net asset value of these projects is listed as CNY 40.8 billion (USD 4.9 billion) in April 2005 and their turnover in 2004 was CNY 22.4 billion (USD 2.7 billion).[21] Most of the enterprises are small or medium-sized, but six are valued at over CNY 1 billion (USD 120.7 million) each (see Table 4.1.).

Box 4.3. **Case study: Hualin Tyre Company***

The Hualin Tyre Company was set up in 1938. Like other privately-owned manufacturing enterprises, it was nationalised in the 1950s. It then became an SOE in the economic reform period and went public in 1999. From the 1950s to 1980s, it was a leading tyre manufacturer. However production costs remained too high for the enterprise to stay competitive. An estimated 5 000 of its 13 000 employees were surplus to requirements. In addition, the enterprise, like many large SOEs, was burdened with social responsibilities, including schools, nurseries and hospitals. In the first half of 2003, Hualin Tyre suspended production due to heavy losses. Its shares were given a warning of delisting on 28 April 2003, since the company had reported consecutive losses over the previous two fiscal years.

In the second half of 2003, Singapore-based GT Tires (China) Investment Co. Ltd. acquired all legal person shares of Hualin Tyre. After the acquisition, the original permanent employment status of the company's staff was redefined as they entered into a more competitive market-oriented environment. Schools and other social service units belonging to the company were divested to local government.

The enterprise was reportedly "revitalised" after the reform. Its sales income in 2004 was four times that of 2003, and its tax payment rose from CNY 5 million to CNY 58 million. As a result, the delisting warning on its shares was lifted.

* Information in this box is from *Industrial Take-off* by Lan Xinzhen *in Beijing Review* online.

Table 4.1. **100 key projects for foreign investment in Jilin in 2005**

Number of enterprises	Assets in CNY
24	10 million-50 million
26	50 million-100 million
44	100 million-1 billion
4	1 billion-5 billion
1	5 billion-10 billion
1	Over 10 billion

Source: Jilin Province Department of Commerce.

A sub-set of this list, consisting of 82 projects, all of them involving some proposed form of transfer of property rights of state-owned enterprises, has also been published by the Department of Commerce of Jilin Province. The detailed statistics provided for each project in this sub-set indicate that the enterprises whose assets are being offered for sale are mostly highly indebted and unprofitable, with some of them non-operational and/or bankrupt. The data in this set show bank loans totalling CNY 6 184 957 100 with net assets of CNY 11 546 363 480, *i.e.* a debt:assets ratio of 53.6%. The figure may be higher, as all enterprises in the list quote a figure for assets, but not all enterprises quote a bank debt figure. The total net loss of the enterprises is CNY 876 603 900 (not counting the 22 enterprises that have entered no figure in the profit/loss column). Twenty-one of the enterprises mention that they are either bankrupt or preparing to file for bankruptcy. Six have been out of production since 2002, two since 2000 and one from 1999.[22]

The Jilin Province Department of Commerce proposes a variety of forms of foreign investor involvement, depending on the circumstances of each enterprise.[23] Such forms include:

- Full transfer of property rights (*i.e.* outright acquisition).
- State-owned equity transfer in part or in full, in cash or industrial shares.
- Bankruptcy and transfer in full of property rights.
- Part sale of an enterprise to management and workers, part sale to outside investors.

The proceeds of sale of whole or part of an enterprise to foreign investors is in some cases specified as solving specific problems, for example:

- Compensation of unemployed staff.
- Utility network renovation.
- Expansion of natural resource or manufacturing output capacity.
- Importing new technology.
- Establishment of R&D centres.

In none of these cases is foreign investment explicitly invited for the purpose of paying off unpaid bank loans. However, this must in practice be a major motivation for the offer of many of the enterprises for sale. For example, the enterprise with the highest debt:assets ratio, of 421.8%,[24] a 100% state-owned enterprise with large annual losses and rising bank debt, is offered for recapitalisation due to bankruptcy with the prospect of adding extra output capacity. The acquirer will have to pay far more in debt repayment than in purchasing the company. Such a disparity may render such enterprises difficult to sell to domestic investors.

Notes

1. All statistics in this and the next two paragraphs are from, or are calculated from, statistics in the National Bureau of Statistics, *China Statistical Yearbook 2004*. There are inconsistencies among these data and also between these data and national statistics in the same source which are explained by differences between national

statistics and the statistics of individual provinces. Such inconsistencies do not significantly affect the conclusions in this report.

2. Ning Yi and Dong Ning (2004).
3. A story current in the region summarises the problem of moving from plan to market. Industry in the North East is compared to a Manchurian tiger. Having been put in the cage of economic planning, the tiger has lost its teeth and claws through inactivity. The zookeepers have now opened the cage and told the tiger to go forth and multiply, but the milk-bred tiger can not survive in the wild and is even afraid of a small cow.
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5. National Bureau of Statistics, *China Statistical Yearbook 2003*.
6. 2000 national population census, in National Bureau of Statistics, *China Statistical Yearbook 2003*.
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12. FDI proportions from MOFTEC (now MOFCOM), *Statistics on FDI in China 2002*.
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Chapter 5

Problems Faced by Investors in Pursuing Mergers and Acquisitions in China

Problems of completing cross-border mergers and acquisitions (M&As) affect domestic investors as well as foreign investors in China.

The broader regulatory framework for investment is complex and incomplete. Government policy on retaining strategic assets is not transparent. Foreign ownership restrictions persist: the foreign investment catalogue regime has not been liberalised and additional discretionary sectoral restrictions are imposed on foreign direct investment (FDI). Cross-border M&A approval procedures are cumbersome, although some streamlining has taken place. There is a lack of transparency in potential acquisition targets, reflecting poor standards of corporate governance and disclosure. Official Chinese valuation methods differ significantly from OECD member country practices, leading to valuations which may unnecessarily discourage purchasers. Hostile takeovers are difficult to accomplish. Current regulations appear to discriminate against foreign investors in the area of pre-merger notification and use unquantifiable notification thresholds. It remains to be seen whether this problem will be solved by the passage of a promised anti-monopoly law.

Problems affect both foreign and domestic investors

At the December 2005 Symposium on China's Policies Towards Cross-Border Mergers and Acquisitions, discussants voiced concern that any assessment of the framework for cross-border M&A be not just oriented towards the interests of foreign investors but also to those of Chinese enterprises, including SOEs. They affirmed the importance of taking into consideration the perspectives of Chinese enterprises in seeking common ground with foreign investors to reach a win-win solution. It is therefore important to point out that the problems outlined in this report are problems for domestic enterprises as well as for foreign investors. It is often domestic enterprises that are seeking a merger or acquisition with a foreign partner, so a domestic enterprise itself may suffer from the cancellation of an M&A deal which might otherwise have brought it new technology, management techniques, markets and debt cancellation. Many institutional obstacles affect all enterprises: due diligence difficulties emanating from poor corporate disclosure, for example, can be as much of a problem for domestic acquirers as for foreign acquirers.

The broader regulatory framework for investment is complex and incomplete

The regulatory framework governing cross-border M&A activity in China remains a complex and incomplete patchwork of laws, regulations and policy decisions emanating from various ministries and other government agencies.

The 2003 Provisional Rules on Mergers and Acquisitions of Domestic Enterprises for Foreign Investors is the most complete set of rules on cross-border M&A promulgated to date, as, unlike previous regulations, they cover all domestic enterprises, including SOEs and privately-owned domestic enterprises. However, a foreign investor considering a merger or acquisition in China must also be aware of many other detailed regulations and policies relating to a wide range of essential matters, including foreign investment project examination, approval and registration procedures, procedures for determining the price of state-owned assets, foreign ownership restrictions, qualification requirements for foreign investors, taxation and fiscal incentives, and antitrust measures.

Since cross-border M&A activity may only take place by the establishment of a new foreign-invested enterprise (FIE), or by acquiring

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ownership of an existing FIE, the individual laws governing Sino-foreign equity joint ventures, Sino-foreign contractual joint ventures, wholly-foreign-owned enterprises and other forms of FIE must also be taken into account. In addition, more general laws, including the General Principles of Civil Law, the Contract Law, the Company Law, and the Securities Law all contain provisions relating to mergers.

Despite the plethora of regulations governing cross-border M&A activity in China, uncertainties remain in some major areas, including sectoral limits. The lack of transparency in Chinese enterprises (see below) already poses serious risks for foreign investors considering acquiring or merging with them; additional risks posed by a less than wholly transparent regulatory framework – which also discriminates against foreign investors – may increase the risk sufficiently to deter many foreign investors from engaging in M&As in China.

Government policy on retaining strategic assets is not transparent

Since the mid-1990s, the Chinese government has been developing a policy of creating industrial conglomerates on the basis of existing SOEs. In 1997 this policy was described by Party Chairman Jiang Zemin at the 15th Congress of the Chinese Communist Party as "holding on to the big and letting go of the small" (*zhua da fang xiao*), indicating that the majority of SOEs, which were small and medium-sized, were to be dealt with flexibly while the state retained control of the largest enterprises with a view to promoting them as national champions.

This slogan informs current policy towards cross-border M&As. Foreign investors may acquire small and medium SOEs and private-sector enterprises but are not free to acquire major SOEs, which are frequently described by officials as "strategic assets". The criteria and procedure for determining what constitutes such a strategic asset are not wholly transparent. For example, a major German electrical equipment manufacturer with extensive investments in China considered acquiring one of the largest Chinese state-owned electrical equipment manufacturers to facilitate electricity supply to a large hydraulic engineering project in China, but was eventually prevented from doing so by a decision of the State Council (China's cabinet) on the grounds that the target enterprise was a strategic asset of China. As a result, the SOE concerned failed to obtain the foreign capital and technology it was seeking. It is not clear upon what grounds the Chinese company was deemed to be a "strategic asset".

At the December 2005 OECD-China Symposium in Beijing on China's Policies Towards Cross-Border Mergers and Acquisitions, discussants proposed that the Chinese government establish a centralised body to determine the government's attitude and specific procedures in advance on issues such as national security in relation to investment projects. This approach would, they suggested, be more transparent and predictable and would provide an authoritative source of information which could be consulted by potential investors at an early stage to enable them to avoid wasting time and money on investment project applications that were eventually found not to conform to (unpublished and perhaps undetermined) government criteria.

