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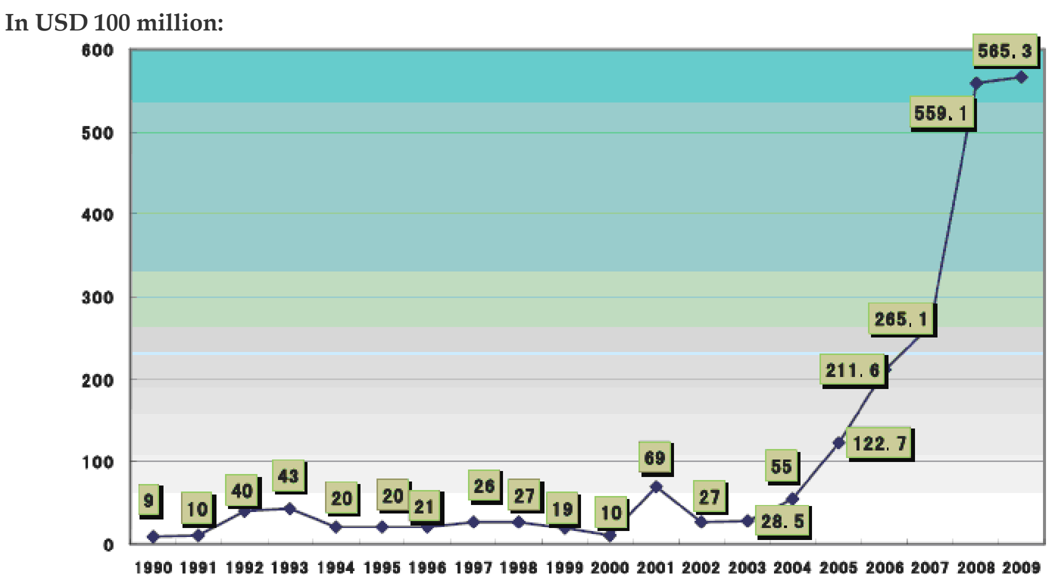
IDENTIFYING AND ADDRESSING OBSTACLES TO OUTBOUND INVESTMENT IN PRACTICE

I. Introduction

In the last 3 years, China has emerged as a leading player in greenfield investments and M&A projects worldwide. Indeed, the central government has recently placed a significant emphasis on outbound investments as a sustained policy. In large part, this is due to the country's urgent need to secure a reliable and long-term supply of resources. To a lesser extent, it is due to swelling foreign exchange reserves and upward pressure on the Renminbi. Businesses, and even governments across the globe, are meanwhile actively seeking Chinese investors to help bolster their economies, many of which are still recovering from the global financial crisis.

According to the Ministry of Commerce (**MOFCOM**), between 2003 and 2010, outbound investment from China increased nearly 20 times, from USD 2.85 billion to USD 56.5 billion. Excluding the financial sector, total investment was USD 43.3 billion in 2009, compared to USD 2.09 billion in 2003.[1] The chart below illustrates this phenomenon over a slightly longer period:

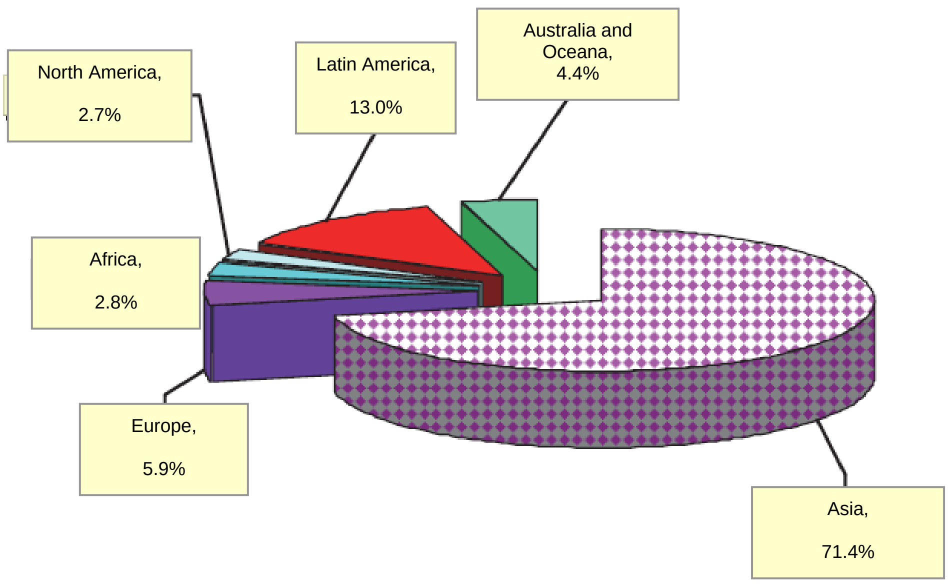
Total PRC Outbound Investment, 1990-2009



[1] MOFCOM statistics available at http://fec.mofcom.gov.cn/article/tjzl/jwtz/201001/960970_1.html and http://fec.mofcom.gov.cn/article/tjzl/jwtz/200401/960905_1.html, respectively.

