The New Takeover Regulation in China: Evolution and Enhancement

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Abstract

This article examines the recently promulgated takeover regulation by the China Securities Regulatory Commission. Along with other laws and regulations, this new regulation has greatly enhanced China's takeover legal regime both in terms of form and substance. It comes at time when the Chinese economy is undergoing a strategic restructuring process and China's capital markets are at the birth of a new era thanks to the ongoing state share reform. The new regulation brings China's takeover law more closely into line with its counterparts in more developed economies, but it remains to be seen whether it will function in practice as hoped due to some potential problems with the regime. The article both investigates the implications of the new regulation for takeover activities in China, and conducts a critique of China's takeover legal regime from a comparative perspective.

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I. Introduction

China attempted over the last couple of years to create a clearer roadmap for mergers and acquisitions ("M&A") players looking at listed target companies in the Chinese securities market. On July 31, 2006, China's securities market watchdog, the China Securities Regulatory Commission (CSRC), promulgated an important regulation with respect to takeovers titled *Shangshi Gongsi Shougou Guanli Banfa* (Measures for Regulating Takeovers of Listed Companies) (the "2006 Takeover Measures").[1]

Along with other previously enacted laws and regulations, this regulation sets up the most comprehensive and workable legal framework for takeovers of Chinese listed companies to date. In terms of formality, it consolidates into one single document the twin takeover regulations promulgated by the CSRC in 2002,[2] rendering the legal framework

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1. Shangshi Gongsi Shougou Guanli Banfa [Measures for Regulating Takeovers of Listed Companies] (promulgated by the CSRC, July 31, 2006, effective Sept. 1, 2006) [hereinafter "2006 Takeover Measures"].

2. *See infra* Part III.A.

more streamlined and easier to apply. More importantly, it makes a number of important substantive changes to fill the gaps in the previous regime.[3] This represents the continued efforts of the Chinese government to develop a modernized regulatory system for takeovers.

Part II of this article examines the context in which this legal reform has been carried out. This provides some background information about the legal framework of the takeover system, and explains the necessity of this legal reform. Part III looks at some of those significant changes designed to enhance the efficacy of Chinese takeover law. Part IV canvasses the policy implications of the legal reform, evaluating the extent to which the new takeover law may function as hoped. Part V offers a conclusion.

II. The Need for Reform: A Background Discussion

The Explanatory Memorandum to the 2006 Takeover Measures (the "Explanatory Memorandum") states that the takeover law revision is to suit the new environment whereby the national economy is facing strategic restructuring and the shareholding structure of listed companies is undergoing a radical transformation.[4] Indeed, the 2006 Takeover Measures came at time when the six-year transition period of China's World Trade Organization (WTO) membership was about to lapse, specifically in December 2006, and Chinese capital markets are at the birth of a new era thanks to the ongoing state share reform.

A. Strategic Restructuring of China's National Economy

M&A activity in China has increased dramatically over the last several years. While M&A transactions were virtually unknown in China a mere decade ago, they are now an increasingly common and important feature of China's economic landscape. Since 2001 when China joined the WTO, every year has been a record year. In 2005, for example, there were 46 billion U.S. dollars worth of inbound and domestic deals—up 34 percent from 2004, and outbound deals accounted for another $7 billion.[5]

The increased pace of M&A activity represents China's efforts to restructure its national economy in a post-WTO era. One of the government's overarching policy goals is the so-called *Guotui Minjin* (state capital retreating to let private capital in). Its purpose is to shunt state-owned enterprises ("SOEs") into the private sector, retaining only a tiny core that the state deems crucial for national defence, energy security, and so on.[6] Therefore, in some sectors, the government is encouraging the consolidation of SOEs into large integrated conglomerates that are intended to be global leaders in their field; in other sectors, the state is reducing the level of its equity ownership, making a large number of SOEs available for private capital. As a result, an estimated 4,000 to 5,000 SOEs are

3. *See infra* Part III.

4. Explanatory Memorandum, para. 1. *See* CSRC, http://www.csrc.gov.cn/n575458/n575667/n642011/2050045.html (last visited Mar. 18, 2008).

5. Tyrrell Levine & Kim Woodard, *The New Face of Chinese M&A*, Far E. Econ. Review, Apr. 18, 2006, at 18.

6. Guowuyuan Guanyu Guli Zhichi he Yindao Getisiyindeng Feiguoyouzhi Jingji Fazhan de Ruogan Yijian [Opinions of the State Council on Encouraging and Supporting the Development of Non-Public Ownership Economy] (promulgated by the State Council Feb. 25, 2007).

privatized each year out of a total remaining stock of roughly 135,000.[7] The government has viewed M&A activity as a key driver of this restructuring and privatization process.

It is worth noting that the restructuring process has been well served by foreign investment. The first wave of foreign direct investment (FDI) in China in the 1980s mostly took the form of joint ventures, including equity joint venture enterprises (EJV)[8] and contractual joint venture enterprises (CJV)[9]. A second wave followed in the 1990s in the form of wholly foreign-owned enterprises (WFOE).[10] Now a third wave of FDI, cross-border M&A, is gaining strength. Until China's accession to the WTO in 2001, China appeared to encourage foreigners to form joint ventures or set up WFOEs while explicitly discouraging M&A. But China has since gradually loosened the regulations that govern foreign takeovers of Chinese assets, especially SOEs and state shares in listed companies, and has made explicit moves to attract foreign M&A. Despite the concern that foreigners may swoop in and buy their way to dominance in key sectors of the Chinese economy, the government appears to believe that, on balance, foreign investment has played and will continue to play a useful role in carrying out its grand plan of strategically restructuring the economy.[11]

B. Shareholding Structure Reform in Listed Companies

As this article is concerned primarily with takeovers of Chinese listed companies rather than all M&A transactions, it is crucial to understand the relevant features of such companies.[12] Chinese companies may be listed on one of China's two national stock exchanges in Shanghai and Shenzhen,[13] and there are several different types of shares, distinguished by rules governing their ownership and trading.

First, depending on the nationality of eligible traders and the currencies in which the shares are traded, there are traditionally two broad types of shares in the market: A-shares and B-shares. A-shares are basically limited to domestic investors, including individuals, legal persons, and the state, with both the principal and dividends denominated in the local currency, namely the Chinese Yuan (CNY). In contrast, B-shares are generally designed for foreigners. While B-shares carry a face value denominated in CNY, they are traded in foreign currency on the basis of exchange rates at the time of transactions. In

7. *See* Levine & Woodard, *supra* note 5, at 19.

8. Zhonghua Renmin Gongheguo Zhongwai Hezi Jingying Qiyefa [Law of the PRC on Chinese-Foreign Equity Joint Ventures] (adopted by the Standing Comm. Nat'l People's Cong., July 1, 1979, amended, Mar. 15, 2001).

9. Zhonghua Renmin Gongheguo Zhongwai Hezuo Jingying Qiyefa [Law of the PRC on Chinese-Foreign Contractual Joint Ventures] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 13, 1988, amended Oct. 31, 2001).

10. Zhonghua Renmin Gongheguo Waizi Qiyefa [Law of the PRC on Foreign Capital Enterprises] (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 12, 1986, amended Oct. 31, 2001).

11. David Boitout & Raphael Chantelot, *A Brave New World for Chinese M&A*, Int'l Fin. L. Rev., Aug. 29, 2006, at 41.

12. For a fuller account of the development and features of the Chinese securities market, *see* Hui Huang, *China's Takeover Law: A Comparative Analysis and Proposals for Reform*, 30 Del. J. Corp. L., 145, 148-153 (2005).