Foreign ownership restrictions persist

As explained above in the summaries of various legal enactments governing cross-border M&As in China, a foreign investor may only acquire or merge with a domestic Chinese enterprise by establishing an appropriate form of new foreign-invested enterprise (FIE). Each type of FIE is governed by a specific law, as outlined in the 2003 Review.[1] If, for example, a foreign multinational enterprise wishes to purchase a Chinese enterprise outright by purchasing all the ownership equity of an SOE or by buying out the equity share of its partner in a joint venture, it must do so by establishing a new wholly-foreign-owned enterprise (WFOE). The resulting WFOE must apply for examination and approval in the same way as if the foreign investor were proposing to set up an entirely new (*i.e.* greenfield) WFOE. Such a WFOE would have to comply with all the provisions of the 1986 law on establishing WFOEs, including sectoral restrictions which are now embodied in the Catalogue for Guidance of Foreign Investment Industries (see below). The same restrictions apply if the foreign investor wishes to establish another kind of FIE, such as an equity joint venture.

The catalogue regime has been insufficiently liberalised

In 1997 the Chinese government adopted a Catalogue for Guidance of Foreign Investment Industries to encourage FDI in specific industrial sectors. Foreign investment projects were classified into prohibited, restricted, permitted and encouraged. Following China's entry into the WTO at the end of 2001, the Catalogue was revised and a new version came into force in April 2002. While welcoming the new Catalogue as a major step forward in FDI regime liberalisation, the OECD's 2003 *Investment Policy Review of China* encouraged the Chinese authorities in their efforts to achieve further liberalisation by removing more categories of project from the prohibited and restricted catalogues and also to consider replacing the catalogue regime with a simple closed list.[2]

In November 2004 the NDRC and MOFCOM announced that a revised Catalogue would take effect from 1 January 2005. This 2005 Catalogue retains the fourfold classification into prohibited, restricted, permitted and

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encouraged of its predecessors.[3] As in earlier catalogues, the ***permitted catalogue*** is not specified – to do so would be a near-impossible task, as it comprises all industries not specifically mentioned in the other catalogues, including new, sometimes unpredictable, industries. The most recent revision, unlike that of 2002, does not represent a liberalisation of the foreign investment regime. The long lists remain largely unaltered, and at least as many restrictions have been added as removed. The issuing of such a document three years after WTO entry indicates that the Chinese authorities are not yet ready to consider wholesale reform of the catalogue system in favour of a simple list approach.

The ***prohibited catalogue*** continues to include several sectors whose closure had been questioned in the 2003 OECD Review, which had suggested that more appropriate means might be found for promoting a number of traditional industries than closing them to foreign investment. Another prohibition examined in the 2003 OECD Review, that on research into genetically modified plant seeds, remains in force. In the area of Social Service Industry, "social investigation" has now been prohibited alongside existing prohibitions on gambling and pornography. The scope of this prohibition is unclear; it almost certainly covers opinion polling, but it remains to be determined to what extent it also includes other forms of research. (Foreign investment in market research remains permitted but has been put under restriction, see next paragraph.) The only item removed from the prohibited catalogue is that of the production of films and of radio and television programmes. These have been moved to the restricted catalogue, with the stipulation that the Chinese partner must hold a majority of the shares in such projects.

At the December 2005 Symposium on China's Policies Towards Cross-Border Mergers and Acquisitions, discussants found that the ***restricted catalogue*** listed restricted sectors but did not explain what the restrictions were. In the restricted catalogue, the prohibition of projects involving the construction and management of thermal-power plants with a single unit installed capacity of less than 300,000 kw has been relaxed by the addition of the qualifying clause "(with the exception of small power grid)". A new item, "construction and operation of large-scale theme park", has been added to the Real Estate Industry sections and another, "Market Research (equity joint ventures or contractual joint ventures only)", to the Social Service Industry category. The overall effect is a slight tightening of restrictions on foreign investment.

The ***encouraged catalogue***, the largest of the three published catalogues, also remains virtually identical, with few items added and removed. The net effect of these changes is a small reduction in the number of industrial sectors in which foreign investment is encouraged. Changes in this catalogue are neutral with regard to foreign investment liberalisation, as neither inclusion nor exclusion imposes any restriction on FDI. The adoption of a unified business tax in the near future may, by narrowing the scope for fiscal incentives, greatly weaken the encouraged catalogue.

In the 2002 Catalogue, wholly-foreign-owned enterprises (WFOEs) were encouraged in Western China in the exploitation and beneficiation of gold mines with ore of low quality or which is difficult to beneficiate; this stipulation is removed from the 2005 Catalogue, leaving this activity encouraged only to equity or contractual joint ventures. The encouragement of WFOEs in mining copper, lead, zinc and aluminium ores is, however, retained. In the Paper Making and Paper Products Industry section, the encouragement of projects in the production of high-quality paper and cardboard has been broadened to include newsprint (specifically excluded in the 2002 Catalogue) but restricted in that it is now limited to equity and contractual joint ventures. In Petroleum Refining and Coking Industry, "production of hard coke and dry coke quenching" has been removed and "production of heavy traffic road asphalt" added. The encouragement to produce differential chemical fibre and high, new technological fibre such as aromatic synthetic fibre, functional environment-amicable ammo synthetic fibre is now limited to plants with an annual production capacity of over 5 000 tonnes, while production of high tensile and high modulus polythene has been added to the Chemical Fibre Manufacturing section. Similarly, the threshold for encouragement of polyester for non-fibre production has been raised from 400 to 500 tonnes a day, while several other varieties of polyester have been added to the list. Major items removed from the iron and steel industry section include the production of broad and thick armour plate, the production of aluminium-zinc alloy plates and clad plates and the processing of steel scrap. In non-ferrous metals, the production of alumina with an annual production of 300 000 tonnes or more has been excised from the encouraged list.

In Communications and Transport Equipment industries, encouragement continues for foreign investment projects involving the manufacture of complete automobiles and automobile engines, but has been removed from the manufacture of complete motorcycles and motorcycle engines as well as motorcycle spare parts. Encouragement for R&D in automobile and automobile engine manufacture has been added. The list of automobile components has been altered to reflect desired technological improvements (*e.g.* "complete brakes" has been replaced by "disc brakes", "gearboxes" by "automatic gearboxes").

It was noted in the 2003 OECD Review that the 2002 Catalogue retained from the 1997 catalogue of encouraged foreign investment industries a clause which included permitted foreign invested projects whose products are to be wholly exported directly. The OECD Review pointed out that since the inclusion of a proposed foreign investment project in either the permitted or the restricted foreign investment list can determine whether or not it is approved, this stipulation could be regarded as effectively imposing an export performance requirement on such projects. This clause has been retained in the 2005 Catalogue.[4]

At the December 2005 OECD-China Symposium in Beijing on China's Policies towards Cross-Border Mergers and Acquisitions, discussants agreed that the catalogues lacked clear definitions and guidance. They also stated that the catalogues were interpreted differently at the various levels of administration and that they were not applied consistently nationwide. The catalogues were not, they alleged, updated regularly; they also found the procedure for compiling the catalogues not to be transparent. Discrepancies exist in the catalogues because they are formulated by various Chinese government agencies at different levels of detail. Omissions may exist because it is not possible to include everything in the catalogues. As a result, it is not necessarily true that a sector that does not appear in any of the three published catalogues is in the unpublished permitted catalogue. Potential foreign investors are therefore unclear as to which sectors are permitted; for example, a French investor who wishes to invest in nursing homes has been unable to find this sector in the published catalogues but is not confident that it is permitted.

Symposium discussants proposed that the Chinese authorities consider simplifying the catalogues into a negative list of prohibited sectors and a positive list of encouraged sectors, with fiscal and other incentives clearly specified. Item details could be defined in a more operational and practical manner to facilitate implementation. Such streamlining would almost certainly require the establishment of an intergovernmental body to co-ordinate the work of the different ministries involved.

Discussants also proposed that studies be conducted to determine the effectiveness of the existing catalogue categories in achieving desired policy objectives.

Consequently, the present OECD Review reiterates that the Catalogue for Guidance of Foreign Investment appears an unwieldy regulatory instrument whose purposes might better served by less restrictive and more transparent means.

Additional discretionary sectoral restrictions are imposed on FDI

In addition to the above-mentioned ownership restrictions set out in the Catalogue, the Chinese government from time to time imposes additional discretionary restrictions on foreign investment in specific sectors. These may appear to have the effect of relegating foreign investment to the status of a subordinate unit of state economic planning, thereby preventing foreign-invested enterprises from competing freely with domestic enterprises.

A recent prominent example is the National Iron and Steel Industry Development Policy approved by the State Council on 20 April 2005.[5] The iron and steel industry is not listed in any of the three published catalogues and is therefore by default in the permitted catalogue and not subject to foreign investment restriction.

Article 23 of the 2005 policy statement, however, states that "in principle, foreign investors that make investment in China's iron and steel industry are not allowed to have a controlling share status." Although some flexibility is implied by the phrase "in principle", the policy statement does not indicate under what conditions the Chinese government (presumably the State Council and/or NDRC – the identity of the decision-making agency is also unclear) may override this provision to allow a foreign controlling interest. Nor does the statement define this "controlling share status", *i.e.* whether this is a holding of 50% or more or just the largest shareholding. In at least one case, an FIE has been asked to reduce its shareholding below 50%. It is conceivable that this requirement could be interpreted more flexibly if the foreign investor were to transfer new technology or furnish access to new sources of iron ore or new markets.

Article 23 also limits overseas iron and steel enterprises making investments in China's iron and steel industry to those possessing iron and steel technology with independent intellectual property rights that have produced at least 10 million tonnes of carbon steel or 1 million tonnes of high-alloy special steel in the previous year. Overseas iron and steel enterprises must "combine with the renovation and relocation of domestic existing iron and steel enterprises without launching new construction sites".

These restrictions appear to represent a continuation of a restrictive policy already practised by the NDRC before the publication of the policy. If it is possible for the State Council to enforce an industrial policy, whether published or unpublished, involving tighter restriction on foreign enterprise ownership than in the current Catalogue, then the Catalogue does not provide transparent and trustworthy guidance for foreign investors considering an investment in China.

