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APPROVALS (INTERNAL AND GOVERNMENT) FOR CHINESE ENTITIES INVESTING ABROAD

Jesse TH Chang

TransAsia Lawyers, Beijing

INTRODUCTION

China has emerged on the world stage as a leading player for global greenfield investments and mergers and acquisitions. The central government has placed a significant emphasis on outbound investments in recent years, due in large part to its swelling foreign exchange reserves and the upward pressure on the Renminbi. In parallel, governments from across the globe are actively seeking Chinese investors to help bolster their economies which are still recovering from the financial crisis.

Not surprisingly, Australia has been one of the most attractive investment destinations for PRC companies, particularly given its geographic proximity and wealth of attractive natural resources. Over the past two years, Australia received US$ 26.6 billion in total investments from China, which is more than any country other than the United States.

As more PRC companies continue to invest in Australia, it is increasingly important for Australian companies to understand how investment decisions are made by PRC companies and thereafter approved by the PRC government authorities.

This paper elaborates on both the internal and regulatory approvals for PRC state-owned enterprises (**SOEs**) and private companies which are considering investments in Australia and other countries. As discussed below, despite China's pronounced "Going Abroad" policy and the dramatic growth of overseas investment, the approval process for PRC investors remains complex, unpredictable and time consuming. Indeed, sales of equity and assets to PRC companies are often delayed or fail to be completed for this reason. Familiarity with these issues will provide Australian companies with realistic expectations as to how, when and even whether a transaction with a PRC investor can be consummated.

SUMMARY

This paper consists of two parts:

- Part I – corporate structures and reporting lines of PRC companies; and
- Part II – PRC regulatory approvals for overseas investments.

Part I sets out the two main corporate structures of PRC companies - SOEs and private companies - and the characteristics of each corporate structure. It also outlines the internal reporting lines of PRC companies and the approval procedures with which PRC companies must comply in order to undertake outbound investments.

Part II provides an overview of the regulatory approval framework for PRC companies wishing to make outbound investments, and the role of each relevant government authority. It also identifies the main challenges in obtaining PRC regulatory approvals, and describes specific examples which illustrate the difficulties and unpredictability associated with obtaining PRC government approvals for international investments.

MAIN BODY

I. CORPORATE STRUCTURES AND INTERNAL REPORTING LINES OF CHINESE COMPANIES

1. Corporate Structures

Modern Corporate Structure
Most PRC companies have adopted a modern corporate structure of a shareholders' meeting sitting on top of a board of directors to which the Chief Executive Officer (**CEO**) (or General Manager) reports. In parallel, a board of supervisors overlooks the decisions of the Board and the CEO.

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

In China, directors are rarely independent. Indeed, they act according to the instructions of the shareholder that appointed them. In turn, the Board appoints the CEO who oversees the daily operations of the company.

Supervisors are responsible for ensuring that a company is run properly and lawfully. In particular circumstances, they may convene a special shareholders' meeting, act to remove a director, and bring a legal action in the name of the company against a director or manager. However, in practice supervisors assume a passive role and rarely invoke these powers.

Most Chinese companies have a controlling – or majority - shareholder, even after they have been listed. Given that mind set, most Chinese companies often insist on acquiring a controlling stake in any overseas entity that they invest in.

Traditional Structure
The parent companies or holding entities of many SOEs have not adopted a modern corporate structure. Instead, they are structured like administrative agencies: they do not have any directors or supervisors, and are typically run by a CEO.

2. SOEs

Reporting lines and investment guidelines
In general, large SOEs comprise a holding company and several layers of subsidiaries.

Many SOEs, particularly those under the direct supervision of the central government - known as Central Enterprises or key SOEs - have adopted uniform investment guidelines for all their group companies which typically cover the following:

- *Investment entities:* certain subsidiaries (*i.e.*, tier I subsidiaries) are provided with wide discretion to make investments, domestically or overseas, whereas other subsidiaries (*i.e.*, tier II or lower subsidiaries) are only authorized to invest under special circumstances. Tier I subsidiaries may include specialized investment entities, which undertake all of the group's international investments. For example, China National Oil and Gas Exploration and Development Corporation is a special investment subsidiary of the China National Petroleum Corporation.

- *Investment appraisal*: the group's investment (or "capital operations") department is responsible for the appraisal of all investments.

- *Internal approvals*: various internal approvals – including the initial approval to begin negotiating an LOI – are required before the SOEs proceed to any definitive investment agreement.

Pre-LOI

As a preliminary matter, an overseas investment project must meet the SOE's general investment policies, including with respect to the investment amount, project size and grade of natural resources being acquired.