13. Chinese companies may also be listed solely or dual-listed on overseas exchanges, typically in Hong Kong or New York.

terms of market capitalization, B-shares account for a fairly small portion, and thus its impact on the market is quite limited.[14]

Second and more importantly, A-shares have been further sub-divided into three subsets in light of the strictly defined groups of shareholders in China: state shares (*guojia gu*); legal person shares (*faren gu*); and public individual shares (*shehui geren gu*). Only public individual shares may be freely traded on the stock exchange (and therefore are called tradable shares) while state shares and legal person shares are subject to severe trading restrictions (and therefore are collectively called non-tradeable shares). In general, non-tradable shares account for about two-thirds of the shares in most listed companies.[15]

As the economic reform proceeds, the government has been making great efforts to gradually solve the problem of market segmentation, with a view to bringing the market more in line with international norms.[16] The A-share/B-share distinction has become blurred over time. On the one hand, since February 2001, B-shares have been made available for domestic investors to purchase with foreign currency.[17] On the other hand, the A-share market is gradually being opened up to foreigners.[18] It appears that the A-shares and B-shares markets will be merged soon and thus the distinction between A-shares and B-shares will become history.

Compared with the smoothness of the scrapping of the A-share/B-share distinction, the tradable/non-tradable shares segregation has proven a much harder problem to address. Non-tradable shares were created by the government in the early 1990s to prevent uncontrolled sales of SOEs to private sectors, but the system artificially distorted the functioning of the market, becoming a serious impediment to its further development.[19] Since 2000,

14. *See* Huang, *supra* note 12, at 149.

15. Until quite recently, the mean shareholding percentages across Chinese listed companies was typically about 30 percent for each of the state, legal persons, and public individual investors, with 10 percent going to other investors such as foreigners. *See* Daqing Qi et al., *Shareholding Structure and Corporate Performance of Partially Privatized Firms: Evidence from Listed Chinese Companies*, 8 PAC. BASIN FIN. J. 587, 593 (2000). Another empirical study came to a similar conclusion as of the end of June 2002. *See* Haichi Ren, Ruhe Youhua Woguo Shangshi Gongsi Ziben Jiegou [How to Improve the Capital Structure of China's Listed Companies], *Shanghai Jinrong Xueyuan Xuebao [J. Shanghai Inst. Fin.]*, No. 2, at 60 (2004) (reporting a figure of 60 percent non-tradable shares and 35 percent tradable shares for all listed companies). CSRC statistics, as of the end of December 2005, showed that the value of tradeable shares was CNY 1.06 trillion, about one-third of the total value of all shares of listed companies. *See* CSRC, http://www.csrc.gov.cn (last visited Dec. 18, 2006).

16. The distinctive feature of market segmentation is essentially a historical product of China's progressive economic reform. For a discussion of the economic and political reasons behind it, *see* Huang, *supra* note 12, at 151-53.

17. Guanyu Jingnei Jumin Touzi Jingnei Shangshi Waizigu de Tongzi [Notice on Permitting Domestic Investors to Invest in B Shares] (promulgated by CSRC, Feb. 21, 2001).

18. There are two main ways in which foreigners can acquire A-shares on the Chinese securities markets. First, since November 2002, large financial institutions that count as a Qualified Foreign Institutional Investor (QFII) have been able to purchase limited quotas of tradable shares in the A-share market. The second avenue is for foreigners to purchase non-tradable shares. In 2002, the State started to allow foreign investors to do so subject to stringent controls. In December 2005, a new regulation was promulgated to enable foreigners to acquire large equity stakes as strategic investment in Chinese listed companies. Waiguo Touzizhe dui Shangshi Gongsi Zhanlue Touzi Guanli Banfa [Administrative Measures for Strategic Investment by Foreign Investors in Listed Companies] (promulgated by the Ministry of Commerce, the CSRC, the State Taxation Bureau, the State Admin. for Indus. & Commerce, and the State Admin. of Foreign Exch., Dec. 31, 2005, effective Jan. 31, 2006).

19. The tradable/non-tradable shares segregation has been widely seen as the fundamental problem with the Chinese stock market, which was largely responsible for serious corporate governance issues. *See* Huang,

several unsuccessful experiments were attempted to reform the non-tradable shares to make them freely tradable on the stock exchanges. These failures, along with other factors, have contributed to the four-year long bear market in China, with the market losing about half of its value from its peak in 2001 and the Shanghai Stock Exchange Composite Index (SSECI) sliding from 2245 points on June 14, 2001, down to a dangerously low level of 998 points on June 6, 2005.[20]

In April 2005, the CSRC issued a new plan for shareholding structure reform entitled *Guquan Fenzhi Gaige*.[21] Unlike its predecessors, this plan adopts a market-based process rather than a government-imposed approach. The reform is carried out essentially through a negotiation between the public shareholders who hold the tradable shares and the state holders who hold the non-tradable shares.[22] Because the reform is aimed to turn the non-tradable shares into tradable shares, it is regarded as conferring on the holders of non-tradable shares a new, valuable trading privilege.[23] For this reason, the holders of non-tradable shares need to give "consideration" to the public shareholders in return for the trading rights. The consideration typically takes the form of new shares, and in some cases, innovative instruments such as warrants have been used. The terms are freely negotiated between holders of tradable shares and holders of non-tradable shares and thus may vary from one company to another. The reform is about to finish and has proven to be a great success this time around, with the SSECI surging to regain all the previously lost ground and reach a new record high of 6124 points on October 16, 2007.[24]

As a result of the reform, the Chinese stock market has assumed a radically different landscape, which will have a far-reaching implication for takeover activity. As will be discussed later, there are two main methods of takeovers in China: takeover by tender offer, which is used for tradable shares, and takeover by private agreement, which is designed for non-tradable shares.[25]

As discussed above, prior to the 2005 shareholding reform, Chinese listed companies were characterized by the segregated shareholding structure featuring one-third tradable shares and two-thirds non-tradable shares. In order to successfully acquire control of a

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supra note 12, at 153. Empirical research has suggested that corporate performance is negatively related to the proportion of state shares. *See e.g.*, Jian Chen, *Ownership Structure as Corporate Governance Mechanism: Evidence from Chinese Listed Companies*, 34 ECON. OF PLANNING 53, 61 (2001).

20. *See* Shanghai Stock Exchange, http://www.sse.com.cn/sseportal/en_us/ps/home.shtml (last visited Sept. 30, 2007).

21. Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Shangshi Gongsi Guquan Fenzhi Gaige Shidian Youguan Wenti de Tongzhi [Notice of the China Securities Regulatory Commission on the Pilot Shareholding Structure Reform of Listed Companies] (promulgated by the CSRC, Apr. 29, 2005). After the successful trial, this reform model was officially recognized in a more formal and detailed regulation applicable to all listed companies. *See* Shangshi Gongsi Guquan Fenzhi Gaige Guanli Banfa [Measures on the Shareholding Structure Reform of Listed Companies] (promulgated by the CSRC, Sept. 4, 2005) [hereinafter "Measures on the Shareholding Structure Reform"].

22. Measures on the Shareholding Structure Reform, *supra* note 21, art. 3 (stating that "the shareholding structure reform of listed companies shall be governed by the principles of openness, fairness and equity, and be conducted on the basis of negotiation on an equal footing, good faith, mutual understanding and self-determination . . .").

23. Xianyin Quan & Bin Hu, *A Legal Analysis of the Shareholding Structure Reform*, ZHONGGUO JINGRONG FAZHI BAOGAO [ANNUAL REPORT ON CHINA'S FINANCIAL LAW], 380, 383-86 (2006).

24. *See* Shanghai Stock Exchange, *supra* note 20.

25. *See infra* Part III.

listed company, often one has to purchase the non-tradable shares by private agreement. Consequently, there have been very few takeovers by tender offer, particularly hostile takeovers, in China to date.[26] This situation is expected to change after the shareholding structure reform, in which non-tradable shares will be gradually transformed into tradable shares. The 2006 Takeover Measures were promulgated against this background.

III. China's Takeover Legal Regime: A Comparative Perspective

A. An Overview

The legal regime regarding takeovers in China consists of a number of laws and regulations. The first influential regulations containing takeover provisions were the Provisional Regulations for the Administration of Stock Insurance and Transaction (the "Provisional Regulations"), promulgated in 1993 and still valid.[27] Since 1999, the Securities Law of the People's Republic of China (the "Securities Law") has contained a whole chapter specifically regulating takeovers of listed companies.[28] These two sets of rules alone, however, established only a broadly sketched framework and appeared to be incapable of meeting the need of regulating takeovers.