Cross-border M&A approval procedures are cumbersome

Many government agencies are involved in cross-border M&A approval

The various laws and regulations governing cross-border M&A (see above) have been issued by many different government bodies separately or in various combinations and require notifications of and approvals by several different ministries and other government agencies.

While MOFCOM retains general powers of supervision and approval of foreign investments, the National Development and Reform Commission (NDRC) also plays an important role in approving large investment projects, including foreign investment projects. The State-owned Assets Supervision and Administration Commission (SASAC) is responsible for state-owned asset management and is therefore an important decision maker in cross-border M&As involving SOEs. The China Securities Regulatory Commission (CSRC) regulates China's stock markets and its approval is necessary for the acquisition of listed companies by share purchases and for acquiring major assets of listed companies. Foreign-exchange transactions in the course of cross-border M&As fall within the jurisdiction of the State Administration of Foreign Exchange (SAFE), which has to ensure that capital controls are enforced and that such transactions are genuine and not a form of money laundering. The State Administration of Taxation (SAT) is responsible for deciding whether new FIEs are entitled to fiscal incentives. When a new FIE has been approved, it must be registered with the State Administration of Industry and Commerce (SAIC), which then issues a business licence.

Some streamlining has taken place, but there is room for improvement

The procedures for completing a cross-border M&A transaction in China consist in the first instance of the procedures for examination, approval and registration of any form of FDI. The 2003 Review found the FDI approval process too cumbersome and proposed a number of measures to streamline it.[6] The Chinese government has indicated that it welcomes these proposals and some progress has been made in speeding up approvals in ways that reflect the OECD recommendations.

The 2003 Review proposed raising the FDI project value limit above which approval has to be submitted to central government departments at national level and increasing the approval powers of local governments accordingly. On 29 July 2004 the State Council issued regulations that raise the limits of foreign investments requiring central government approval. Now only proposed projects valued at USD 100 million or above in the encouraged and permitted catalogues and projects valued at USD 50 million in the restricted catalogue require NDRC approval. On 9 October 2004 the NDRC published supplementary regulations stipulating that only projects valued at USD 500 million or above in the encouraged and permitted catalogues and those valued at USD 50 million or above in the restricted catalogue require NDRC review and State Council approval. They also stipulate that local governments must report approved foreign investment projects valued at USD 30 million or above to the NDRC, but only for the record.

The new provisions may, however, also represent a move by the NDRC to exert more control over investment, possibly rendering the approval process less transparent. The above-mentioned requirements appear to duplicate existing approval procedures operated by MOFCOM and are regarded by foreign investors as adding another layer of cost and effort to the process of forming or transferring shares in foreign-invested enterprises.[7] To the extent that approval criteria may differ between national and local organs of MOFCOM and the NDRC, it is also possible that investors may be subject to conflicting requirements.

Local authorities, including those in North-East China, are playing an important part in this. For example, the OECD found in Changchun, the capital of Jilin province, that the local government has instituted a "one-stop shop", with all government agencies involved in processing a foreign investment approval application located in the same building together with additional useful facilities such as banks, a travel agency and a post office. The director of the centre claims that registration can be achieved not only within the now statutory three working days, but within one day. A one-stop shop for cross-border M&A transactions has also been reportedly established in Harbin. These one-stop shops have significantly lightened the burden of approval procedures for foreign investors. However, their scope of operation appears to be limited to relatively small and unsophisticated cross-border M&A transactions that do not require higher-level approval.

While these measures represent real progress in streamlining foreign investment project approval, there remains room for improvement in the process, particularly in regard to obstacles such as ownership restrictions considered elsewhere in this report.

In addition to the FDI approval process *per se*, the approval and registration of a cross-border M&A transaction requires a number of extra steps involving the authorities listed above. This set of procedures can be cumbersome and confusing, potentially entailing a commercially harmful delay in completing the transaction.

Findings of the December 2005 OECD-China Symposium

Co-ordination of government agencies involved in cross-border M&As could be improved

At the December 2005 OECD-China Symposium in Beijing on China's Policies towards Cross-Border Mergers and Acquisitions, discussants agreed that there was a lack of transparency in existing codes and rules. They found that there were too many government agencies or regulatory authorities involved in the foreign investment approval process, rendering it too complex and inadequately transparent. It is also, they said, often unclear who is first person to speak to when initiating a merger or acquisition or who is the final decision-maker in the process.

Discussants proposed that the Chinese government establish a single, over-arching organisation at central government level to decide on proposed cross-border mergers and acquisitions. While it may not be possible in the short term to reduce the number of ministries involved in the cross-border M&A approval process, the number of approval points could be minimised and all of them brought together in a "one-stop M&A shop" in each region.

Communications with foreign investors could be improved

Discussants also proposed ways in which the Chinese authorities could more generally improve communications with foreign investors. Communications between MOFCOM and foreign-invested enterprises could, they suggested, be regularised and institutionalised. This communication could, if preferred, be tried at local level and then expanded to national level if successful. It was suggested that MOFCOM establish industry advisory panels to field inquiries, process requests for information and publicise feedback, and should also hold public hearings on major issues affecting foreign investors. Discussants wanted more English-language versions of regulations issued by the competent authorities to be made available to potential foreign investors.

There is a lack of transparency in potential acquisition targets

A major problem in preparing and completing acquisition of Chinese enterprises is the lack of accurate and timely financial information. In 2002 China adopted a Corporate Governance Code for Listed Enterprises, based on the OECD Principles of Corporate Governance, which reinforced and extended provisions on corporate governance in the Company Law and the Securities Law. However, there remains much room for improvement in transparency and disclosure standards in Chinese companies, as is corroborated by Chinese institutions, for instance the Shanghai Stock Exchange, which publishes an annual report on corporate governance.[8] Foreign investors frequently encounter difficulties in obtaining sufficient financial information on which to base a rational valuation for a potential acquisition.

A subsequent problem may be the existence of unrecorded liabilities of which the foreign investor only becomes aware some time after acquisition, resulting in extra unplanned expenditure which renders the acquisition less profitable than expected, and can conceivably make it unprofitable. Furthermore, indemnification against such unrecorded liabilities is not common, except in the larger, more sophisticated cross-border M&A transactions in which internationally standard documentation is used. However, indemnification claims based on such clauses may be difficult to settle if the seller lacks the financial resources to meet them. Customary purchase price hold-backs and/or escrows to protect against seller liquidity problems may not be easy to achieve.

The 2003 Review noted that if foreign investors were to play a full part in the restructuring of Chinese industry by developing relationships with existing domestic corporations, whether privately-owned or state-owned,[9] improvements in corporate governance practices were necessary. It further pointed out that although the Chinese government had established a framework of laws and regulations designed to ensure sound corporate governance, a substantial effort at better implementation of existing rules was perceived as a key issue in strengthening corporate governance in China, particularly in the area of transparency and disclosure.[10]

The Review stated that information was not generally disclosed accurately, on time or in a form understandable by shareholders. If existing shareholders can not obtain timely and accurate information, it is *a fortiori* probable that potential purchasers are also denied such information. In some important sectors of the economy, there may be little or no information available whatsoever, leaving the potential foreign acquirer with no basis on which to calculate profitability. One of the respondents in the OECD survey, a major bank in an OECD member country, reported that there is "no proper data collecting and evaluation system in operation" in target banks and "no data reporting system for branch networks".

The Review identified a major cause of the problem as being rooted in the statistical system of SOEs, which was originally designed to produce information on the fulfilment of state-set output plans. During the reform period it has metamorphosed into a system that is intended to supply data for the calculation of enterprise income tax. Managers of both listed and unlisted companies therefore have little or no practical experience of the type of financial information that should be provided to shareholders and the public (*i.e.* potential investors). There are also strong incentives to distort and manufacture information, often stemming from the loyalty of management to parent companies that may be benefiting from related party transactions which entail a diversion of funds that may in some cases be detrimental to the profitability of the company concerned.[11]

In many countries, information about major enterprises becomes available when companies seek stock market listings. This is less so in China, where stock markets are still in their infancy, there are few experienced professional analysts and institutional investor involvement remains minimal. Investors tend to expect, not entirely without foundation, that share values will be supported by the state, and tend therefore to be less demanding of accurate information. The stock market at present tends to fall somewhat short of the task of providing a wholly objective standard by which to value companies. This lack of transparency may tend to weaken the use of stock market valuation as an incentive to optimise company performance. Initial public offerings (IPOs) by SOEs may worsen rather than improve the valuation of performance of the enterprises concerned. This is because companies tend to submit inflated figures in the financial statements they are required to provide, concealing their real situation until well after they have secured a financial listing.[12]

Foreign investors considering the acquisition of part or all of the Chinese-owned assets in a joint venture have encountered difficulties in doing so because of uncertainty as to whether these assets are state-owned. Where the assets are owned by the state, they are subject to the state assets transfer rules, which involve, *inter alia*, compulsory asset valuation and public bidding. There appears to be no clear and uniform definition of what is a "state-owned property right". The confusion arises in part from complex cross-holdings by state entities. As a result, local authorities are able to exercise discretion in deciding whether such a right exists, creating uncertainty in the process of acquiring and transferring assets. Cases have been reported in which officials from different government agencies have issued contrary opinions. A clear and unambiguous definition of what constitutes a "state-owned asset" would be of benefit to all parties concerned.

Foreign investors and the law and accounting firms that represent them routinely cite problems of due diligence as a major obstacle to cross-border M&As in China. For example, the bank mentioned above reported in the OECD survey of company experiences regarding cross-border M&A transactions in China that employees and management in target enterprises were reluctant to share critical information, noting that "the closer a branch or sub-branch is to the headquarters, the more reluctant or scared the respective managers seem to be". One multinational enterprise seeking companies in its sector to acquire in China even states that it is impossible to conduct normal due diligence there because all the potential targets distort information as soon as they know they are being considered; instead, the company engages in what it terms "pre-due diligence" activities of which the target enterprises are unaware.

At the December 2005 OECD-China Symposium in Beijing on China's Policies towards Cross-Border Mergers and Acquisitions, discussants confirmed that the reluctance of the parent company of an enterprise being considered for merger or acquisition to provide adequate access and documentation to enable adequate due diligence is a major problem. It was suggested that Chinese enterprise owners need to appreciate that providing full information to a potential purchaser can greatly facilitate an M&A transaction and provide a sound basis for post-transaction co-operation.

