

# Client Alert

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Litigation Department

## China Offers First Official Clarification on Merger Notification Provisions of New Anti-Monopoly Law

The Chinese Anti-Monopoly Law (AML), which was passed in October 2007, is scheduled to come into effect on August 1, 2008. Among the business conduct covered by the AML are mergers and acquisitions.<sup>1</sup> On March 27, 2008, the Legislative Affairs Office of the State Council of the People's Republic of China (PRC) published a draft regulation on mergers (Regulation), clarifying the circumstances in which pre-merger filings will be required in the PRC and offering some details on how reviews will be conducted. Assuming that China fully implements and assiduously enforces its new law, it could easily become the third critical stop (after the US and EU) on the "Grand Tour" for antitrust review of significant transactions, since a large and increasing number of such transactions have an important China component. In this *Alert*, we discuss certain key aspects of the proposed Chinese merger control regime, as currently defined by the AML and the Regulation.

### The Chinese Merger Control Regime in its Global Context

Almost all merger control laws require (1) a "concentration"—usually a merger, acquisition of shares or assets, formation of a joint venture, change in control or other similar specified

triggering event, and (2) some threshold level of significance as a prerequisite for jurisdiction and merger review. Most modern merger control laws follow the EU blueprint in requiring a concentration to bring about a "change in control," defined to include transactions that give an acquiring party either positive or negative control, thereby excluding many passive minority investments from review. As to the notification thresholds, the current state of the art is defined by combined revenue requirements, which are useful proxies both for the overall significance of the transaction (*e.g.*, combined worldwide revenues of buyer and target) and the nexus to domestic commerce (*e.g.*, combined sales within and into a jurisdiction).

The proposed Chinese merger control regime is generally in-line with the global trend to impose a fairly certain concentration test (with one notable exception) and two clear and objectively quantifiable thresholds based on global and domestic revenues. This enables parties to concentrations to make a clear *ex ante* assessment of their filing obligations. Unfortunately, however, the AML lays out a third, alternative market-share threshold. Market share tests can be difficult to apply in practice because only rarely is there any clear precedent on how to define the

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relevant market. Where there is no clear precedent, determining market shares is fact-intensive and subject to competing interpretations. As a result, analyzing Chinese markets may be costly to conduct and turn up unpredictable results. In a jurisdiction that employs a market share notification threshold, failing to notify can leave parties with the risk that the competition authority will later dispute their determination of the relevant market and assert that the share threshold is met. This contains obvious potential for uncertainty and dispute. It is the main reason why market-share thresholds are discouraged by the “Recommended Practices” of the International Competition Network.<sup>2</sup>

## Concentration

Under the AML, three events qualify as a concentration: (i) a merger, (ii) the acquisition of control, and (iii) the acquisition of “decisive influence” over or “decisive effect” on the target.<sup>3</sup>

### Acquisition of control

The draft Regulation now clarifies that an acquisition of control occurs in an acquisition of more than 50 percent of the assets, voting securities or similar rights of the target or where the buyer acquires the ability to designate more than half of the target’s directors.<sup>4</sup>

### Decisive influence

More ambiguous is the statement in the Regulation that “decisive influence” over the target’s business strategies “with respect to production and operation” qualifies as a concentration.<sup>5</sup> One could interpret this language as being broadly in-line with the EU practice of identifying a veto right over the business plan, budget, appointment of key officers and certain financial decisions beyond those of a purely financial investor. In that case, the focus of the regulation would properly remain on the exercise of a competitively significant influence slightly below

the acquisition of control threshold, a concept familiar to companies operating internationally from German merger control law. The express reference to “production,” however, also permits a reading that would entail more invasive obligations on parties to commercial contracts. For example, a company entering into a supply agreement with a Chinese manufacturer, where the agreement provides for the right of the buyer to require adherence to certain quality standards, could be said to confer “decisive influence” over the supplier’s business strategies with respect to production.

### Being the “largest shareholder” = concentration?

In sharp contrast to the useful clarifications discussed above, the inclusion of becoming “the largest holder of shares with voting rights or assets” of the target as an instance of acquiring control is without clear precedent in international practice and is very likely to cause substantial practical problems.<sup>6</sup> Taken at face value, a pension fund, increasing its investment in a public company with a broadly diverse investor base from, say, 7 percent to 8 percent, could trigger a notification requirement simply by becoming (even temporarily) the company’s largest shareholder. Worse yet, an investor might become the “largest shareholder” in circumstances wholly unconnected to its own actions—and completely unknown to it—if another shareholder sells down.

There is no reasonable basis for a presumption of control arising from being the largest shareholder. The point of the “concentration” requirement is to identify instances in which a target typically loses a significant measure of its independence. Acquiring a majority shareholding is such an event. The same is true, to a lesser degree, for the acquisition of a blocking minority stake. In contrast, being the largest shareholder by itself has no effect on

control, because the largest shareholder has no inherent special rights. Consequently, the category is over-inclusive and a questionable proxy for control.

