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Current Antitrust Controls of Foreign Investors' Acquisitions of Domestic Enterprises

I Current Antitrust Regulations of Foreign Investors' Acquisitions of Domestic Enterprises

On 7 June 2006, the State Council of the People's Republic of China approved in principle the *Antitrust Law of the People's Republic of China (Draft)* (**Draft Antitrust Law**). However, the Draft Antitrust Law must still be submitted to the Standing Committee of China's National People's Congress for consideration, making it unclear whether the law, which has been under debate for many years, will actually be promulgated next year. Generally, China does not have a systemic and integrated antitrust regulatory system yet.

The major antitrust regulations relating to foreign investors' acquisitions are contained in the *Provisions for the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (**M&A Provisions**), jointly issued by six government agencies[1] on 8 August 2006. These provisions continue to use the antitrust examination mechanism established by the 2003 *Interim Provisions for the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.

The M&A Provisions provide a framework for antitrust regulation of foreign investors' acquisitions. Article 51 sets forth criteria for when the acquisition of domestic enterprises by foreign investors must be reported to the Ministry of Commerce (**MOFCOM**) and the State Administration of Industry and Commerce (**SAIC**) for possible antitrust examination. Article 52 establishes procedures for MOFCOM and the SAIC to conduct antitrust examinations. Article 53 sets forth reporting criteria for offshore acquisition activities, and Article 54 provides exemptions from antitrust examination.

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According to the M&A Provisions, if a foreign investor's acquisition of a domestic enterprise meets any of the following criteria (**Mandatory Reporting Requirements**), the investor must report the transaction to both MOFCOM and the SAIC (collectively, **the Examining Agencies**):

i. any party to the acquisition has a same-year business volume in the China market exceeding RMB1.5 billion;

ii. any party to the transaction has acquired more than ten (10) Chinese enterprises in the same or related industries within one year;

iii. any party to the transaction has acquired a 20% share of the China market; or

iv. the transaction causes any party to acquire a 25% share of the China market.

Even if none of the above conditions is met, a foreign investor may still be required to report its acquisitions to MOFCOM or the SAIC if competing domestic enterprises, relevant governmental departments or trade associations so request; if MOFCOM or the SAIC believe that the acquisition involves an extremely large market share; or if other major factors exist which may significantly affect market competition (**Requested Reporting Scenario**).

If an acquisition meets any of the following criteria, a party to the acquisition may apply to MOFCOM and the SAIC for exemption from antitrust examination:

i. the transaction may improve conditions for fair competition in the market;

ii. the transaction restructures an unprofitable enterprise and guarantees the continued employment of the workers;

iii. the transaction introduces advanced technology and management techniques and enhances the international competitiveness of the enterprise; or

iv. the transaction may improve the environment.

II Antitrust Reporting and Examination Procedures for Foreign Investors' Acquisitions of Domestic Enterprises

If an acquisition meets any of the Mandatory Reporting Requirements or Requested Reporting Scenario listed above, the investor(s) shall file a report with the appropriate authorities, including MOFCOM's Antitrust Investigation Office, after the acquisition agreement is executed.

The antitrust examination will last 30 working days, starting from the date when the Examining Agencies receive all required documentation. If, within 30 working days, the applicants receive no further notice, the transaction will be considered to have passed examination. If the applicants are requested to provide further documentation or explanation, the examination term will be prolonged according to the specific situation.[2]

MOFCOM and the SAIC shall hold hearings if they believe an acquisition may cause over-concentration of the market, harm legitimate competition, or damage consumer interests. The hearing shall be scheduled within 90 days of the receipt of all required documents. MOFCOM and the SAIC shall request the relevant departments, institutions, enterprises and other interested parties to attend the hearing.

III Key Points in Antitrust Investigations

i. Methodology, Standards and Evidence Used to Define the Relevant Market

In antitrust examinations, the size of the market share depends largely on the definition of the relevant market. Therefore, clearly and precisely defining the relevant market has an important and decisive effect on the antitrust examination. Although defining the market is of great importance, the M&A Provisions do not provide any principles for defining the relevant market, nor do they indicate how to define the relevant market in practice. To our understanding, the M&A Provisions do not contain market definitions because resolving such complex issues requires the accumulation of practical experience. It is therefore wise to leave the question open rather than provide a hasty and arbitrary definition before the anti-trust law is enacted.

Accordingly, because there is no law to rely upon, the parties to an acquisition must expend a great deal of efforts defining the relevant market.

In practice, the relevant market will be defined in different ways in different cases. Normally, a market is defined along both geographic and product dimensions so as to identify and define the boundaries of market competition.