In response to this, the CSRC promulgated two important regulations governing takeovers of listed companies in 2002, substantially improving the efficacy of the takeover law.[29] Still, drawing upon these two regulations, the CSRC promulgated the 2006 Takeover Measures to suit the new circumstances after the shareholding structure reform. Although this regulation is not without defects,[30] it has further greatly completed China's takeover legal regime and is now forming a sound basis for takeover activities.[31]

26. *See* Huang, *supra* note 12, at 157-158 (discussing the small number of tender offer cases in China).

27. Gupiao Faxing Yu Jiaoyi Guanli Zanxing Tiaoli [Provisional Regulations for the Administration of Stock Issuance and Transaction] (promulgated by the State Council Sec. Comm'n, Apr. 22 1993).

28. Zhonghua Renming Gongheguo Zhenquan Fa [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999, amended Aug. 28, 2004 and Oct. 27, 2005) [hereinafter "Securities Law"].

29. The twin regulations were Shangshi Gongsi Shougou Guanli Banfa [Measures for Regulating Takeovers of Listed Companies] (promulgated Sept. 28, 2002, effective 1 Dec. 1, 2002, repealed Sept. 1 2006) [hereinafter "2002 Takeover Measures"], and Shangshi Gongsi Gudong Chigu Biandong Xinxi Pilu Guanli Banfa [Measures for Regulating Information Disclosure of the Changes in Shareholdings of Listed Companies] (promulgated Sept. 28, 2002, effective Dec. 1, 2002, repealed Sept. 1 2006) [hereinafter "2002 Information Disclosure Measures"]. Both regulations were repealed as a result of the promulgation of the 2006 Takeover Measures, but their contents have been largely reproduced in its successor. For a detailed discussion of those two regulations, *see* Huang, *supra* note 12, at 145.

30. *See infra* Part IV.B.

31. There are some other sources of law which may be relevant to takeover transactions. For example, Company Law of the People's Republic of China contains some provisions about mergers and acquisitions. Zhonghua Renming Gongheguo Gongsi Fa [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994, amended Dec. 25, 1999, Aug. 28, 2004, and Oct. 27, 2005). In addition, the listing rules of the stock exchanges must also be consulted when conducting takeovers of listed companies. Shanghai Zhengquan Jiaoyisuo Gupiao Shangshi Guize [Shanghai Stock Exchange, Share Listing Rules] (promulgated 1998, amended 2000, 2001, 2002, 2004 and 2006).

As to takeovers of listed companies by foreigners, there is a separate group of regulations in addition to those for domestic acquirers. These regulations impose limits on the access of foreigners to the domestic market, but if access is granted, foreigners will comply with basically the same takeover laws as Chinese

The policy objective of China's takeover regulation is that the takeover of listed companies shall be conducted in line with the principles of openness (*Gong Kai*), fairness (*Gong Ping*) and equity (*Gong Zheng*), also known as the Three Gong Principles.[32] These principles have had a profound shaping effect upon Chinese takeover law and are incorporated throughout the whole of the 2006 Takeover Measures. The principal elements of Chinese takeover regulation will be examined below from a comparative perspective.

The CSRC is the securities regulatory authority under the State Council and is charged with implementing centralized and unified regulation of China's securities market.[33] It therefore has jurisdiction and powers over the takeover of listed companies.[34] Indeed, as a technocrat, it is assigned a virtually exclusive dispute resolution role with respect to takeovers. The 2006 Takeover Measures brought about a significant change whereby the CSRC establishes a special internal committee known as the Takeover Committee.[35] This committee is composed of professionals and relevant experts in the takeover area whose function is to provide opinions about takeover regulation at the request of a functional department of the CSRC.[36]

B. The Mandatory Bid Rule

In accordance with the equality of opportunity principle, a mandatory bid rule sits at the heart of China's takeover law. Under Article 88 of the Securities Law:

> Where an investor holds or holds with any other person 30% of the stocks as issued by a listed company by means of agreement or any other arrangement through securities trading at a stock exchange and if the purchase is continued, he shall issue a tender offer to all the shareholders of the said listed company to purchase all of or part of the shares of the listed company.[37]

The 2006 Takeover Measures set out more detailed provisions to implement this rule. First, it is clear that an acquirer can become a controlling shareholder of a listed company by directly obtaining shares and can become an actual controller of a listed company by means of investment relationship, agreement, or any other arrangement.[38] This effectively recognizes that a listed company can be acquired by means of tender offer or private agreement as well as by any other legal means, such as inheritance, and that all of these acquisitions may trigger the mandatory bid rule.[39]

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nationals. *See* 2006 Takeovers Measures, *supra* note 1, art. 4 (stating that takeovers of listed companies by foreigners should necessitate approval from relevant governmental department). The detailed discussion of the foreign takeover regulation is beyond the scope of this article.

32. 2006 Takeover Measures, *supra* note 1, art. 3.

33. Securities Law, *supra* note 28, art. 7. For a detailed discussion of the evolution of the regulatory regime, *see* Huang, *supra* note 12, at 154-156.

34. 2006 Takeover Measures, *supra* note 1, art. 10.

35. *Id.*

36. The role of the Takeover Committee will be examined further in Part IV.B.2.

37. Securities Law, *supra* note 28, art. 88.

38. 2006 Takeover Measures, *supra* note 1, art. 5.

39. *Id.* art. 47 (providing that takeovers by private agreement are subject to the mandatory bid rule). In a recent case, Dikang Konggu Co. was forced to make a tender offer because it acquired more than 30 percent of the state shares of Chengshang Group by a private agreement. *See* Jun Li, *The Transfer of State Shares of Chengshang Group Triggers Mandatory Bid*, Guoji Jingrong Bao [Int'l Fin. News], Apr. 15, 2003, at 7.

Second, when calculating an investor's shareholding, the voting rights of its associates or parties acting in concert (so-called *Yizhi Xingdongren*) will also be counted. The associates are those with whom the primary person is acting in concert by way of private agreement or any other arrangement so as to increase their joint voting powers in a listed company.[40] To facilitate enforcement, the 2006 Takeover Measures provide a long list of situations where certain people are deemed to be associates of an investor in the absence of contrary evidence.[41] Compared with the already broad scope of associates in Australia,[42] the Chinese version appears to be even broader.[43] In addition, the calculation of an investor's shareholding is not limited to shares but extended to those non-share securities that can be converted into shares in the future.[44]

Third, the concept of control is clearly set out in Article 84 of the 2006 Takeover Measures. An investor controls a listed company if it has more than a 50 percent shareholding, can exercise 30 percent of voting rights, or otherwise has the capacity to determine the election of more than half of the directors or the outcome of decisions of shareholder meetings.[45] This concept seems similar to that in Australian takeover regulation, which is broad enough to embrace a factual control situation.[46]

From an international perspective, the mandatory bid rule has been an issue of contention. Australia and the U.K. have been amongst the proponents of such a mechanism. Indeed, China's mandatory bid rule is almost identical to that in the U.K. as stated in the City Code on Takeovers and Mergers.[47] In Australia, acquiring more than a threshold of 20 percent of voting power in a company is prohibited, subject to a number of exceptions, including the making of a takeover bid.[48] In stark contrast, an acquirer under U.S. law has greater flexibility—it is not required to make an offer if it becomes a 30 percent shareholder as it would under the Chinese regime.[49]

40. 2006 Takeover Measures, *supra* note 1, art. 83.

41. *Id*.

42. Corporations Act, 2001, § 12 (Austl.) [hereinafter "Corporations Act"].

43. For example, under Chinese law, the deeming situations include those where there is an equity control relationship between the investors, where the investors are controlled by the same entity, and where one investor is capable of influencing the other person's affairs by virtue of private agreement or other business relationships. Moreover, other people such as directors of the acquiring company and their family members would also come within the definition, while they are not necessarily associates in Australia.

44. 2006 Takeover Measures, *supra* note 1, art. 85. Examples may include options and warrants. There is a parallel provision in Australian takeover law. *See* Corporations Act, *supra* note 42, § 608(8) (providing anticipatory relevant interests). One difference, however, is that convertible debentures appear to also be covered in the Chinese calculation while in Australia it is not counted until the later time of conversion.