While the MOFCOM statistics indicate that outbound investment overwhelmingly targets Asia (see diagram below), those numbers are actually misleading, as they track the funds' first port of call after they exit China. In practice, for tax and regulatory reasons, funds for such investments often flow through Hong Kong-based special purpose vehicles. Thus, their true destination is obscured.

China Outbound Foreign Direct Investment in 2009, by Destination [2]



Notwithstanding the explicit "Going Abroad" policy of the Chinese government, and the efforts that have been made to increase access to foreign exchange and streamline domestic approvals, the outbound investment process itself remains complex, unpredictable and time-consuming. This is true of both the internal and external procedures required of Chinese investors. As a result, investments involving Chinese entities are often delayed, or fail altogether. Just as Chinese investors anticipate this difficult approval process when undertaking projects abroad, their foreign partners are also advised to study and understand it thoroughly.

II. PRC Corporate Structures and Internal Approval Procedures

1. Modern Corporate Structure

For purposes of this article, we categorize Chinese investors into state-owned enterprises (**SOEs**), private companies and listed entities.

Most PRC companies have adopted a modern corporate structure, with a shareholders' meeting sitting on top of a board of directors to which the Chief Executive Officer (**CEO**) reports. It is important to note that directors are rarely independent in China: they act according to the instructions of the shareholder nominating them. The board, in turn, appoints the CEO who oversees the daily operations of the company.

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[2] http://hzs.mofcom.gov.cn/accessory/201009/1284339524515.pdf

With the exception of those companies that have not been restructured, the shareholders' meeting is by law the highest authority and appoints all directors and supervisors.

Most Chinese companies have a single controlling shareholder even after they have been listed. Accordingly, Chinese companies typically insist on acquiring a controlling stake in any overseas entity in which they invest.

2. SOE Reporting Lines and Investment Guidelines

In general, large SOEs comprise a holding company and several layers of subsidiaries. The parent companies (i.e., holding entities) of many SOEs have not adopted a modern corporate structure. Instead, they are structured like administrative agencies: there are no directors or supervisors, and are typically run by the CEO.

Many SOEs, particularly those under the direct supervision of the central government – aptly known as "Central Enterprises" – have adopted uniform investment guidelines for all their group companies. The guidelines can be very bureaucratic and cumbersome.

Investment Projects Criteria

As a preliminary matter, an overseas investment project must meet the SOE's general investment policies, including the investment amount, project size and grade of natural resources being acquired. Once this has been verified, the subsidiary's project development team will appraise the project with the support of its technical, legal and financing departments. It will then submit a preliminary written report to the subsidiary's investment department for approval. If approval is granted, the investment department will report it to the subsidiary's Executive Committee (**EC**), which comprises the CEO, the CFO and vice-presidents.

The EC will then, in turn, either reject or approve the project. Approved projects will be reported to the subsidiary's board, which may decide directly whether to proceed with the investment.

If the investment amount involved in a particular project exceeds the subsidiary's internal investment limit, the board will forward the project to the holding company's investment department for approval. The subsidiary may only proceed with the negotiation and subsequent execution of the project's LOI if and when the holding company approves the investment.

Signing of LOI

Before signing an LOI, certain SOEs will submit an "Information Report" to the key PRC approval authorities, including the National Development and Reform Commission (**NDRC**, the ministry principally in charge of outbound investments) and the State-Owned Assets Supervision and Administration Commission (**SASAC**). This is particularly common among those SOEs that interact closely with the government, such as the Aluminum Corporation of China (**Chinalco**) and the China Minmetals Corporation.

Due Diligence

After the SOE's subsidiary has executed an LOI, it will commence due diligence proceedings, conduct a feasibility study, and negotiate the definitive transaction agreements. Each step will be conducted under the guidance and supervision of the holding company. Based on the results of the feasibility study, the SOE will submit a financing application to a PRC bank for purposes of seeking an in-principle commitment to fund the investment.

Thereafter, the subsidiary will again go through the internal approval process described above. After approving the investment, the holding company's investment department will coordinate with its outside legal and financial advisors to prepare a final investment appraisal report Alternatively, it may rely on the one prepared by the subsidiary's investment department.

Final Approval

The report will then be submitted to the holding company's EC for preliminary review and approval. It will subsequently be reported to the holding company's board (or CEO, in the absence of a board) for final sign-off. Where the investment amount exceeds the authority of the SOE's board/CEO, the subsidiary will hold a shareholder's meeting to review and approve the project.

3. <u>Exceptions</u>

The above procedures do not apply where:

- the SOE does not have a multi-tier structure; or
- the holding company is making the investment directly.