➢ Geographic Market

When the parties to an acquisition attempt to prove and define the relevant market, they must first consider the differences among different regions. National foreign trade policies, customs tariffs, languages, legal environment, and conditions and facilities necessary for access to distribution in a given country or area are some of the factors which may help define a regional market. Transportation costs and consumers' views and preferences also affect market definition. For most commonly-used products, the entire mainland of China will likely be considered as the relevant market. However, when a product has low profit margins and high transportation costs (e.g. cement), it may be possible to define the relevant market as a specific region.

➢ Product Market

The relevant product market is defined by the characteristics, price and intended usage of the products. If consumers believe related products / services in a market are interchangeable or substitutable, that market will likely be recognized as the relevant product market for those related products. Therefore, substitutability of products or services is the key to defining the relevant product market. For example, a shoe manufacturer produces men's and women's shoes. Normally, men's and women's shoes are not substitutable. The shoes could therefore be considered to have two distinct product markets – the market for men's shoes and the market for women's shoes.

Demand substitutability of a product can be determined based upon the physical and technical characteristics of the products, price, consumer demand, suppliers' ability to meet demand, and other similar factors.

When assessing supply-side substitutability, the following factors may be taken into account: is it difficult for a new supplier to obtain the necessary technology; how long and how much will it cost a new supplier to change its manufacturing process; will the new supplier be able to obtain the necessary raw materials or component products; what quantities will a new supplier be able to produce.

- Demonstrating the Relevant Market

Demonstrating the relevant product market requires a large amount of market research and data support. In our experience, the relevant data may be acquired from public information issued by relevant authorities. Data may also be obtained through investigation into distribution channels, interviews with experts and competitors, inquiries of manufacturers, and consumer surveys. This data must be as accurate, complete, and reliable as possible. Therefore, retaining financial and legal advisors or other professional consultants to help with data collection is recommended. Since the reliability of statistical evidence primarily depends on the source of information, data collected by independent, reliable organizations is best. In some situations, a company's records or public information from other companies in the same industry may also constitute proof. For example, a company's accounting records showing how price variation leads to changes in sales of other related products may be used to demonstrate the substitutability of products.

When defining the relevant market for antitrust examinations, the market share of each party to an acquisition shall be calculated separately. In our experience, investors will often encounter problems due to the lack of authoritative supporting data. Even if such data exist, it is likely that it will not cover the entire relevant market, either from a geographic or product perspective. In such situations, it is necessary to find alternative sources of data or to make reasonable adjustments to and deductions from the existing data. In the latter case, it is important to provide the Examining Agencies with a detailed explanation of what adjustments were made and what inferences were drawn.

ii. Technological Situation

In our experience, when considering technological issues, the Examining Agencies focus on two factors. On one hand, as clearly stated in the M&A Provisions, if an acquisition introduces advanced technology and increases international competitiveness, the parties may apply for exemption from antitrust examination. On the other hand, the Examining Agencies are concerned that acquisitions may lead to technological monopolies, or raise the market's technological threshold to the point that it negatively effects competition. Parties to an acquisition must therefore carefully consider how to balance these issues.

iii. The Acquisition's Effect on the Market

- The Acquisition's Effect on Competition

Based on the Draft Antitrust Law and the M&A Provisions, it is our understanding that the authorities' main concern is whether an acquisition will lead to excessive market concentration. The Examining Agencies usually consider whether the acquisition will obstruct competition within the market, whether the acquisition will create barriers to market entry, and other such issues when deciding whether to approve an acquisition.

- The Acquisition's Effect on Consumers

  Consumer protection is one of the main objectives of antitrust legislation. Therefore, a transaction's long term impact on consumers will draw special attention from the Examining Agencies. In on our experience, a transaction's effect on consumers can be proven through analysis of its impact on the varieties, quality, and prices of related goods and services.

- The Acquisition's Effect on Society

  Under the M&A Provisions, investors may apply for exemption from antitrust review if the acquisition will restructure an unprofitable enterprise while guaranteeing the continued employment of the enterprises' workers. Exemptions are also available for acquisitions that improve the environment.

- The Economic Rationality of the Acquisition

  Pursuant to the guidelines published by MOFCOM, applicants shall explain the economic rationale of their acquisition. In our experience, the Examining Agencies are concerned whether transactions are fair and reasonable, whether they will have any adverse impact on the Chinese market, whether they will restrict the development of domestic industry, and whether they will cause the disappearance of domestic brands. If the parties can prove that the acquisition will improve domestic enterprises' international competitiveness, introduce high-technology and management experience, or will benefit consumers, they are more likely to obtain approval.

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1 The Ministry of Commerce, the State Assets Supervision and Administration Commission of the State Council, the State Administration of Taxation, the State Administration for Industry and Commerce, the China Securities Regulatory Commission and the State Administration of Foreign Exchange.

2 See MOFCOM's *Guide to Antitrust Examinations of Foreign Investors' Mergers and Acquisitions of Domestic Enterprises*, issued on 20 April 2006.