45. 2006 Takeover Measures, *supra* note 1, art. 84.

46. *See* Corporations Act, *supra* note 42, § 50AA.

47. The Panel on Takeovers and Mergers, The Takeover Code, (2006), Rule 9, F1, *available at* http://www.thetakeoverpanel.org.uk/new/codesars/data/code.pdf (last visited Mar. 18, 2008) [hereinafter "City Code on Takeovers and Mergers].

48. Corporations Act, *supra* note 42, §§ 606, 611, 616. It should be noted that the Australian takeover provisions are somewhat different from the mandatory bid rule. These provisions are in effect more stringent than the mandatory bid rule because the mandatory bid rule allows for control to pass prior to a general offer via "pre-bid agreements or understandings between bidders and target shareholders," thus reducing the costs of takeovers. *See* Corporate Law Economic Reform Program, Commonwealth of Australia Paper No.4, Takeovers—Corporate Control: A Better Environment for Productive Investment, para 4.1 (Apr. 1, 1997), *available at* http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=284 (last visited Mar. 18, 2008).

49. 15 U.S.C. §§ 78m(d)-(f), 78n(d) (2000).

The mandatory bid rule could provide a great degree of shareholder protection by ensuring that the control premium is shared amongst all shareholders. This is seemingly in line with the Chinese "Three Gong" principles. This is not the case in the United States, where "it is possible for a bidder to purchase a control block from a private party without making an offer to other shareholders and probably without any sharing of a control premium paid to the departing control group."[50] Thus, China's takeover law seems more attractive than its American counterpart from the target shareholders' point of view. This, however, comes at the expense of the contestability of takeovers because it would increase the cost of takeovers and scare off some potential bidders.[51]

This concern could be better met by fine-tuning the mandatory bid rule rather than abandoning it to keep a balance between the two conflicting goals. On the one hand, the height of the triggering barrier set in the rule could greatly influence the practical outcome of the rule. Even though it may be difficult to set the numbers to fit local situations, the inherent flexibility of the mandatory bid rule could be a valuable tool to meet the policy goals. For example, if the 30 percent shareholding threshold proves to be too high in the context of China, it can be reduced down to 20 percent, as is the case in Australia.

On the other hand, the harshness of the mandatory bid rule can be mitigated by providing a way out where appropriate. In China, the obligation to make mandatory bids can be exempted by the CSRC. Since the exemption system had previously caused serious problems,[52] the 2006 Takeover Measures have paid considerable attention to this issue, clarifying the grounds upon which the CSRC may grant an exemption.[53] In order to improve the efficiency of the system, the CSRC sets out two application processes. More specifically, in some cases where the matter is complicated, the application needs to go through a formal process;[54] in other cases where crossing the 30 percent threshold appears to be technically caused by non-takeover activities such as inheritance or underwriting arrangements, a simplified procedure is to be followed to allow quicker processing.[55]

By way of comparison, this list of exemptions appears in line with those set out in Australian takeover law.[56] For example, under Article 62, apart from the CSRC, the shareholders of the target company can also pass a resolution to exempt the acquirer from the mandatory bid rule,[57] which is essentially the "approval by resolution of target" exception in Australia.[58] There is also a newly introduced exemption under which an investor

50. *See* Robert B. Thompson, *Takeover Regulation After the "Convergence" of Corporate Law*, 24 SYDNEY L. REV. 323, 326 (2002). In the United States, the acquirer would most likely have to offer a large premium of about 50 percent in its tender offer. *See* Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, MIDLAND CORP. FIN. J., Summer 1986 1, 2 (stating that "[t]akeovers benefit target shareholders—premiums in hostile offers historically exceed 30 percent on average, and in recent times have averaged about 50 percent.").

51. Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control* 109 Q. J. ECON. 957, 960 (Nov. 1994).

52. *See infra* Part IV.A.

53. 2006 Takeover Measures, *supra* note 1, pt. IV. For example, exemptions may be granted if the acquirer and the transferor can prove that the transfer has not caused the change of the factual controller of the listed company. *Id.* art. 62(1).

54. *Id.* art. 62.

55. *Id.* art. 63.

56. Corporations Act, *supra* note 42, § 611.

57. 2006 Takeover Measures, *supra* note 1, art. 62(2), (3).

58. Corporations Act, *supra* note 42, § 611(7).

can increase its shareholding by less than 2 percent in a rolling period of twelve months,[59] a counterpart of the Australian "3% creep in 6 months" exception.[60]

C. Tender Offer Rules

As discussed earlier, whatever the method of acquiring more than 30 percent of the shares in a target listed company, the mandatory bid rule will apply subject to exemptions granted by the CRSC. Under the 2002 Takeover Measures, the mandatory bid could only be a full bid. In 2005, the Securities Law was amended to permit the bid to be either full or partial.[61] In conformity with the fairness and openness principles,[62] the 2006 Takeover Measures set out detailed provisions on how to conduct a takeover bid.

Apart from the permission of partial bids, there are several other significant changes to the previous regime in this area. First, the way of payment in a takeover bid becomes more flexible. Previously, an offer under a takeover bid must be in cash only, which has caused a lot of trouble for acquirers in terms of financing and post-takeover integration.[63] The 2006 Takeover Measures have relaxed the stance on this issue, providing that an acquirer can pay the price of the takeover of a listed company by cash, securities, combination of cash and securities, or any other lawful method.[64] This brings the takeover in China more in line with international practices where a combination of cash and stock is commonly used in takeovers.[65] But in the case of a full bid, the acquirer must provide cash alternative for the target shareholders to choose.[66]

Second, the lower limit of the offer price has been substantially changed. According to the 2006 Takeover Measures, the price offered under a takeover bid must not be less than the maximum price that the bidder has paid for the bid security during the six months preceding the date of the bid.[67] Further, if the offer price is below the arithmetic average value of the daily weighted average prices during the thirty trading days prior to the date of the bid, a financial consultant must be hired by the bidder to produce a report on issues such as whether there is any manipulation of stock prices, whether the bidder has failed to disclosed its concerned parties, whether there is any other arrangement for the bidder to obtain the shares of the target company during the previous six months, and finally whether the offer price is reasonable.[68]

This new price rule is a response to the problems arising from the 2002 Takeover Measures. Previously, the offer price had to be set differently between tradable and non-

59. 2006 Takeover Measures, *supra* note 1, art. 63(2).

60. Corporations Act, *supra* note 42, § 611(9).

61. Baoshu Wang & Hui Huang, *China's New Company Law and Securities Law: An Overview and Assessment*, 19(2) Australian J. of Corp. L. 229, 237 (2006).

62. Art. 26 of the 2006 Takeover Measures requires that in a takeover bid, all the shareholders of the target company be treated equally and fairly.

63. Shenggui Zhang, *The Impact of the New Takeover Measures on the Market*, *available at* http://www.9ask.cn (last visited Jan. 24, 2007) (pointing out that the pure-cash rule had been a significant obstacle to takeovers in China).

64. 2006 Takeover Measures, *supra* note 1, art. 36.

65. *See e.g.*, Richard Dobbs et al., *Are Companies Getting Better at M&A?*, The McKinsey Q. (Dec. 2006), *available at* http://www.Mckinseyquarterly.com; Corporations Act, *supra* note 42, § 621(1).

66. 2006 Takeover Measures, *supra* note 1, art. 27.

67. *Id.* art. 35.

68. *Id.*

tradable shares. Specifically, the price for tradable shares was determined by reference to the market price while the price for non-tradable shares was based on the net asset value per share.[69] In light of the 2005 shareholding structure reform, this dichotomous treatment has become obsolete, and a uniform rule for price setting is warranted. More importantly, under the 2002 Takeover Measures, one of the benchmarks for setting the offer price for tradable shares was 90 percent of the arithmetic average value of the daily weighted average prices during the thirty trading days prior to the date of the bid.[70] As noted above, the 2006 Takeover Measures have removed the 90 percent discount which had caused perverse takeover activities as illustrated in the following case.