Lack of disclosure can be particularly damaging when it includes failure to disclose significant unrecorded liabilities. These may include payments that the target company has failed to make into the company's welfare fund

Box 5.1. **Some examples of due diligence problems**

A 2001 study by PriceWaterhouseCooper* found frequent due diligence problems in a number of areas:

- Land use rights not converted from allocated land to granted land, thereby precluding the target company from transferring the land use rights.
- Activities conducted are beyond the target company's permissible business scope.
- The target company does not have legal title to some assets recorded in its books or does not have sufficient documents to support the book value of the assets.
- Loans to shareholders or related parties are not fully documented.
- Foreign currency loans or payables have not been properly registered with the State Administration of Foreign Exchange (SAFE), so repayments of these loans, interest and payables are questionable.
- Intangibles, such as patents and trademarks, have not been properly registered with the relevant authorities.
- No employment contracts are in place.
- Representative office licence is used for branch office operations.
- Financial statements are unreliable or of poor quality.
- Idle assets or assets under-utilised have not been properly accounted for on the books.
- There are unrecorded purchases, guarantees, commitments, tax, illegal or semi-legal agreements.
- Trading results are manipulated through incorrect sales cut-off, special subsidies from the parent or related-party transactions.
- Financial information needs to be converted into International Accounting Standard (IAS) format so that the potential buyer can understand the target's operating results better.
- Access to information is limited, particularly in areas of competitor intelligence.
- Social welfare costs have been understated.
- Future business projection is based on unsound assumptions.
- The target company has adopted aggressive tax schemes or made verbal special arrangements with local authorities without any legal basis.
- Capital equipment imported under a duty-free quota is used by a related or unrelated entity. This gives rise to potential claw-back of customs duty and import value-added tax (VAT).
- Tax compliance status of the target is weak, especially in the areas of VAT, individual income tax, withholding tax on foreign contractors and stamp duty on purchase and sales contracts/orders.
- Mandatory social welfare contributions are not fully funded.
- Unsupportable transfer pricing policy is adopted to shift profits overseas or to related Chinese affiliates to which a lower income tax rate is applicable.

* *www.pwcglobal.com/cn.*

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and for which the acquirer then becomes liable. They may also include payments to other entities in cash or kind for which the target enterprise is liable on a regular or irregular basis which are unrecorded in the company's accounts and which are not disclosed to the acquirer before acquisition. Such unrecorded liabilities often become known for the first time when a demand for payment is made, sometimes months after acquisition.

In one industry, a foreign multinational enterprise seeking potential acquisitions has told the OECD that it is impossible for it to calculate the future profitability of Chinese companies in its sector because it appears that their sales appear generally to be secured by "under-the-counter payments" to regional distributors which would be illegal for the foreign company to continue making under its home country law.

The 2003 Review mentioned occasional uncertainties over the allocation of land use rights. In some cases, it is not clear whether a target enterprise possesses the land it stands on and therefore whether it may lawfully transfer the land use rights. Uncertainties also occur more generally concerning property rights over enterprises in the context of the widespread policy of "letting go of the small" and there have been cases of Chinese enterprise owners charged with illegal appropriation of state property. Foreign investors may thus sometimes be wary of acquiring a Chinese enterprise for fear of unwittingly becoming party to theft of state assets.

Due diligence frequently uncovers more than one problem with an enterprise that is a potential candidate for acquisition. For example, one Canadian children's products company considering purchase of a Chinese SOE found that the target exhibited problems with land use rights, accounting discrepancies, non-compliance with Chinese regulations and under-contribution to social welfare funds.

In many OECD member countries, it is normal during due diligence for an acquirer to seek indemnification for liabilities such as pre-acquisition tax liabilities. In China such arrangements are not common, especially among small and medium-sized enterprises, and many target companies are likely to reject requests for such an indemnity. Where indemnification can be agreed, it is not always certain that the seller possesses the resources to meet obligations that might be incurred if it is invoked.

The Company Law, together with the Securities Law, the Securities Investment Fund Law and the Labour Law forms the legislative basis for corporate governance of listed companies in China. According to the CSRC, the objective of the legal framework is to protect the interests of the investors based on the principles of "transparency, fairness, and justice". Legislation is supplemented by other regulations, administrative rules, listing requirements, departmental rules, guidelines and codes. The authorities are now considering necessary amendments to the Company Law in order to, inter alia, introduce a more appropriate framework for proper corporate governance. Among the expected improvements are a strengthening of shareholder rights with respect to information and a strengthening of the position of the external auditor.[13] Measures such as these are likely to result in improved disclosure and transparency.

Chinese valuation methods differ significantly from OECD member country practices

When a foreign investor proposes to acquire an SOE, the target enterprise must be valued by a licensed valuation organisation under the auspices of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). SASAC is formally charged with promoting the reform and restructuring of state-owned enterprises as well as with preserving and increasing the value of state-owned assets for enterprises under its supervision. Therefore while SASAC actively seeks foreign investor involvement in SOE restructuring, including by M&A, it must also ensure that SOEs are not acquired for prices which represent a reduction of asset value. Once the value of the company has been determined by SASAC, negotiations on price may continue, but the result must not deviate more than 10% from the set price. A foreign investor may therefore not pay less than 90% of this price.

Loss of asset value has been a serious problem in the case of acquisitions of SOEs by managers or by managers and employees. Management buy-outs (MBOs) and management-employee buy-outs (MEBOs) began in 1999 as part of a broader initiative to reform SOEs. Reports in the official Chinese media subsequently alleged that MBOs were subject to widespread irregularities, including illegal appropriation of state assets and under-priced sales. The partial information that is publicly available shows management ownership acquisitions at discounts ranging up to 80% of net asset value. In March 2003 the Ministry of Finance suspended the examination and approval of MBOs to curb such abuses. The ban was lifted in December 2003, but the State Council and SASAC imposed severe restrictions designed to prevent managers from running down their companies in order to be able to acquire them cheaply and to stop managers from buying a company with the company's own funds. Managers wishing to continue such practices then reportedly resorted to indirect methods such as establishing trust companies. In December 2004 the State Council issued a ban on MBOs in large SOEs and SASAC issued restrictions on MBOs in small and medium-sized SOEs. In April 2005 further regulations were promulgated to prevent indirect ownership transfer through trustees and to ensure that MBOs may only occur where state-owned property

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supervision and administrations are in place and where they do not contravene other laws and regulations.

Faced with the recent large-scale loss of SOE asset value resulting from MBOs, it is not surprising that the Chinese authorities have put in place corresponding mechanisms to prevent the loss of state assets from cross-border M&A sales, which may be seen as subtracting from national, as well as public, wealth. However, while the tendency of MBOs is towards under-pricing of such assets, cross-border M&A sales are more likely to involve relatively high sales prices. In MBOs, the buyer is frequently also the seller and is thus in a position to lower the sales price. A foreign investor is an outside buyer and has no control over price, while the seller has an interest in obtaining a high price.

Major differences exist between Chinese valuation practices and those used in OECD member countries. The accounting method used to determine the net asset value of a company in China is historic book value. This method takes no account of the discounted present value of the stream of future earnings from an asset. As a result, a company that has over-invested in expensive obsolete machinery or in production lines making products for which there is no market may be greatly over-valued. Since the SOEs that are seeking cross-border M&A tend to be highly-indebted and unprofitable, such over-valuations are highly likely in the SOE sector.

More sophisticated methods of measuring the value of a company – for use in normal operations as well as sale of the company – may reduce the incidence of disputes over valuation methods of Chinese enterprises which foreign investors wish to acquire and create a more acceptable basis for price negotiation.[14]

It is also likely that many valuations of Chinese enterprises, both SOEs and private-sector enterprises, are not wholly objective because they are not conducted by impartial bodies. In OECD countries, it is common practice to employ major multinational accounting firms that are wholly independent of both buyer and seller and have international reputations to uphold. Such firms are almost never employed in making such valuations in China. In some cases, the units that perform the valuation are staffed by accountants with former links to the companies they are valuing.

The Chinese government has a right to use whatever methodology it thinks appropriate to value its own assets. However, the use of valuation criteria that are not internationally standard may result in economic consequences that are less beneficial to China than would be the use of more market-determined methods.

Differences in valuation methodology may deter cross-border acquisitions that might have taken place if the selling price of a Chinese SOE had been market-determined. Even where there is a lack of financial transparency in the target firm, the potential acquirer is likely to conduct a market-based valuation which takes into account estimates of discounted future earnings of the assets for sale. If this valuation is less than 90% of the official net asset value calculated under current official procedures, the transaction is unlikely to take place.

Conversely, it is possible that the net asset value of the SOE to be acquired understates the value for the firm in terms of its potential future earnings stream, for example in a situation where the physical assets of the SOE are small but its non-physical assets – such as workforce skills or brand reputation – are relatively abundant. In such cases, a cross-border acquisition may take place at a price which may provide a less than optimal return on state assets as a result of standard official net asset value calculation.

Hostile takeovers are difficult to accomplish

The 2002 Measures for Administration of the Takeover of Listed Companies (Takeover Code) permit investors, including foreign investors, to acquire a company through the stock market, as well as by agreement or via a public offer. However, as pointed out in the 2003 Review,[15] the bulk of shares on the Shanghai and Shenzhen stock markets are CNY-denominated A shares, which have hitherto not been available for purchase by foreigners (who have only been able to hold B shares, denominated in USD or HKD).

In addition, approximately two-thirds of the shares in listed companies in China are non-tradable and are largely held by SOEs, though this situation is now starting to change following the promulgation of share segregation reform measures in 2005 that will gradually convert non-tradable to tradable shares (see below).[16] The total market capitalisation of the 1 379 A and B share listed companies in March 2005 was CNY 34.8 billion, of which the negotiable market capitalisation was only CNY 11 billion. Only 6% of listed companies have more than 40% of their total equity in tradable shares. On average, the larger the company the higher the percentage of state-owned shares which are not tradable. Generally there is an excessive concentration of non-tradable shares in one big shareholder, dispersed ownership of tradable shares and a tiny or non-existent percentage of institutional investors. At the end of 2001, the average largest shareholder of an A share company owned 44.3% of all the company's shares.[17]

A discriminatory restriction is also currently imposed on foreign acquirers of state-owned and legal-person shares. The Notice on Transfer to Foreign Investors of State-Owned Shares and Legal-Person Shares issued by the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission (SETC) imposes a one-year lock-up period for any foreign investor acquiring state-owned shares or legal-person shares. No such restriction is imposed on domestic acquirers. This mandatory transfer restriction is seen by foreign investors as impairing the liquidity of their equity investments in companies listed on China's stock exchanges and therefore as a disincentive to cross-border M&A activity in China.