Upon verification of the above, 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, vice-presidents and the CFO.

The EC will, in turn, either reject or approve the project. In the latter case it will be reported to the subsidiary's Board which may decide directly whether to proceed with the investment.

If the investment amount 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 LOI if and when the holding company approves the investment.

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**) 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 Aluminium Corporation of China and the China Minmetals Corporation, which would likely not sign an LOI if the authorities indicate that approval is not assured.

Post-LOI

After the SOE's subsidiary has executed an LOI, it will commence due diligence, conduct a feasibility study and thereafter negotiate the definitive agreements. Each step will be conducted under the guidance and supervision of the holding company. In addition, based on the results of the feasibility study, the SOE will submit a financing application to a PRC bank, to seek its 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, or alternatively it may rely on the one prepared by the subsidiary's investment department.

The report will then be submitted to the holding company's EC for preliminary review and approval, after which it will be passed to the holding company's Board or CEO (if it does not have a Board).

If the investment amount exceeds the authority of its Board, the subsidiary will then hold a shareholder's meeting to review and approve the project. This is largely a formality: in practice, the holding company, as the majority shareholder, would already have approved the investment.

Exceptions
The above internal reporting and approval procedures are not applicable under the following circumstances:

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

Not all SOEs adhere strictly to a formal internal reporting line, particularly those that have not been structured as a corporation for a long period of time and lack experience with overseas investments.

Therefore, it is important to check at the outset of a potential investment project the modus operandi of the SOE in question, their international investment experience and the Chinese government's position towards the proposed investment.

3. Private Companies

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

Most private Chinese companies have a controlling – or majority - shareholder, even after they have been listed. With the exception of those in the IT industry, such shareholder tends to be rather inexperienced and often pays little attention to corporate governance and reporting lines. However, the shareholder is generally very practical and will frequently make a quick decision upon sensing a sound investment opportunity.

Below are the steps that tracked the investment decision process of a company that recently undertook a high-profile transaction in Australia:

- the investment opportunity was referred to the company's investment department, comprising specialists in finance, mining and technology;
- the department worked with internal technical, financial and legal advisors to generate a report to the controlling shareholder for purposes of seeking approval to sign the LOI;
- after the LOI was signed, the company approached the government authorities and banks, in order to obtain in–principle government approval and financing commitments;
- the final decision on whether or not to proceed with the investment was made by the individual controlling shareholder.

4. 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, *e.g.*, the requirement to convene a shareholders meeting with advance notice, for purposes of approving an investment transaction.

II. PRC REGULATORY APPROVALS FOR OVERSEAS INVESTMENTS

1. Regulatory Framework

There are six key PRC government agencies that regulate overseas investments, namely: State Council, NDRC, SASAC, Ministry of Commerce (**MOFCOM**), State Administration of Foreign Exchange (**SAFE**) and China Securities Regulatory Commission (**CSRC**).

State Council and NDRC

The NDRC is responsible for approving the following outbound projects:

- investments in natural resource projects ranging from US$ 30 million (inclusive) to US$ 200 million; and
- investments requiring foreign exchange ranging from US$ 10 million (inclusive) and US$ 50 million.

Projects which exceed the above limits must be approved by the State Council, which also approves all investments in Taiwan and the countries that do not have diplomatic relations with China. Projects involving lower amounts can be approved by the relevant provincial NDRC.

Chinese companies must inform the State Council or the NDRC (as the case may be) of the details of an overseas project before beginning any "material activities" in connection with the definitive agreements. Permission to proceed is generally granted or denied within seven working days.

If an investment project is not reported to the State Council or the NDRC before negotiations begin, the formal approval application may be rejected and the NDRC may also issue a public criticism notice or even impose economic penalties.

PRC entities must also obtain formal approval from the NDRC before actually executing any definitive agreement or participating in any bidding process. The NDRC will issue its decision within 20 working days after accepting a formal approval application but may extend it by 10 working days where necessary.

SASAC

The SASAC manages all of China's state-owned assets and is effectively the government's nominated shareholder of SOEs. Therefore, all SOEs wishing to invest abroad must obtain the approval of, or file for records with, the SASAC which process generally takes 20 working

days.

MOFCOM

After successfully obtaining the State Council or the NDRC's approval, Chinese investors must also acquire an approval certificate from the MOFCOM which generally should be issued within 30 working days after its acceptance of the application.

Investors need this approval certificate to carry out additional government approval procedures in China, including those for foreign exchange, banking and customs. The approval certificate expires after two years, which means that all Chinese investors must complete within this time frame all necessary procedures for their investment project both in China and abroad.