The Nangang Gufen case has been widely seen as the first instance of takeover by tender offer in the strict sense on the Chinese securities market.[71] On December 3, 2003, Nangang Group, the parent company of Nangang Gufen, entered into an agreement with several business partners, including Fuxing Group, to form a new company called Nangang United. The Nangang Group agreed to transfer the state shares it held in Nangang Gufen to Nangang United as its contribution. Because the transferred state shares exceeded 30 percent of all shares in Nangang Gufen, Nangang United, as the acquirer, had to face the mandatory bid rule. After failing to get an exemption from the CSRC, Nangang Untied was forced to make history in an offering that was the first ever takeover bid in China's stock market.

But the price-setting rule under the 2002 Takeover Measures has made this first tender offer case an embarrassing farce. Clearly, Nangang United did not want the remaining shareholders to tender their shares. Therefore, the offer price was set at the minimum as required by 2002 Takeover Measures. Specifically, the offer price for non-tradable shares was CNY 3.81 per share on the basis of the net asset value test, while the offer price for tradable shares was pitched at CNY 5.84 per share, equivalent to 90 percent of the arithmetic average value of the daily weighted average prices during the thirty trading days prior to the date of the bid. Because the offer price for tradable shares was at a discount to the market price rather than at a premium, none of shareholders of tradable shares accepted the offer, which was the expected and desired outcome for Nangang United.

This case reflects two important problems with the 2002 Chinese takeover law. First, the segregated equity ownership structure has made the operation of the mandatory bid rule in China distinctly different from its overseas counterparts. It was precisely because of the tradable/non-tradable segregation that Nangang United was able to set a different price for the holders of tradable shares, shunning its duty to give shareholders of tradable shares an equal opportunity to share the premium granted to holders of non-tradable shares. As discussed before, this problem will disappear as a result of the shareholding structure reform.

The second problem, of course, can be found in the previous rule for setting the price for the holders of tradable shares. As illustrated in the above case, the 90 percent discount rule could allow the bidder to deliberately set the offer price along the bottom line, where the rejection of the offer would be almost a certainty and thus the bidder could lawfully

69. 2002 Takeover Measures, *supra* note 29, art. 34.

70. *Id*. at art. 34(1).

71. Wenzhi Luo & Hanbing Dong, *Shangshi Gongsi Binggou Falv Shiwu [Legal Practice for M&A of Listed Companies]*, 145-152 (2005).

avoid the financial costs imposed by the mandatory bid rule. In recognition of this, the CSRC has revised the price rule in the 2006 Takeover Measures as shown above.

The 2006 Takeover Measures have also established another set of relevant rules to ensure that the takeover bid will be conducted in accordance with its underlying principles. The principle of equal opportunity is expressed in Article 26, which provides that all target shareholders should be treated equally in takeovers.[72] This fundamental norm is reinforced by a prohibition upon the giving of collateral benefits during the bid.[73] The principle of openness is embodied in the information disclosure regime, with respect to takeovers and the principle of fairness, and sheds light on the procedures for conducting the takeover bid.[74]

These rules provide a safeguard for target shareholders to prevent coercive tender offers through adequate information disclosure about the tender offer and the right to have reasonable time to consider it. For example, the bidder must inform the market of the terms of the offer,[75] and the offer should be open for a minimum time to avoid shareholders making a hasty decision.[76] If the bidder wants to vary the terms of the offer, the approval of the CSRC is required,[77] and variation cannot occur within fifteen days prior to the expiration of the bid unless a competing bid is made.[78] Further, the target's shareholders can withdraw their acceptance within three days before the expiration of the bid.[79] Most other jurisdictions have similar provisions.[80]

In order to ensure equal treatment of all target shareholders, China's takeover law pays particular attention to minority shareholders after takeovers. If the tender offer expires and the acquirer has gotten enough shares (usually 75 percent of all outstanding shares) to cause the de-listing of the target company, the remaining shareholders have the right to enforce the sale of their shares on the same terms as those in the offer.[81] In this way, the remaining minority shareholders can be protected from a freeze-out merger on terms less favorable than those of the offer. Australian takeover regulations contain a similar regime regarding the compulsory buy-out of bid class securities.[82] In contrast, the U.S. Williams

72. 2006 Takeover Measures, *supra* note 1, art. 26.

73. *Id*. art. 38 (providing that the bidder must not purchase securities in the bid class outside the bid or go beyond the terms as stipulated in the bid).

74. 2006 Takeover Measures, *supra* note 1. pt. III.

75. *Id*. art. 29 (requiring the bidder to disclose relevant issues such as the purpose of the takeover, the offer price, and the payment arrangement).

76. *Id*. art. 37 (providing that the effective period of the offer must be no less than thirty days and no more than sixty days, except where there is a contested offer).

77. *Id*. art. 39.

78. *Id*. art. 40.

79. *Id*. art. 42(2).

80. *E.g.*, in the United States, *see* 15 U.S.C. § 78n(d)-(e) (2000); 17 C.F.R. § 240.14e-1 (2004). In Australia, *see* Corporations Act, *supra* note 42, § 624(1) (duration of the offer), §§ 632-635 (steps in market bid), § 636 (content of bidders' statement), § 652 (withdraw of an offer).

81. Securities Law, *supra* note 28, art. 97; 2006 Takeover Measures, *supra* note 1, art. 44. According to the listing requirement, a listed company must meet a number of criteria, one of which is that the publicly held shares in a company must account for more than 25 percent of all outstanding shares, and if the total amount of the issued capital of the company exceeds CNY 0.4 billion, then the publicly held shares must be more than 10 percent. Securities Law, *supra* note 28, art. 50.

82. Corporations Act, *supra* note 42, §§ 662A-662C (providing that if the bidder has relevant interests in at least 90 percent of the securities in the bid class at the end of the offer period, the bidder must offer to buy out the remaining holders of bid class securities). Previously, the compulsory buy-out threshold in China was

Act provides less protection for remaining shareholders in a freeze-out merger. Thus, in the United States, minority shareholders could be paid consideration with a value lower than the bid price in an immediate takeover.[83]

D. Disclosure of Substantial Shareholdings

In the interest of ensuring an informed market for securities in the target and its control, the takeover laws of most jurisdictions generally require a bidder to make an adequate and timely disclosure of its interests in a listed target.[84] The so-called disclosure of "substantial shareholdings" is intended to provide the market with an early warning of possible takeovers.[85] In China, the promulgation of the 2006 Takeover Measures coupled with the Securities Law provides for broad disclosure with respect to substantial shareholders.[86] When an investor comes to hold 5 percent of the shares issued by a listed company, the investor must disclose his or her position.[87] To do so, the investor must submit a written report to the CSRC and the stock exchange within three business days from the date when such shareholding occurs.[88] During this period, the investor may not continue to purchase or sell shares of the listed company.[89] Thus, the investor is prohibited from changing his or her ownership position until the market is informed. In addition, if the shareholding of a substantial shareholder increases or decreases by 5 percent each time, they should disclose this information in the same way and must not trade the relevant shares within the disclosure period or within two days thereafter.[90]

The 2006 Takeover Measures set out more detailed provisions to implement the disclosure requirement. First, they clarify that when counting a person's interests in a listed company, the shareholding of their associates or people acting in concert will be included.[91] Second, two different disclosure systems are established for use depending on the level of substantial shareholdings. Specifically, if an investor and its concerted parties are not the largest shareholder or actual controller of a listed company, and their joint shareholding is above 5 percent but below 20 percent, a simplified disclosure system applies.[92] If, however, their shareholding exceeds 20 percent and up to 30 percent, then a detailed report must be made.[93]

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also 90 percent, but in 2005 it was changed by reference to the listing standard on the grounds that delisting is likely to expose the remaining target shareholders to the exploitation of the new controller. *See* Wang & Huang, *supra* note 61, at 237. The Australian law also provides for a scheme of compulsory acquisition under which a bidder can compulsorily acquire any remaining securities in the bid class if the bidder has successfully acquired at least 75 percent of the securities in the bid and the total shareholding has increased to at least 90 percent. Corporations Act, *supra* note 42, §§ 662A-662C.

83. Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, *in* Knights, Raiders, and Targets: The Impact of the Hostile Takeover 371, 374 (John C. Coffee, Jr. et al. eds., 1988).

84. *See* Huang, *supra* note 12, at 167.

85. Richard W. Jennings et al., Securities Regulations: Cases and Materials 652 (7th ed. 1992).

86. The 2002 Information Disclosure Measures were basically incorporated as a whole into the 2006 Takeover Measures as its second part titled "Information Disclosure about Ownership of Listed Companies."

87. Securities Law, *supra* note 28, art. 86(1).

88. *Id.*

89. *Id.*

90. *Id.* art. 86(2).

91. 2006 Takeover Measures, *supra* note 1, art. 13.

92. *Id.* art. 16.

93. *Id.* art. 17.

This requirement of disclosing substantial shareholdings can be found in the takeover laws of most jurisdictions. In the United States, Section 13(d) of the Securities Exchange Act imposes a similar disclosure requirement on persons within ten days of the date that they acquire beneficial ownership of more than 5 percent of a public company.[94] Unlike China, U.S. law permits substantial shareholders to continue to purchase shares during this period before making the announcement.[95] If, however, there is a material change in the holdings, including an acquisition or disposition of 1 percent of outstanding shares in the said company, the owner must promptly file an amendment.[96]

In Australia, if a shareholder begins to have, or ceases to have a relevant interest in 5 percent or more of the all shares in a company or scheme, that shareholder is deemed to have acquired a substantial holding in that company or scheme.[97] This is relevant because once this occurs, that shareholder must disclose the information within two business days after he or she first becomes aware of this information.[98] Further, where there is a movement of at least 1 percent in the substantial shareholders' holdings, such movement must be disclosed within two business days.[99] Thus, Australia requires disclosure in much the same fashion as both China and the United States.

Clearly, the threshold for substantial shareholdings and the time for disclosure would exert significant influence on the contestability of takeovers.[100] The lower the threshold, the more protection the target shareholders will have; therefore, the resulting takeover would be more difficult. Generally, the bidder needs to accumulate a certain number of shares, called a "toehold," before initiating a takeover.[101] If the bidder is required to disclose his or her holdings too early, the market would react to raise the share price, and the takeover would be more expensive.[102]

Therefore, a trade-off must be made between the protection of shareholders and the contestability of corporate control by choosing the appropriate threshold and disclosure time. This balance should be determined on the basis of the local situation. Thus, it might be the adjustment of the threshold and disclosure time according to the changing commercial environment. In China, for example, the 1993 Provisional Regulations require a substantial shareholder to disclose a change in its holding of at least 2 percent of the outstanding shares.[103] In order to encourage takeovers, this threshold has been raised to 5 percent in the Securities Law, as previously discussed. The increase from 2 percent to 5 percent may be arbitrary and may seem to have an impressionistic flavor; however, in

94. 15 U.S.C. § 78m(d) (2000).
95. 17 C.F.R. § 240.13d-1(e)(2)(ii) (2004).
96. *Id.* § 240.13d-2(a).
97. Corporations Act, *supra* note 42, § 9.
98. *Id.* § 671B(6).
99. *Id.* § 671B(1)(b).
100. Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 898 (2nd ed. 1995) (pointing out that "the disclosure obligation imposed by 13(d) [of the Securities Exchange Act 1934] has particular significance for a would-be acquirer").
101. *See, e.g.*, Guido A. Ferrarini, Share Ownership, Takeover Law and the Contestability of Corporate Control at 4, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265429 (citations omitted).
102. *Id. See also* Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 Tex. L. Rev. 1, 13 (1978) (opining that a stringent disclosure rule would create disincentives for potential bidders).
103. Provisional Regulations, *supra* note 27, art. 47.

the absence of reliable empirical data, it is difficult to judge whether the figures are incapable of balancing shareholder protection with the contestability of takeovers.

IV. Implications: Opportunities and Challenges for the Future

A. Prospects

China's new takeover legal regime will undoubtedly have far-reaching implications for business and investment in practice. It is intended to encourage wealth-creating takeover activities to help restructure the national economy and optimize the allocation of resources.[104] This objective has been well illustrated in those significant changes, such as the permission of partial bids, the more methods of payment allowed, and the more efficient systems for governmental approval and information disclosure. The market is optimistic that this will provide a lot of opportunities for both domestic and foreign investment.[105]

In accordance with the shareholding structure reform, the 2006 Takeover Measures sets up a takeover regime with a clear emphasis on takeovers by tender offer. Previously, in order to gain corporate control, it was often necessary or highly desirable to purchase those shares by private agreement for several reasons. First, as noted earlier, before the 2005 shareholding structure reform, the non-tradable shares represented about two-thirds of the shares in most listed companies. It was virtually impossible to take over a company without acquiring part of those non-tradable shares. Second, due to the segregated equity structure, the price of non-tradable shares was systematically much lower than that of tradable shares in the same company.[106] In addition, it would also be preferable to purchase a control block of non-tradable shares for reasons of speed and certainty, even though the purchase of non-tradable shares requires governmental approvals.[107]

The third important reason lies in the ability to exempt the mandatory bid obligation. As noted earlier, like any other means of acquiring shares, takeover by private agreement would trigger the mandatory bid rule if the transfer of non-tradable shares causes the transferee to cross the 30 percent threshold. To avoid the high cost of making a mandatory bid, acquirers would apply to the CSRC for an exemption. In the past, the

104. Explanatory Memorandum, *supra* note 4, para. 1.

105. *See e.g.*, Guobing Zhong, *The Promulgation of the New Takeover Measures will Give Rise to Value-Creating Takeovers*, Shenzhen Shangbao [Shenzhen Business News] Aug. 2, 2006, at 6. Indeed, for foreigners, with the continued strong growth of the Chinese economy, M&A transactions offering immediate access to the Chinese market are becoming an increasingly attractive alternative to green-field investments. In many industries, including financial services and manufacturing, constraints on M&A are just now being lifted.

106. Because the non-tradable shares are not listed on the stock exchanges, they are priced at the net asset value per share. In practice, the price of the non-tradable shares has been significantly lower than the market price of the tradable shares. For example, in the 1994 Hengtong Investment case, the first instance of takeover by private agreement, the non-tradable shares were priced at CNY 4.3 per share while the market price of the tradable shares was around CNY 13. Guanghua Yu, *Using Western Law to Improve China's State-Owned Enterprises of Takeovers and Securities Fraud*, 39 Val. U. L. Rev. 339, 350 (2004).

107. Securities Law, *supra* note 28, art. 101 (providing that the acquisition of state shares is subject to the approval of the relevant administrative departments).

CSRC frequently gave exemptions to allow takeovers to go ahead without making a bid to all target shareholders.[108]

Takeover by private agreement, therefore, has long been a preferred method of gaining corporate control in China.[109]

This is about to change under the 2006 Takeover Measures. Indeed, once all non-tradable shares are turned into tradable shares as a result of the reform, the problems of the segregated equity structure and the different prices for different shares will disappear. The previously loose exemption system, which has made takeover by private agreement a very cheap way to gain corporate control, is likely to be tightened up. As discussed earlier, the 2006 Takeover Measures are much more restrictive than their 2002 predecessor with respect to the grounds upon which the CSRC could grant an exemption.[110] Although the CSRC will continue to grant exemptions on a case-by-case basis, it has made clear that the exemption is now going to be much more difficult to obtain, and the mandatory bid rule will have real teeth.[111] Takeover by tender offer, therefore, will become the main way to acquire shares with a view to gaining corporate control.[112]

The 2006 Takeover Measures strengthen the regulations that prevent opportunistic takeovers while at the same time encouraging bona fide takeovers. First, they set out a number of substantive requirements with respect to an investor's eligibility to make takeovers. Under Article 6, an investor is barred from taking over any listed companies if it has certain problems; for example, investors that owe a large amount of debt that have become due and payable, or investors that have ever committed a major illegal act or have ever been suspected of being involved in any major illegal act within the recent three years may be barred from taking over listed companies.[113] Second, when making a takeover bid to be paid in cash, the bidder must deposit no less than 20 percent of the total amount of

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108. By the end of 2000, all 121 takeovers by private agreement had successfully obtained an exemption from the CSRC. Bingan Li, *A Discussion of the Exemption from the Mandatory Bid Rule*, 18(6) FALU LUNTAN [LEGAL FORUM] 50 (2003). The reason behind the readiness of the CSRC to grant an exemption was largely the need of an active takeover market to facilitate the transfer of state shares as part of the grand economic reform plan. If an exemption could not be obtained, the mandatory bid rule would apply, and the resulting high cost would create strong disincentives to the acquisition of non-tradable shares. *See* Yu, *supra* note 106, at 352.