The situation may now be improving following the issuing of a Notice on the Trial Reform of Segmented Share Structure of Limited Companies by the CSRC. Pursuant to this notice and to implementing rules adopted by China's stock exchanges, many companies are now converting the state-owned and legal-person shares into freely tradable shares. Under the Administration Measures on Strategic Investment in Listed Companies by Foreign Investors, published on 31 December 2005 by MOFCOM, CSRC, the State Administration of Taxation, SAIC and SAFE, which came into effect on 31 January 2006, foreign investors can purchase A shares of listed companies which have completed share segregation reform or which have listed after such reform. Purchase shall be through transfer by agreement or private placement.

While the Takeover Code permits foreign investor acquisition of Chinese listed companies via the stock market, this can currently happen only with the agreement of the major shareholder. Hostile takeovers of domestic Chinese enterprises via the Chinese stock markets may therefore be difficult to complete. The scope for hostile takeovers is effectively limited to those Chinese enterprises belonging to parent companies listed on stock exchanges outside China's economic jurisdiction, such as the Hong Kong Stock Exchange (where most of these are listed) or the New York Stock Exchange.

The threat of a hostile takeover is a market discipline encouraging managements to strive for profitability and efficiency so that they can maximise shareholder value. Failure to do so can result in a hostile takeover and subsequent restructuring involving replacement of underperforming managers. This threat can therefore be seen as supporting the Chinese government's aim of maintaining and increasing national assets. In the existing situation, managements in China are more secure from hostile takeovers than in most market economies, allowing many loss-making companies to survive. Difficulties in accomplishing hostile takeovers are more likely to encourage behaviours leading to value destruction rather than value creation.

Findings of the December 2005 OECD-China Symposium

At the December 2005 OECD-China Symposium in Beijing on China's Policies towards Cross-Border Mergers and Acquisitions, discussants strongly endorsed the current validity of the examples of due diligence problems listed in Box 5.1. They reiterated that corporate financial data in China were frequently inaccurate and unreliable. They stated that there was generally a lack of information or an unwillingness to disclose necessary information on the part of Chinese enterprises. It was pointed out that this is frequently because the enterprises concerned would not be viable if they paid tax and therefore they keep two sets of accounts, an internal set for management and a false set for the tax authorities. This practice renders them liable to prosecution if discovered, making them reluctant to disclose financial information. Discussants also stated that foreign investors were often frustrated to find that essential information, for example on land-use rights, is not made available before a cross-border merger or acquisition is completed. It was also pointed out that related party transactions may cause great confusion, as they tend to be unwritten, vague and a frequent source of corruption. Such transactions may distort, positively or negatively, the financial results of a target entity. They may also cause future unexpected tax liabilities due to the potential transfer pricing problems. Discussants concluded that the overall culture of transparency is not widespread in China.

Symposium discussants proposed that the Chinese government develop standardised due diligence guidance for SOEs, covering *inter alia* ownership structures, related party transactions and land-use rights. They also suggested that the government consider a remedial programme to address past regulatory gaps, such as missing permits. The programme would remove the motivation for current managers to avoid dealing with such problems. Discussants suggested that on the Chinese side, the government develop training programmes and educational campaigns to promote the concept of "acting as a responsible seller" and provide best practice case studies to illustrate common features of successful due diligence. Such a programme could, they suggested, follow traditional Chinese government practice in being implemented first in a specific enterprise, industrial sector, or locality, and then expanding the measure nationwide.

Competition policy and cross-border M&A

As noted above, the 2003 Interim Provisions contain regulations on pre-merger notification that appear to discriminate against foreign investors and others that are based on unquantifiable pre-merger notification thresholds.

Anti-monopoly legislation has been in the drafting stage since the mid-1990s. The current anti-monopoly provisions in the 2003 Interim Provisions for Merger and Acquisition of Domestic Enterprises by Foreign Investors provide the current regulatory framework governing cross-border mergers and acquisitions. While these provisions have to some extent clarified the situation governing anti-trust notification requirements for proposed cross-border mergers, a full legal framework within which they can be effectively implemented is still lacking. Such a framework may well be provided by the

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anti-monopoly law which the Chinese government is preparing to enact. Until then, it is not clear how the anti-trust provisions of the 2003 Interim Provisions can be enforced.

An anti-monopoly law has not been passed. However, drafts of the proposed law have been circulated. The Secretariat of the OECD's Competition Committee has reviewed these,[18] and has provided detailed comments on the latest draft to the Chinese Government. The OECD considers this draft to be a major advance on the Interim Provisions. It includes a non-discriminatory merger notification requirement applying to both domestic and cross-border mergers, grants investigative powers to the authorities, sets fixed penalties for violations and provides for judicial review in disputed cases. In the OECD's view, however, many defects remain, and the OECD has urged the Chinese authorities to address them.

In brief, the OECD's recommendations relating to the merger control provisions of the draft are as follows:

- Clarify in certain respects the definition of transactions that are considered concentrations or mergers, and as such are subject to the law.
- Eliminate market shares as a criterion defining the obligation to notify a merger. Market shares are not objective, and using them for this purpose introduces considerable uncertainty into the process. Also, strengthen the "local nexus" component of the notification thresholds, thereby eliminating from the notification requirement some transactions that are almost certain not to affect competition significantly in China.
- Reduce in certain respects the amount of information that must be supplied with a notification.
- Shorten the period during which the parties to a merger may not consummate their transaction following notification, and clarify the computation of the waiting periods that apply when a detailed review of a merger is necessary.
- Provide the Antimonopoly Authority with the power to issue to the merging parties a request for additional information in cases where it determines that a more intensive review is necessary.
- Modify the substantive standard according to which mergers are approved or denied. In particular, the standard for disapproval should require a *probability* or *likelihood* that the concentration will have the necessary anticompetitive effects, and the predicted anticompetitive effect should be *substantial*, or *significant*.
- Clarify in certain respects the provision in the draft that permits the Antimonopoly Authority to approve an anticompetitive merger that "will produce great benefits for the national economy and the public interest".

- Provide the Antimonopoly Authority with the power to issue regulations governing the procedures for merger review, including in certain respects the applicable notification requirements.

Notes

1. OECD (2003b).
2. OECD (2003b).
3. NDRC (2004).
4. NDRC (2004).
5. *China Metallurgical Newsletter*, Volume 7, No. 14, 28 July 2005.
6. OECD (2003b).
7. Submission by the Business and Industry Advisory Council to the OECD (BIAC).
8. Shanghai Stock Exchange (2004).
9. The Code of Corporate Governance for Listed Companies in China does not cover unlisted SOEs. However, China is actively discussing SOE-related corporate governance issues with the OECD. Section V of the OECD Guidelines on Corporate Governance of State-Owned Enterprises state that state-owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.
10. OECD (2003b).
11. OECD (2003b).
12. OECD (2003b).
13. Chapter 10 of OECD (forthcoming), *China Governance*.
14. For example, Zhang Zhengjun of the Development Research Centre of the State Council proposed the use of economic value added (EVA) in his presentation on the Assessment of the Maintenance or Addition of the Value of State-owned Assets by Corporate Value Indicators at the Second OECD-China Dialogue on corporate governance in May 2005.
15. OECD (2003 b).
16. Shanghai Stock Exchange (2004).
17. Presentation by Dr. Ruyin Hu, Director of the Research Centre of the Shanghai Stock Exchange on Corporate Governance of State Controlled Listed Companies in China: Problems, Progress and Prospects at the Second OECD-China Dialogue on corporate governance in May 2005.
18. Anti-Monopoly Law of The People's Republic of China (Draft for Comments) 8 April 2005. Subsequent drafts, the latest of which is dated 14 September 2005, have been circulated for comment.

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Chapter 6

Recommended Policy Responses

The Chinese authorities are invited to consider a number of policy responses to the challenges outlined in the previous chapter.

Foreign ownership restrictions could be relaxed by pruning and/or replacing the catalogues for guidance of foreign investment projects.

Greater regulatory transparency could be achieved by further streamlining the cross-border mergers and acquisitions (M&As) approval process, maintaining a consistent list of restrictions, and by defining and explaining the term "strategic industries".

A sound competition law, conforming to recognised international best practices in merger review, would contribute materially to transparency and fairness for the business community, including both foreign investors and domestic market participants.

China is encouraged to continue its dialogue with the OECD on corporate governance and to consider establishing models of good corporate governance practice.Wider adoption of internationally-recognised accounting standards and asset-valuation methods by Chinese enterprises would also be welcomed.

The reform of the share ownership structure of limited companies and the decision to permit foreign investors to purchase previously non-tradable and A shares constitute a major step forward in opening China's capital markets to foreign participation. The Chinese authorities are encouraged to consider relaxing remaining restrictions on such participation.

The Chinese government may wish to consider trying out these policy options in a pilot project in North-East China before implementing them on a national scale.

There are a number of measures that the Chinese government can take to remove obstacles to cross-border M&A so that it can play a fuller part in both the revitalisation of the old industrial bases in North-East China and in promoting China's economic development more generally.

Relaxing foreign ownership restrictions

Pruning and/or replacing the catalogues

In the 2003 Review, the OECD proposed that in view of the positive experience to date of sectors that have been opened to 100% per cent foreign ownership, the next steps in opening up could include:

- Publishing a consolidated list of all foreign ownership restrictions in all sectors.
- Explaining the reasons for each of these ownership restrictions.
- Progressively removing remaining foreign ownership restrictions.
- Phasing in full foreign ownership in the remaining sectors over a period similar to that prevailing in other sectors under existing commitments where no such case can plausibly be made.