## Notification Thresholds

Article 3 of the Regulation sets out three notification thresholds:

	Global revenues	Revenues in China	Market share in China
<b>Test 1</b>	All parties combined RMB9 billion (US\$1.3 billion) <sup>7</sup>	At least two parties each RMB300 million (US\$42 million)	–
<b>Test 2</b>	–	All parties combined, RMB1.7 billion (US\$242 million); and at least two parties each RMB300 million (US\$42 million)	
<b>Test 3</b>	–	–	25%

The first two tests are objective and easy to apply, even though the RMB300 million threshold (US\$42 million) is relatively low. The requirement that at least two parties each must have a certain minimum nexus to commerce in China is a welcome development, avoiding situations where the revenues of the buyer or the target alone could trigger a notification, as is the case under China's current M&A notification rules, as well as under the present merger notification law of Germany, for example.

### Market-share threshold

The market-share threshold—like similar provisions in the merger control laws of other jurisdictions, such as Brazil, Spain, Turkey, Taiwan or the UK—will prove difficult to apply in practice and cause significant uncertainty regarding the filing obligations of the transacting

parties. Moreover, the Regulation does not expressly define whether the 25-percent market share must be the additive result of the concentration (*e.g.*, a 10-percent buyer purchases a 20-percent target) or whether the mere non-additive presence of a party with 25-percent market share suffices (*e.g.*, a 0-percent buyer purchases a 30-percent target). Given the explicit departure

in Test 2 from a single-party, domestic nexus requirement to a two-party (*i.e.*, additive), domestic nexus requirement, there is a strong systematic argument that the 25-percent market share should be additive. Moreover, competition policy suggests that only accretive transactions require notice. The plain language of the Regulation, however, does not compel this result.

### Discretionary notification

Another potentially troubling feature is that the government “may nevertheless require the undertakings to file a pre-merger notification . . . even where the thresholds . . . have not been met.”<sup>8</sup> This provision permits the agency to assert jurisdiction over mergers that fall short of the already low thresholds and thus introduces additional uncertainty in the process. That said, the provision also holds the promise for parties to have

their non-reportable but potentially problematic mergers analyzed by the agency on an expedited, predictable timetable, thus eliminating the risk of an *ex post* challenge.

## Procedural Features

Despite some ambiguity in Article 3 of the Regulation, the Chinese merger control regime clearly mandates pre-merger notification with a prohibition on closing until the expiration of the waiting period or receipt of affirmative clearance by the agency.<sup>9</sup> The procedural framework is as follows:

- 1) Voluntary pre-filing consultation.<sup>10</sup>
- 2) Substantive filing, including a description of the markets and impact on competition.<sup>11</sup>
- 3) First phase. During this 30-day preliminary investigation, the agency may grant “early termination” for transactions that pose no competitive threat.<sup>12</sup> Absent early termination, the parties are free to close if the 30-day period expires without any action by the agency.<sup>13</sup>
- 4) Second phase. A decision by the agency that further investigation is warranted triggers a 90-business day clock, which in defined circumstances can be extended up to another 60 days.<sup>14</sup>

## Single notification

There are no separate buyer and target (or, as in the US, seller) filings. In a merger, the parties file a joint notification. In all other circumstances, only the buyer must file.<sup>15</sup> The “single notification” rule could be of particular significance in hostile deals, because the target cannot hold up agency approval by refusing to comply with the notification requirement.

## Confidentiality

Another welcome provision allows the agency, upon request, to treat materials supplied by the parties as confidential,

provided that the parties show that “disclosure of their submitted documents . . . would be harmful to them.”<sup>16</sup> There are, however, significant ambiguities concerning the circumstances in which the agency will grant such a request.

## Suggested Next Steps

The Regulation is, by and large, a step in the right direction. However, the proposed Chinese merger control law still contains at least two questionable elements: (1) the presumption that being the “largest shareholder” results in an acquisition of control, and (2) the market-share threshold—especially if adopted in its “non-additive” form.

Fortunately, the State Council has invited interested parties to submit comments until April 12, 2008. We encourage institutional investors and others whose business involves China to contact Tad Lipsky in our Washington, D.C. office, Hanno Kaiser in our San Francisco office or John Colahan in our London office, if they would like to submit comments or join others in submitting a consolidated response.

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## Endnotes

<sup>1</sup> Chap. 4, Art. 20-31, AML.

<sup>2</sup> <http://www.internationalcompetitionnetwork.org/media/archive0611/mnprecpactices.pdf>.

<sup>3</sup> Art. 20, AML.

<sup>4</sup> Art. 2, Regulation.

<sup>5</sup> *Id.*

<sup>6</sup> Art.2 (3), Regulation.

<sup>7</sup> Currency conversion as of 4/1/2008. See: <http://www.oanda.com/convert/classic>.

<sup>8</sup> Art. 4, Regulation.

<sup>9</sup> Art. 25, 26, AML.

<sup>10</sup> Art. 8, Regulation.

<sup>11</sup> Art. 9, Regulation.

<sup>12</sup> Art. 14, Regulation.

<sup>13</sup> Art. 25, AML.

<sup>14</sup> Art. 26, AML.

<sup>15</sup> Art. 7, Regulation.

<sup>16</sup> Art. 13, Regulation.

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