Not all SOEs adhere strictly to a formal internal reporting line, particularly those that have only recently been structured as a corporation and lack international investment experience.

That being the case, it is important for foreign parties to check, at the outset of a potential investment project, the *modus operandi* of the SOE in question, as well as its international investment experience and the Chinese government's general opinion of the proposed investment.

4. <u>Private Companies</u>

The internal reporting lines of Chinese private companies are similar to, but generally much simpler and more flexible than, those of SOEs.

As with SOEs, most private Chinese companies have a controlling shareholder, even after they have been listed. This is typically a single individual. With the exception of those in the IT industry, such shareholders tend to be inexperienced and often pay little attention to corporate governance and reporting lines. However, they are generally very pragmatic, and will frequently make quick decisions upon sensing a sound investment opportunity.

5. Listed Companies

Listed companies in China have the same internal reporting lines and investment approval procedures as either an SOE or a private company, depending on their structure. They must also consult with their controlling shareholder (or holding company) at each stage of the investment project, from inception to the signing of the definitive agreements.

In addition, listed companies must adhere strictly to the corporate governance and disclosure requirements of the exchange on which they are listed.

III. Issues with Regard to Obtaining Governmental Approvals

1. Challenges for PRC Investors

There are 4 primary challenges in obtaining PRC regulatory approvals.

Multiple Authorities

Firstly, China's current approval regime involves at least 3 governmental authorities (*i.e.,* the NDRC, Ministry of Commerce and the State Administration of Foreign Exchange). There is no single law governing the approval of outbound investments, and no single authority can sign off on the entire approval process. Thus, the approval process is complex, unpredictable and protracted.

Lengthy Approval Process

Secondly, there are no detailed requirements for outbound investment application documents under PRC law. No set rules or guidelines exist with regard to how the materials should be prepared. As a result, the government authorities may request various corrections or supplements as they unilaterally see fit. The approval process can thus be unpredictable, time-consuming and cumbersome, which puts Chinese investors at a distinct disadvantage - particularly when participating in a competitive bid internationally.

Uncertainty of Approval Criteria

Thirdly, the opaque nature of the approval process is exacerbated by a lack of clear approval criteria. For instance, under the 2009 *Administrative Measures on Outbound Investment*, no investment will be approved if it endangers "national sovereignty, security, and the public interest". A wide range of projects could potentially be rejected by the Chinese authorities on this subjective basis.

Preference of Governmental Authorities

Finally, if more than one Chinese company expresses an interest in investing in a particular outbound investment opportunity, the various government authorities will usually coordinate to select one of them. In such situations, SOEs often have an advantage over private companies because they have stronger government backing and financial support.

2. Other Complications

Other factors have also been known to delay projects or cause them to fail the approval process altogether. For example:

Failure to comply with industry-specific regulations

Sichuan Tengzhong was not permitted to acquire Hummer because the transaction was deemed to violate China's policy of developing energy-efficient cars.

Political sensitivities

The investment in Corriente Resources in the summer of 2009 by a joint venture between China Railway Construction and Tongling Nonferrous Metals was delayed because Ecuador was considered, at that time, to be too friendly with Taiwan.

Failure to involve the provincial authorities

Although the provincial authorities do not have the final say in approving a project when central approval is required, winning their "nod" could be crucial so that they will forward the application package to the central authorities. In some cases, Chinese investors have been accused of being disrespectful of the provincial authorities by failing to inform them of, and seek their opinion on, potential investments. As a result they decided to withhold the submission of the applications to the central authorities.

IV. Key Considerations for Transactions with PRC Companies

In conclusion, to optimize their chances of success with viable PRC investors, foreign entities are advised to be familiar with not only their potential partners, but also the Chinese approval process.

Internal Approval Process

PRC companies – especially SOEs – have multi-layered reporting lines. Hence, an investment proposal needs to survive several rounds of internal sign-offs before the final decision is made. From the foreign seller's perspective, in order to not waste time or the opportunity, it must understand with which level of the Chinese purchaser's internal organs (and supervising authority) it is dealing.

Controlling Shareholder's Opinion

Foreign investees should ascertain as soon as possible whether their transactions have the support of the controlling shareholder. That support is typically the determining factor for all internal investment approvals: the board or shareholder's meeting merely serves to rubber-stamp the shareholder's decision.

PRC Governmental Approval Process

In addition, foreign sellers need to understand the PRC government's approval process, so that they can take it into account not only for purposes of being able to negotiate more efficiently and effectively with the Chinese party, but to also understand the timing and direction for drafting the definitive investment agreements.

PRC Government Authorities Viewpoint

Finally, foreign sellers could resort to a simple and direct approach by requesting their Chinese partners to disclose preliminary information about the project to the relevant PRC approval authorities early on, and to update them regularly. This will facilitate the approval process and enable the parties to work together to ensure that any questions raised by the authorities are handled efficiently.

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