The Review consequently suggested that the catalogue regime might be replaced with a single short list of sectors barred to foreign participation, supplemented by a clear explanation of the grounds for selection. All projects not on the list would then be permitted. As a transitional step towards wholesale reform of the catalogues, it would be good practice to reconsider the prohibition of foreign investment where the intention of controlling specific activities may be more effectively achieved in other ways, such as prudential regulation. The result would be the publication of a smaller prohibited catalogue containing only items which it is international practice to restrict or which China has a special and understandable reason for restricting.

These proposals are not reflected in the revised Catalogue promulgated at the beginning of 2005, which were not accompanied by a full explanation either of the revisions or the retained text.

The Chinese government is invited to reconsider the proposals in the 2003 Review positively in the light of its experience of further opening up the economy to foreign investment since acceding to the WTO in 2001.

Catalogue reform may be easier to accomplish step by step, beginning with clarification of the existing catalogue regime and the improvement of co-ordination between the various government agencies involved in developing and implementing the catalogues. Clarification might be assisted by conducting a study to measure the effectiveness of the catalogues in achieving their stated aims.

Greater regulatory transparency

Further streamlining the approval process

An important element of regulatory simplification that needs to be addressed is the further streamlining of procedures for approving a cross-border M&A transaction. The Chinese authorities have made progress in simplifying the approval process for proposed FDI projects, but the procedure for approving and registering a cross-border merger or acquisition remains complex and confusing, involving too many separate government bodies. As a first step towards further streamlining, the Chinese authorities could conduct a stock-taking exercise to enumerate all the steps in the approval process and consider which of them could be consolidated with other steps to eliminate time-wasting and unnecessary procedures, having regard to the efficient and appropriate allocation of responsibilities among government agencies. Until the number of agencies and the number of decision points involved in the foreign investment project approval process have been reduced, the Chinese authorities are invited to consider the establishment of one-stop shops for cross-border mergers and acquisitions at national and provincial/municipal level.

Maintaining a consistent list of restrictions

The publication of an industry policy for the iron and steel sector that includes tighter restrictions on foreign investment than are contained in the Catalogue for Guidance of Foreign Investment shows that the catalogue regime does not provide full information to potential foreign investors on which sectors are open to foreign investment. It also indicates that discretionary powers of foreign investment restriction exist which may result in inconsistency between different government policies and/or between different branches of government.

The Chinese government is invited to clarify the relationship between industrial policies involving restrictions on foreign investment and the Catalogue for Guidance of Foreign Investment, especially in cases where these mutually inconsistent. The Chinese government is again invited to make available to foreign investors a consolidated list of all foreign ownership restrictions available in all sectors, as proposed in the 2003 Review.

Defining and explaining "strategic industries"

The Chinese government routinely states that what it terms "strategic industries" are off limits for cross-border M&A. However, there remains great uncertainty regarding *i)* the definition of strategic industries, *ii)* the identity of all strategic industries and *iii)* the rationale for classifying specific industrial sectors as strategic industries. While it is understandable that, for example, directly defence-related sectors such as weapons production are regarded as being of strategic importance, it is not clear why other sectors should be so included. It appears possible that in some instances industries are classed as strategic to obstruct foreign competition, thereby reducing competitive pressures that might otherwise improve profitability and efficiency. The Chinese government is invited to provide:

- A definition of the term "strategic industry".
- A full list of all "strategic industries" (*i.e.* a subset of the consolidated list of foreign ownership restrictions proposed above).
- An explanation of the inclusion of each industrial sector in the list.
- A single location where a potential foreign investor may learn whether or not the sector in which the investor is considering a cross-border M&A transaction is strategic.

Providing a sound substantive and procedural basis for reviewing the competitive effects of mergers

The Chinese government is preparing to enact a competition law. The OECD Review welcomes the openness with which the Chinese government has shared drafts of this law with interested parties, including legal experts in OECD member countries. It also welcomes the intention of the Chinese government to establish a non-discriminatory framework for considering industrial concentration, as the drafts of this law indicate that domestic and foreign-invested enterprises will be treated alike in the new law.

A sound competition law, which conforms to recognised international best practices in merger review, will contribute materially to transparency and fairness for the business community, facilitating cross-border M&A, while at the same time providing an important measure of protection for the Chinese consumer against anticompetitive mergers.

Increasing corporate transparency

Greater transparency

The Chinese government promotes good corporate governance practices through the Code of Corporate Governance for Listed Companies, yet serious problems of non-compliance with the Code persist in such companies. The Chinese government is encouraged to persevere with efforts to enforce the

Code, particularly in the areas of transparency and disclosure of financial information.

China is encouraged to continue its dialogue with the OECD on corporate governance. In particular, it is encouraged to continue its discussion with the OECD on corporate governance principles for SOEs following the successful 2nd China-OECD Policy Dialogue on Corporate Governance in May 2005 on the theme of corporate governance of state-owned assets. The *OECD Guidelines on Corporate Governance of State Owned Enterprises* adopted by member countries in April 2005 constitute a key input to this discussion.

The Chinese government is invited to consider encouraging the establishment models of good corporate governance practice in specific sectors and enterprises.

Wider adoption of internationally-recognised accounting standards and asset valuation methods

As noted in the 2003 Review,[1] China has made great strides in training accountants and ensuring that they operate within an effective regulatory framework and are organised in a professional body charged with implementing internationally-recognised accounting standards. Nevertheless, foreign investors seeking financial information regarding possible acquisition targets frequently report non-standard accounting practices that make it difficult to assess the performance and potential of an enterprise. The Chinese government has promised actively to promote and accelerate the adoption of International Accounting Standards (IAS) to eliminate differences between financial reporting standards and auditing standards between Chinese and foreign enterprises. The OECD Review welcomes this pledge and supports efforts to train more accountants capable of implementing IAS.

Opening capital markets

Stock market transactions are an important channel for cross-border M&As. The 2003 Review pointed out that foreign investor access to China's stock markets was highly restricted.[2] As a result, foreign investors found it difficult to acquire Chinese companies by purchases of listed shares. This restriction, combined with the ownership structure of most Chinese enterprises, made hostile takeovers well nigh impossible, encouraging complacency on the part of inefficient enterprise managers.

In 2005 the Chinese authorities embarked on a major reform of the share ownership structure of listed companies. As part of this reform, formerly non-tradable shares are being made tradable and foreign investors will increasingly be permitted to purchase them, including A shares. These reforms are a major step in opening up the stock market to foreign investors.

Nevertheless, discriminatory restrictions on foreign ownership of listed companies, such as the mandatory one-year restriction on the transfer of shares acquired by foreign investors, persist. The Chinese authorities are encouraged to consider relaxing such restrictions.

North-East China as a possible test bed for pilot projects

There are indications that the Chinese government, while recognising the need for adoption and implementation of policy options such as those outlined above, considers that it is not practical to do so over a short period of time. As proposed by discussants at the December 2005 Symposium on China's Policies Towards Cross-Border Mergers and Acquisitions, China might wish to consider introducing some liberalisation measures on a pilot basis in North-East China as a means of contributing to the revitalisation of the country's old industrial base. If successful, these measures could then be spread to the rest of the country. This pragmatic method of local testing is one that has proved useful in developing and entrenching previous reforms in China.

Notes

1. OECD (2003b).
2. OECD (2003b).

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Abbreviations

CSRC	China Securities Regulatory Commission
FDI	Foreign direct investment
FIE	Foreign-invested enterprise
MNE	Multinational enterprise
MoF	Ministry of Finance
MOFCOM	Ministry of Commerce
MOFTEC	Ministry of Trade and Economic Co-operation [merged into MOFCOM in 2003]
PBoC	People's Bank of China
QFII	Qualified foreign institutional investor
SAFE	State Administration for Foreign Exchange
SAIC	State Administration of Industry and Commerce
SASAC	State-owned Assets Supervision and Administration Commission
SETC	State Economic and Trade Commission [merged into MOFCOM in 2003]
SOE	State-owned enterprise
WFOE	Wholly-foreign-owned enterprise

ANNEX A

Informal External Advisory Group on OECD Investment Committee-China Investment Policy Co-operation

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ANNEX B

Survey of Company Experiences Regarding Cross-border M&A Transactions in China

In July 2005 a questionnaire was distributed by the Secretariat of the OECD Investment Committee to OECD member country based enterprises operating in China. Questionnaire on cross-border mergers and acquisitions in China. The questionnaire sought to discover what, if any, problems the enterprises had encountered when considering and/or implementing mergers and acquisitions involving domestic Chinese enterprises. In particular, it asked whether the member country based enterprise had experienced:

- Disputed valuation of the assets to be acquired.
- Non-standard accounting practices in regard to valuation/auditing.
- Lack of transparency regarding any business operations of the target enterprise.
- Difficulties in conducting due diligence.
- Refusal or reluctance on the part of representatives of the target enterprise to provide indemnification against unregarded liabilities.
- Complicated procedures for approving and/or registering the resulting new foreign-owned enterprise.
- Opposition or obstacles on the part of local government to the merger or acquisition.
- Problems stemming from the requirement to notify a merger or acquisition under current anti-monopoly regulations.
- Lack of clarity regarding the incidence of taxation with regard to the planned or actual merger or acquisition.

Finally, respondents were asked to make an overall assessment of the existing climate for cross-border mergers and acquisitions and recommendations for new policy measures (or for improved implementation/enforcement of existing policies) to facilitate such mergers and acquisitions. Results have been incorporated in the body of this report.

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ANNEX C

Statistical Tables

Table C.1. **Growth of FDI inflows, 1979-2005**

	Projects (number)	Contracted (USD million)	Realised (USD million)
1979-82	920	4 958	1 769
1983	638	1 917	916
1984	2 166	2 875	1 419
1985	3 073	6 333	1 956
1986	1 498	3 330	2 244
1987	2 233	3 709	2 314
1988	5 945	5 297	3 194
1989	5 779	5 600	3 393
1990	7 273	6 596	3 487
1991	12 978	11 977	4 366
1992	48 764	58 124	11 008
1993	83 437	111 436	27 515
1994	47 549	82 680	33 767
1995	37 011	91 282	37 521
1996	24 556	73 276	41 726
1997	21 001	51 003	45 257
1998	19 799	52 102	45 463
1999	16 918	41 223	40 319
2000	22 347	62 380	40 715
2001	26 140	69 195	46 878
2002	34 171	82 768	52 743
2003	41 081	115 070	53 505
2004	43 664	153 500	60 630
2005	44 001	189 064	60 325

Source: MOFCOM FDI Statistics.