109. The aforementioned first case of takeover by tender offer, i.e., the Nangang Gufen case, did not take place until the end of 2003. *See supra* Part III.C.

110. *See supra* Part III.B.

111. *The CSRC's Answers to the Relevant Questions Asked by the Reporter from the Chinese Government Website Office About the New Takeover Measures*, *available at* http://www.gov.cn/zwhd/2006-09/17/content_389685.htm (last visited Mar. 18, 2008) [hereinafter "*CSRC Answers*"].

112. It should be noted that because the present shareholding structure reform is a gradual process, takeover by private agreement will remain a common method of gaining corporate control for a certain period of time. A key feature of the 2005 reform is that in order to alleviate the concern of dilution effects on public investors from the conversion of the non-tradable shares into tradable shares, it imposes a minimum twelve-month lock-up on non-tradable shares following their conversion into tradable shares. After this lock-up period, holders of formerly non-tradable shares that hold more than 5 percent of the company's shares may only sell a limited number of shares, no more than 5 percent of the total shares within any rolling twelve months, and no more than 10 percent with any rolling twenty-four months. This process is going to take time given the large number of non-tradable shares in the market. *See* Shangshi Gongsi Guquan Fenzhi Gaige Guanli Banfa [Measures on the Shareholding Structure Reform of Listed Companies] (promulgated by the CSRC Sept. 4, 2005), art. 27.

113. 2006 Takeover Measures, *supra* note 1, art. 6.

the offered price in the bank designated by the securities depository and clearing institution as the performance guarantee.[114] This is to prevent a form of "bluffing" announcement of takeovers. Third, the shares acquired cannot be sold within twelve months of the conclusion of the takeover, but this lock-up rule does not apply if the acquired shares are to be transferred to the acquirer's associates.[115]

As takeover activity is becoming increasingly sophisticated on the Chinese market, new measures have been introduced accordingly. For example, in order to maintain a better informed market, the 2006 Takeover Measures add a new chapter to specifically regulate indirect takeovers.[116] The term "indirect takeovers" refers to the situation where although an investor does not itself take over a listed company by directly acquiring its shares, the investor gains the control of the listed company by other means such as private agreement, investment relationship or any other arrangement.[117] This type of control over voting shares in a listed company is equivalent to the concept of relevant interests in securities in Australia,[118] or the notion of beneficial ownership of shares in the United States.[119]

In addition, the 2006 Takeover Measures contain rules with respect to management buy-out (MBO) for the first time. The term MBO generally refers to the takeover of a company by its own management rather than outsiders. Since the vast majority of Chinese listed companies are actually reorganized state-owned enterprises, MBO has long raised serious political as well as ethical issues.[120] The Yue Meidi case, an influential MBO test case in China, occurred in January 2001 when the law was basically silent on MBO.[121] Although this case was criticized over several issues such as the price of the acquisition and information disclosure, it has provided valuable MBO experience for both practitioners and regulators in China.

Drawing upon this experience and overseas practice, the 2006 Takeover Measures regulate MBO for the very first time. Compared with ordinary takeovers, MBO is subject to much more stringent regulation.[122] At the very least, however, MBO is now legitimized and has clear rules to follow. This certainly opens the door for more MBO cases in China.

Last, it is important to note that a new scheme concerning private financial consultants is introduced to complement the CSRC's governmental enforcement of takeover law. In a takeover bid, both the acquirer and the target need to engage qualified financial consul-

114. *Id*. art. 36.

115. *Id*. art. 74. This is to be contrasted with the Australian takeover law under which associates are not at liberty to dispose of voting shares between each other. Corporations Act, *supra* note 42, art. 610(3).

116. 2006 Takeover Measures, *supra* note 1, pt. V.

117. *Id*. art. 56.

118. Corporations Act, *supra* note 42, art. 608.

119. 17 C.F.R. § 240.13d-3 (2004).

120. *See* On Kit Tam, *Ethical Issues in the Evolution of Corporate Governance in China*,37 J. BUS. ETHICS 303, 305 (2002).

121. *See* Luo & Dong, *supra* note 71, at 132-136.

122. 2006 Takeover Measures, *supra* note 1, art. 51. For example, the resolution on MBO shall be made by disinterested directors, be consented by more than two thirds or more of independent directors, be submitted to the general meeting of shareholders of the company for deliberation and be adopted by more than half or more of the voting rights held by disinterested shareholders who attend at the general meeting of shareholders.

tants, such as investment bankers. The financial consultant performs a number of important functions, including the provision of professional services for their client as well as the fulfillment of some duties of regulatory character. For example, the financial consultant for the acquirer should conduct a due diligence investigation into the acquirer's financial condition, provide professional services to help the acquirer plan and carry out the takeover, ensure the quality of the information disclosed by the acquirer, and supervise the behavior of the acquirer within twelve months after the takeover is finished.[123] Thus, the financial consultant has a dual role to play: the first is as a commercial entity advancing the interests of its clients; the second is as a market participant with some important regulatory responsibilities. It is believed that this regulatory structure makes use of market disciplines and will improve the overall efficacy of the regulatory regime regarding takeovers.[124]

B. Problems

Although the 2006 Takeover Measures have set up a relatively complete legal regime regarding takeovers, it does not come without problems. These problems may, if left unaddressed, have a significant impact on the efficacy of the regime. Indeed, the reform has made some important innovations, but the workability of those innovations is in serious doubt due to the lack of detailed and functional provisions. For example, the 2006 Takeover Measures make a breakthrough by stipulating that tender offers may be subject to conditions.[125] But they do not provide useful guidance as to what conditions are permissible and how the conditions operate. This is problematic because the bidder may potentially shift some of the bid's risk onto offerees in a way that has a coercive effect or lacks transparency.[126] Two other serious defects of the new legal regime are discussed below.

1. *Partial Takeover*

The first problem lies in the partial takeover rule. As noted before, in an effort to encourage takeovers, the 2006 Takeover Measures permit partial takeovers in order to allow a bidder to takeover a company while having to outlay an amount considerably less than would be the case with a full takeover. Partial takeovers perform a useful economic function and may be beneficial to investors because they provide a cheaper way to conduct value-creating takeovers. But it is likely to be abused, and thus the CSRC retains strict control over it. For example, in the case of a partial bid, the percentage of shares the acquirer plans to acquire must not be less than 5 percent of all outstanding shares in the target company.[127] This is intended to prevent the use of partial bids to commit market manipulation or insider trading.[128]

123. *Id.* art. 65.
124. *CSRC Answers*, *supra* note 111.
125. 2006 Takeover Measures, *supra* note 1, art. 29(7).
126. In Australia, conditions that may be included in takeover bids are carefully regulated. Corporations Act, *supra* note 42, pt. 6.4, div 4 (providing a prohibition upon several types of conditions and regulating the use of defeating conditions).
127. 2006 Takeover Measures, *supra* note 1, art. 25.
128. Explanatory Memorandum, *supra* note 4, para. 3(6).

Still, there is a major loophole in the partial bid rule from the perspective of the equality principle underpinning the Chinese takeover law. Under Article 43, if the bidder in a partial bid receives acceptances for a greater number of shares than specified in the offer, each acceptance shall be pro-rated to the same proportion and the excess returned to target shareholders.[129] This form of partial bid appears to be the so-called pro-rata bid, which may exert coercive pressure on shareholders and cause uncertainty as to the number of shares ultimately sold. Indeed, by their nature, partial bids may prevent target company shareholders from having the opportunity to participate equally in the bid without coercion. In a successful partial bid, the control premium will have been paid only to those accepting shareholders. This may place coercive pressure on shareholders to accept the partial bid because if they do not, they may miss out on participating in the premium for control.