SAFE

The SAFE oversees the flow of foreign currency in and out of China. Companies wishing to invest overseas must clear the SAFE's review procedures and register with the SAFE, in order to obtain approval to exchange Renminbi into foreign currency for financing projects.

The SAFE is also responsible for approving "up-front expenses" to be remitted overseas in foreign currency, during the pre-NDRC or MOFCOM approval stage. Such preliminary expenses generally may not exceed 15% of the total amount of the proposed investment, and include those covering guarantee deposits for bidding or acquisition processes, expenses for market research, office leases and employee hiring.

CSRC

The CSRC – the local equivalent of the ASIC - regulates the securities exchanges and futures markets in China.

All Chinese companies must obtain CSRC approval if they are listed on the A-share market and wish to participate in an overseas investment where the deal size exceeds 50% of the company's total assets, net assets or revenue.

2. Challenges and Lessons

The main challenges in obtaining PRC regulatory approvals are:

(a) Multiple Authorities: As discussed above, China's current approval regime involves at least three governmental authorities (*i.e.*, NDRC, MOFCOM and SAFE). There is no single law governing the approval of outbound investments and no single authority can sign off on the entire approval process. This means that the approval process involves multiple layers and is complex, unpredictable and protracted.

(b) Lengthy Approval Process: There are no detailed requirements for outbound investment application documents under PRC law. As such, it is difficult for Chinese companies to prepare these documents and the government authorities may request various corrections or supplements to the application. As a result, the approval process can be both time-consuming and cumbersome, which puts Chinese investors at a distinct disadvantage, particularly when participating in a competitive bid.

(c) Uncertainty of Approval Criteria: The uncertainty and non-transparency of the governmental approval process is in some ways the policy itself for Chinese investors. For instance, under the 2009 *Administrative Measures on Outbound Investment*, no outbound investment will be approved if it endangers "national sovereignty, security, and the public interest". A wide range of investments could potentially be rejected by the government authorities based on these criteria.

(d) Preference of Governmental Authorities: 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 entity and thus avoid competition among the Chinese bidders. In such situation, SOEs often have an advantage over private companies because they have stronger government backing and financial support.

(e) Other Complications: Examples of factors which delayed projects or caused them not to be approved are set forth below:

- *Compliance with industry-specific regulations:* Sichuan Tengzhong was not permitted to acquire Hummer, because the transaction was deemed to contravene China's policy of developing energy-efficient cars.

- *Political sensitivities:* The investment in TSX listed Corriente Resources this summer by the joint venture between China Railway Construction and Tongling Nonferrous Metals was delayed because Ecuador (where the asset was located) was considered during 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, its "nod" is important for forwarding the application package to the central authorities. There have been cases where Chinese investors have been accused of demonstrating disrespect for the provincial authorities by failing to inform them of potential investments and to seek their opinion. As a result, the investors' approval applications were not ultimately reported upwards to the central authorities or were blocked from securing final approval.

CONCLUSION

Chinese outbound investment presents Australians with a number of opportunities. However, as illustrated above, Chinese investors continue to be subject to a rigorous and unpredictable approval process, which creates challenges for any proposed investment overseas.

In this connection, familiarity with each of the following issues is critical when evaluating a transaction with a PRC company:

(a) Internal Approval Process: PRC companies - especially SOEs – have many layers of reporting lines. Hence, an investment proposal needs to survive several rounds of internal sign-offs before the final investment decision is made. From the foreign seller's perspective, in order not to waste time or the sale opportunity, you must

understand with which level of the Chinese purchaser's internal organ (and its authority) you are dealing.

(b) Controlling Shareholder's Opinion: The foreign seller must ascertain as soon as possible whether the transaction has the support of the controlling shareholder. The opinion of the controlling shareholder is typically the determining factor for all internal approvals of investments. By comparison, the board of directors or shareholder's meeting merely serves as a rubber stamp.

(c) PRC Governmental Approval Process: It is critical that the foreign seller be familiar with the PRC governmental approval process so that it can take this information into account both during the negotiations with the Chinese party and in the drafting of the definitive agreements.

(d) View of the PRC Government Authorities: The foreign seller should request the Chinese investors to disclose the preliminary comments on the project of the relevant PRC government approval authorities and to update them regularly so as to understand whether the project has the latter's blessing.

Each potential deal with a PRC company should be thoroughly evaluated in the context of how it will be deliberated and decided internally and whether it will likely be approved by the PRC government authorities. The failure to do so could result in unnecessary costs and time being expended for a transaction which will not proceed.