Table C.2. **Growth of cumulative FDI, 1979-2003**

	Projects (number)	Contracted (USD million)	Realised (USD million)
1979-82	920	4 958	1 769
1983	1 558	6 875	2 685
1984	3 724	9 750	4 104
1985	6 797	16 083	6 060
1986	8 295	19 413	8 304
1987	10 528	23 122	10 618
1988	16 473	28 419	13 812
1989	22 252	34 019	17 205
1990	29 525	40 615	20 692
1991	42 503	52 592	25 058
1992	91 267	110 716	36 066
1993	174 704	222 152	63 581
1994	222 253	304 832	97 348
1995	259 264	396 114	134 869
1996	283 820	469 390	176 595
1997	304 821	520 393	221 852
1998	324 620	572 495	267 315
1999	341 538	613 718	307 634
2000	363 885	676 098	348 349
2001	390 025	745 291	395 223
2002	424 196	828 059	447 966
2003	465 227	943 131	501 471

Source: MOFCOM FDI Statistics.

Table C.3. **FDI inflows to China and all OECD member countries, 1998-2004**
USD billion

Country or territory	1998	1999	2000	2001	2002	2003	2004
China	43.8	38.8	38.4	46.9	52.7	53.5	60.6
Austria	4.5	3.0	8.8	5.9	0.4	7.4	4.9
Belgium and Luxembourg	22.7	38.7	243.3	51.0			
Belgium					15.6	32.1	34.4
Canada	22.6	25.2	63.3	27.6			
Denmark	7.7	6.8	14.5	11.6	6.9	2.7	–11.4
France	31.0	47.1	42.9	50.5	49.1	42.5	24.3
Germany	24.6	54.8	195.2	26.4	50.6	27.3	–38.6
Greece	–	0.6	1.1	1.6	0.1	0.7	1.4
Iceland	0.1	0.1	0.2	0.2	0.1	0.3	0.4
Ireland	8.9	19.0	24.1	9.7	29.0	26.9	14.1
Italy	4.3	6.9	13.4	14.9	14.6	16.4	16.8
Netherlands	37.9	31.9	54.3	51.9	25.1	19.3	–4.6
Norway	4.0	7.5	6.0	2.0	0.7	3.8	2.2
Portugal	3.1	1.2	6.4	6.3	1.8	6.6	1.1
Spain	11.8	15.8	37.5	28.0	35.9	25.6	9.9
Sweden	19.6	60.9	23.4	11.9	11.7	1.3	–1.9
Switzerland	8.9	11.7	16.3	8.9	6.3	16.6	4.5
Turkey	1.0	0.8	1.7	3.3	1.0	1.7	2.6
UK	70.6	82.9	119.7	52.7	24.1	20.4	78.5
United States	179.0	289.5	307.7	167.0	80.8	67.1	106.8
Japan	10.2	21.1	29.0	6.2	9.2	6.3	7.8
Finland	12.1	4.6	8.8	3.7	7.9	3.3	4.7
Australia	6.1	5.7	11.9	4.6	15.6	6.8	42.2
New Zealand	1.8	0.9	1.3	4.2	–0.5	0.7	2.6
Mexico	11.9	12.5	14.7	27.7	15.3	11.7	16.6
Czech Republic	3.7	6.3	5.0	5.6	8.5	2.1	4.5
Hungary	2.0	2.0	1.6	3.9	3.0	2.2	4.2
Poland	6.4	7.3	9.3	5.7	4.1	4.1	6.2
Korea	5.2	10.7	10.1	3.5	2.4	3.5	8.2
Slovak Republic	0.5	0.4	2.1	1.6	4.1	0.6	1.1

Sources: IMF, International Financial Statistics (for China, except for 2001, where the figure is from the National Bureau of Statistics); OECD, *International Investment Perspectives*, 2002 and 2005 editions (OECD countries).

Table C.4. **FDI by type, 1979-2005**

(USD million realised FDI)

	Equity joint ventures	Share of total %	Contractual joint ventures	Share of total %	Wholly-foreign-owned	Share of total %	Joint exploitation	Share of total %	Compen-sation trade	Share of total %	Foreign-invested shareholding enterprises	Share %	Other	Share of total %	Total
1979-82	103.0	5.8	530.0	29.9	0.0	0.0	487.0	27.5	413.0	23.3	0.0	0.0	237.0	13.4	1 770.0
1983	73.6	8.0	227.4	24.8	42.8	4.7	291.5	31.8	197.3	21.5	0.0	0.0	83.5	9.1	916.0
1984	254.7	18.0	465.0	32.8	14.9	1.1	522.9	36.9	98.5	6.9	0.0	0.0	62.8	4.4	1 418.9
1985	579.9	29.6	585.0	29.9	13.0	0.7	480.6	24.6	168.6	8.6	0.0	0.0	129.1	6.6	1 956.2
1986	804.5	35.9	793.8	35.4	16.3	0.7	260.3	11.6	181.1	8.1	0.0	0.0	187.7	8.4	2 243.7
1987	1 485.8	56.1	620.0	23.4	24.6	0.9	183.2	6.9	222.3	8.4	0.0	0.0	110.8	4.2	2 646.6
1988	1 975.4	52.9	779.5	20.9	226.2	6.1	212.6	5.7	316.6	8.5	0.0	0.0	221.4	5.9	3 731.7
1989	2 037.2	54.0	751.8	19.9	371.4	9.8	232.2	6.2	261.3	6.9	0.0	0.0	119.6	3.2	3 773.5
1990	1 886.1	50.2	673.6	17.9	683.2	18.2	244.3	6.5	158.7	4.2	0.0	0.0	109.0	2.9	3 754.9
1991	2 299.0	49.3	763.6	16.4	1 134.7	24.3	169.0	3.6	208.3	4.5	0.0	0.0	92.0	2.0	4 666.6
1992	6 114.6	54.2	2 122.5	18.8	2 520.3	22.3	250.1	2.2	172.3	1.5	0.0	0.0	111.8	1.0	11 291.6
1993	15 347.8	55.3	5 237.6	18.9	6 505.6	23.4	424.0	1.5	89.7	0.3	0.0	0.0	166.2	0.6	27 770.9
1994	17 932.5	52.8	7 120.2	21.0	8 035.6	23.7	678.2	2.0	88.9	0.3	0.0	0.0	90.4	0.3	33 945.8
1995	19 077.9	50.5	7 535.6	19.9	10,3168	27.3	590.2	1.6	211.5	0.6	0.0	0.0	73.7	0.2	37 805.7
1996	20 754.5	49.3	8 109.4	19.2	12,6061	29.9	255.5	0.6	158.3	0.4	0.0	0.0	251.3	0.6	42 135.2
1997	19 495.4	41.7	8 930.0	19.1	16,1875	34.6	356.0	0.8	90.0	0.2	288.2	0.6	1 383.3	3.0	46 730.3
1998	18 388.0	40.4	9 719.0	21.4	16 470.0	36.2	179.0	0.4	–	–	707.0	1.6	0.0	0.0	45 463.0
1999	15 827.0	39.3	8 234.0	20.4	15 545.0	38.6	384.0	1.0	–	–	292.0	0.7	0.0	0.0	40 319.0
2000	14 343.0	35.2	6 596.0	16.2	19 264.0	47.3	382.0	0.9	–	–	130.0	0.3	0.0	0.0	40 715.0
2001	15 754.0	33.6	6 212.0	13.3	23 873.0	50.9	511.0	1.1	–	–	528.0	1.1	0.0	0.0	46 878.0
2002	14 992.0	28.4	5 058.0	9.6	31 725.0	60.2	272.0	0.5	–	–	697.0		0.0	0.0	52 743.0
2003	15 392.0	28.8	3 836.0	7.2	33 384.0	62.4	33.0	0.1	–	–	328.0	0.3	532.0	1.0	53 505.0
2004	11 570.0	19.1	3 112.0	5.1	40 222.0	66.3	109.0	0.2	–	–	777.0	1.3	4 840.0	8.0	60 630.0
2005	10 480.0	17.4	1 831.0	3.0	42 961.0	71.2	0.0	0.0	–	–	918.0	1.5	4 135.0	6.9	60 325.0

Note: From 1997, compensation trade is not included in the official figures for realised FDI inflows. It is included in the total here to show how the proportion of compensation trade has changed over the whole period. Total realised FDI calculated from this table is therefore higher than the official total, from which compensation trade has since been excluded, and all percentages therefore differ from those calculated with compensation trade omitted. While compensation trade represented a major proportion of FDI at the beginning of the reform period, in recent years its contribution has been negligible.

Source: MOFCOM, *Statistics on FDI in China*, 2004; *www.fdi.gov.cn*.

Table C.5. **Changing sources of FDI inflows to China, 1986-2005**

% of total realised FDI inflow for year

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Hong Kong (China)	59.2	68.6	64.7	60.0	53.9	55.1	68.2	62.8	58.2	53.5	49.6	45.6	40.7	40.6	38.1	35.7	33.9	33.1	31.3	29.8
European Union	8.0	2.3	4.9	5.5	4.2	5.6	2.2	2.4	4.6	5.7	6.6	9.2	8.8	11.1	11.0	8.9	7.0	7.4	7.0	8.6
United States	14.5	11.4	7.4	8.4	13.1	7.4	4.6	7.5	7.4	8.2	8.3	7.2	8.6	10.5	10.8	9.5	10.3	7.9	6.5	5.1
Japan	11.7	9.5	16.1	10.5	14.4	12.2	6.5	4.8	6.2	8.3	8.8	9.6	7.5	7.4	7.2	9.3	7.9	9.5	9.0	10.8
Chinese Taipei	–	–	–	4.6	6.4	10.7	9.5	11.4	10.0	8.4	8.3	7.3	6.4	6.5	5.6	6.4	7.5	7.4	5.1	3.6

Source: MOFCOM FDI Statistics.

Table C.6. **Regional distribution of FDI inflows into China in 2005**

Locality	Projects (number)	Share (%)	Contractual value (USD million)	Share (%)	Realised value (USD million)	Share (%)
Total	**44 001**	**100.0**	**189 064.5**	**100.0**	**60 324.7**	**100.0**
Beijing	2 138	4.9	7 680.0	4.1	3 528.3	5.9
Tianjin	1 305	3.0	7 077.9	3.7	2 433.1	4.0
Hebei	569	1.3	2 155.9	1.9	516.2	0.9
Shanxi	78	0.2	991.6	0.5	98.1	0.2
Inner Mongolia	190	0.4	968.3	0.5	263.3	0.4
Liaoning	2 703	6.1	15 294.7	8.1	2 302.9	3.8
Jilin	350	0.8	709.5	0.4	332.3	0.6
Heilongjiang	267	0.6	282.8	0.5	405.7	0.7
Shanghai	4 233	9.6	14 174.7	7.5	6 711.1	11.1
Jiangsu	7 124	16.2	46 279.9	24.5	9 501.5	15.8
Zhejiang	3 387	7.7	15 843.1	8.4	5 208.7	8.6
Anhui	421	1.0	1 518.2	0.8	538.9	0.9
Fujian	1 987	4.5	5 887.8	3.1	2 061.3	3.4
Jiangxi	937	2.1	3 770.1	2.0	1 032.5	1.7
Shandong	6 437	14.6	27 165.7	14.5	8 887.5	14.7
Henan	464	1.1	2 055.0	1.1	518.7	0.9
Hubei	519	1.2	2 048.1	1.1	753.3	1.3
Hunan	716	1.7	3 762.3	2.0	1 146.4	1.9
Guangdong	8 384	19.1	23 740.5	12.6	12 363.9	20.5
Guangxi	351	0.8	1 101.3	0.6	375.3	0.6
Hainan	172	0.4	287.1	0.2	43.7	0.1
Sichuan	413	0.9	1 834.9	1.0	606.8	1.0
Chongqing	206	0.5	656.4	0.4	220.3	0.4
Guizhou	61	0.1	189.5	0.1	34.6	0.1
Yunnan	152	0.4	436.2	0.2	173.5	0.3
Tibet	16	0.0	16.9	0.0	0.5	0.0
Shaanxi	253	0.6	1 328.9	0.7	190.4	0.3
Gansu	33	0.1	133.5	0.1	20.6	0.0
Qinghai	29	0.1	93.4	0.1	4.8	0.0
Ningxia	31	0.1	190.3	0.1	42.1	0.1
Xinjiang	75	0.2	259.7	0.1	8.5	0.0

Source: MOFCOM FDI Statistics.

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Table C.7. **FDI inflows to East, Central and West China in 2005**

Region	Projects (number)	Share (%)	Contractual value (USD million)	Share (%)	Realised value (USD million)	Share (%)
Total	**44 001**	**100.0**	**189 064.5**	**100.0**	**60 324.7**	**100.0**
East	38 439	87.4	165 887.3	87.7	53 558.1	88.8
Centre	3 752	8.5	15 968.0	8.5	4 825.9	8.0
West	1 810	4.1	7 209.2	3.8	1 940.7	3.2

Source: MOFCOM FDI Statistics.

Table C.8. **Sectoral distribution of FDI inflows in 2005: specific sectors**

Sector	Projects (number)	Share (%)	Contractual value (USD million)	Share (%)	Realised value (USD million)	Share (%)
Total	44 001	100.0	189 064.5	100.0	60 324.7	100.0
Agriculture, forestry, animal husbandry and fishing	1 058	2.4	3 837.3	2.0	718.3	1.2
Mining and extraction	252	0.6	1 016.3	0.6	355.0	0.6
Oil and natural gas extraction	27	0.1	139.0	0.1	114.7	0.2
Manufacturing	28 928	65.7	127 357.3	67.4	42 452.9	70.4
Textiles	1 269	2.9	5 452.0	2.9	2 104.0	3.5
Chemicals	1 525	3.5	7 700.1	4.1	2 808.8	4.7
Pharmaceuticals	460	1.0	2 240.1	1.2	555.5	0.9
Common equipment	2 004	4.6	8 442.2	4.5	2 032.1	3.4
Specialised equipment	1 900	4.3	8 090.0	4.3	1 941.2	3.2
Telecommunications equipment, computers and other electronic equipment	2 878	6.5	21 018.9	11.1	7 711.2	12.8
Utilities	390	0.9	2 566.8	1.4	490.2	0.8
Construction	457	1.0	831	0.4	905	1.5
Transport, warehousing, post and telecommunications	734	1.7	5 224.0	2.8	1 812.3	3.0
Wholesale and retail	2 602	5.9	4 344.0	2.3	1 038.5	1.7
Financial industry	40	0.1	551.4	0.3	219.7	0.4
Leasing and commercial services	2 981	6.8	8 580.1	4.5	3 745.1	6.2
Scientific research, technical services and geological prospecting	926	2.1	1 755.0	0.9	340.4	0.6
Water conservancy, environment and public administration	139	0.3	921.3	0.5	139.1	0.2
Education	51	0.1	159.7	0.1	17.8	0.0
Healthcare, social insurance and social welfare services	22	0.0	164.6	0.1	39.3	0.1
Culture, physical education and entertainment	272	0.6	1 069.3	5.9	305.4	0.5
Public management and social organisations	0	0.0	0.0	0.0	3.7	0.0
Accommodation and catering	1 207	2.7	2 736.7	1.4	560.2	0.9
Tourism and hotels	199	0.5	1 286.4	0.7	216.2	0.4
Real estate	2 120	4.8	19 400.3	10.3	5 418.1	9.0
Real estate development	1 728	3.9	17 815.4	9.4	5 020.1	8.3
Residents services and other services	329	0.7	1 366.2	0.7	260.0	0.4

Source: MOFCOM FDI Statistics.

Table C.9. **Share of FIEs in total exports and imports, 1986-2005**

	FIE exports and imports as share of total (%)	FIE exports as share of total (%)	FIE imports as share of total (%)
1986	4.0	1.9	5.6
1987	5.6	3.1	7.8
1988	8.1	5.2	10.6
1989	12.3	9.4	14.9
1990	17.4	12.6	23.1
1991	21.3	16.8	26.5
1992	26.4	20.4	32.7
1993	34.3	27.5	40.2
1994	37.0	28.7	45.8
1995	39.1	31.5	47.7
1996	47.3	40.7	54.5
1997	47.0	41.0	54.6
1998	48.7	44.1	54.7
1999	50.8	45.5	51.8
2000	49.9	47.9	52.1
2001	50.8	50.1	51.7
2002	53.2	52.2	54.3
2003	55.5	54.8	56.2
2004	57.4	57.1	57.8
2005	58.5	58.3	58.7

Source: MOFCOM FDI Statistics.

Table C.10. **FIE Exports and imports, 1986-2005**
USD million

	Exports	Imports	Trade balance
1986	582	2 403	–1 821
1987	1 210	3 374	–2 164
1988	2 461	5 882	–3 421
1989	4 914	8 796	–3 882
1990	7 813	12 302	–4 489
1991	12 047	16 908	–4 861
1992	17 360	26 387	–9 027
1993	25 237	41 833	–16 596
1994	34 713	52 934	–18 221
1995	46 876	62 943	–16 067
1996	61 506	75 604	–14 098
1997	74 900	77 720	–2 820
1998	80 962	76 717	4 245
1999	88 628	85 884	2 744
2000	119 441	117 273	2 168
2001	133 235	125 863	7 372
2002	169 937	160 286	9 651
2003	240 341	231 914	8 427
2004	338 606	324 557	14 049
2005	444 210	387 516	56 694

Source: MOFCOM FDI Statistics.

Table C.11. **Top ten destinations of China's outward FDI in 2004**
USD million

Recipient	FDI received
Hong Kong, China	2 629
Cayman Islands	1 286
British Virgin Islands	386
Sudan	147
Australia	125
United States	120
Russia	77
Indonesia	62
Singapore	48
Nigeria	46

Source: MOFCOM.

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Table C.12. **Top ten destinations of China's outward FDI cumulated to end-2004**

USD million

Recipient	FDI received
Hong Kong, China	30 393
Cayman Islands	6 660
British Virgin Islands	1 089
United States	670
Macao, China	625
Korea	562
Australia	495
Singapore	241
Bermuda	185
Thailand	182
Sudan	172
Vietnam	160
Zambia	148
Japan	139
Germany	129
Spain	123
Peru	126
Mexico	125
Russia	123
Malaysia	123

Source: MOFCOM.

Table C.13. **Sectoral distribution of China's outward FDI flows in 2004**

USD thousand

Total	**5 497 990**
Agriculture, forestry, animal husbandry and fishing	288 660
Mining and extraction	1 800 210
Manufacturing	755 550
Electricity, gas and water production and supply	78 490
Construction	47 950
Transport, storage and postal services	828 660
Telecommunications, computer services and software	30 500
Wholesale and retail	799 690
Accommodation and catering	2 030
Real estate	5 510
Leasing and commercial services	749 310
Scientific research, technical services and geological prospecting	18 060
Water conservancy, environment and public administration	1 200
Residential and other services	88 140
Healthcare, social insurance and social welfare	10
Culture, sports and entertainment	980
Public management and social organisations	50

Source: MOFCOM.

Table C.14. **Sectoral distribution of China's outward FDI stock in 2004**

USD thousand

Total	**44 777 260**
Agriculture, forestry, animal husbandry and fishing	834 230
Mining and extraction	5 951 370
Manufacturing	4 538 070
Electricity, gas and water production and supply	219 670
Construction	817 480
Transport, storage and postal services	4 580 550
Telecommunications, computer services and software	1 192 370
Wholesale and retail	7 843 270
Accommodation and catering	20 810
Real estate	202 510
Leasing and commercial services	16 445 520
Scientific research, technical services and geological prospecting	123 980
Water conservancy, environment and public administration	911 090
Residential and other services	1 093 140
Healthcare, social insurance and social welfare	220
Culture, sports and entertainment	5 920
Public management and social organisations	14 340

Source: MOFCOM.

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* Asterisk denotes Web sites in English or with English versions of Web sites that are mainly in Chinese. Other sites are in Chinese only. English versions of Chinese government Web sites may be less complete than the Chinese versions.

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