This is particularly so in the case of pro-rata bids where the accepting shareholders could in fact tender a higher proportion of their shares in the likely event of non-acceptance by some shareholders. For example, if a 29 percent shareholder makes a pro-rata bid to acquire in total a little over 50 percent and receives acceptances for 20 percent of the shares from only some large shareholders, these accepting shareholders can actually sell their shares in full. This will have a strong coercive effect on target shareholders because unless they accept the offer, they would not participate in the control premium and would be left in the rump of minority shareholders. For this reason, pro-rata bids have been prohibited in Australia since 1986.[130]

Instead, Australia permits another form of partial bid, known as proportional bids, under which an offer is made for the same proportion of each shareholder's holding in the target company.[131] For example, if the 29 percent shareholder makes a proportional bid for 50 percent of every other shareholding and the holders of all outstanding shares accept the offer, the bidder would end up holding 64.5 percent of the total shares. Proportional bids do not exert the same degree of coercive pressure as is the case with pro-rata bids. A failure to accept a proportional bid does not result in an increased proportion of the control premium going to accepting shareholders; therefore, there is no incentive in such a bid to rush to accept for fear of missing out.

It should be noted, however, that although proportional bids can ensure achievement of equality of opportunity amongst target shareholders, they shift to bidders the uncertainty as to the number of shares ultimately sold. In practice, it would be unusual for all target shareholders to accept a proportional bid. Therefore, a bidder must pitch a proportional bid at such a level as it estimates will take into account non-acceptances in order to attain the shareholding it wants to acquire. If there are more acceptances than expected, the bidder may have to acquire more shares and spend more than is necessary to gain corporate control. Thus, a trade-off must be set between considerations of equity between target shareholders and potential cost savings for bidders.[132] It is submitted that the Australian experience merits serious consideration in the Chinese condition, as both countries aim to promote shareholder protection in accordance with the equality of opportunity principle.

129. 2006 Takeover Measures, *supra* note 1, art. 43.
130. H.A.J. FORD ET AL., FORD'S PRINCIPLES OF CORPORATIONS LAW 1131 (12th ed. 2005).
131. Corporations Act, *supra* note 42, § 618.
132. Philip Lipton & Abe Herzberg, UNDERSTANDING COMPANY LAW 504 (12th ed. 2004).

2. *Takeover Defenses*

The issue of takeover defenses is another area where the 2006 Takeover Measures have made significant improvements but nevertheless remain problematic. As discussed above, takeover by tender offers will become the dominant way of takeovers as a result of the shareholding structure reform. This will certainly increase the number of hostile takeovers and therefore the use of takeover defenses by the target directors. Under Article 33 of the 2002 Takeover Measures, the target directors were prohibited from taking certain defensive actions, such as issuing new shares and buying back its own shares.[133] This list of prohibited conduct has been criticized as both over-inclusive and under-inclusive:

> The list in . . . [the 2002 Takeover Measures] . . . is doomed to be both over-inclusive and under-inclusive. On the one hand, it is over-inclusive in that it is hard to argue that the six listed defenses would damage the lawful interests of the target company and its shareholders in any situations and thus should be prohibited altogether. Rather, these defenses could be effectively used for the benefit of the company and its shareholders in the face of a truly undesirable takeover. . . . On the other hand, it is under-inclusive in that there is little doubt that any defensive tactic is likely to be abused, at least in theory. It would be dangerous to think that all the defenses other than the six listed types in Article 33 would not damage the lawful interests of the target company and its shareholders in any circumstance. . . . Therefore, the solution adopted by Article 33 seems too rigid to accommodate the complex and rapidly changing commercial situations where defensive tactics could emerge and operate.[134]

Indeed, regulating takeover defenses by arbitrarily enumerating certain prohibited conduct can be well described as the legislator-based model or "prohibitive model," which is characterized by paternalism and rigidity. This was in stark contrast to overseas practice. In the U.S. court-based model, corporate management enjoys wide discretion to implement a considerable body of defensive measures, subject to intense judicial scrutiny preventing the abuse of the defenses.[135] There, the conduct of the target directors is regulated through the general principles of corporate law, especially the law on directors' duties.[136] In the U.K., however, the City Code on Takeovers and Mergers imposes a rule of neutrality upon target directors by proscribing the use of defenses without shareholder approval.[137] This practice can be labeled the "shareholder-based" model since it is the shareholders, rather than the directors, who have the final say with respect to the employment of defensive measures.[138] Since 2000, Australia has adopted a "specialist-based" model[139] where the use of defensive measures by target directors is primarily left to the

133. 2002 Takeover Measures, *supra* note 29, art. 33. For a detailed discussion of this provision, *see* Huang, *supra* note 12, at 172-75.

134. Huang, *supra* note 12, at 176-77.

135. Robert C. Clark, Corporate Law, 581-82 (1986) (offering an explanation of various defensive measures).

136. For a detailed discussion of the U.S. practice, *see* Huang, *supra* note 12, at 177-79.

137. City Code on Takeovers and Mergers, *supra* note 47, Rule 21.1.

138. For a detailed discussion of the U.K. position, see Huang, *supra* note 12, at 179-80.

139. *See e.g.*, Erin Walsh, *Judging the Takeovers Panel*, 20 Company and Sec. L.J. 435, 435-36 (2002).

judgment of an independent specialist panel, known as the Takeovers Panel, not the courts.[140]

In response to the problems with the approach taken in the previous regime, the 2006 Takeover Measures have made some substantial changes. On the one hand, Article 8 provides that when taking defensive measures, target directors must meet their fiduciary duties owed to their company and that the defensive measures should be beneficial to the target company and shareholders and must not pose an inappropriate obstacle to the attempted takeover.[141] On the other hand, under Article 33, during the takeover bid period, certain defensive transactions that could frustrate the bid must not be taken unless they are approved by shareholders at the general meeting.[142] These transactions will usually have a significant effect on the company's financial condition and business performance, including the disposal of corporate assets, the making of external investment, the seeking of loans, and the major adjustment of its main business.[143] Moreover, a specialist takeover committee is established to assist in dealing with complicated issues regarding takeovers.[144]

On the surface, it appears that the 2006 Takeover Measures have now adopted a combination of overseas practices. As discussed above, Article 8 generally draws upon the U.S. experience; Article 33 clearly borrows from the U.K.experience in relation to the application of some selected defensive measures; and the establishment of the specialist takeover committee resembles the Australian practice. This reform is certainly an improvement of the previous regime, but it is less clear whether it will function as expected. There are legitimate concerns over whether those different types of overseas experience can co-exist peacefully within a single regime. Although they may not be strictly mutually exclusive, the coordination of them will be a daunting task to grapple with in itself. For example, there could be some areas where the U.S.-experience-based Article 8 overlaps with, and thus conflicts with, the U.K.-experience-based Article 33 due to the blurred boundary of the latter.

Putting aside the potential conflicts that may arise from the ambitious importation of various overseas practices, it remains to be discussed whether those overseas models can adapt themselves to the Chinese local situation. This author has suggested before that it would be difficult for the U.S. model to take root in China because unlike the United States, China lacks, among other things, a team of highly qualified judges to determine the complicated issues of breach of fiduciary duties in the setting of takeovers.[145] This problem can be, to some extent, alleviated by the establishment of the specialist takeover committee.[146] But this specialist committee is different from its Australian counterpart in that it is not an independent body and has no power to make a final decision.[147] In other

140. For a detailed discussion of the Australian practice, *see* Huang, *supra* note 12, at 180-82.

141. 2006 Takeover Measures, *supra* note 1, art. 8.

142. *Id*. art. 33.

143. *Id*.

144. *Id*. art. 10(2).

145. Huang, *supra* note 12, at 185-86.

146. This author has made this suggestion before and is now pleased to see it partially adopted. *See* Huang, *supra* note 12, at 188-89 (arguing that the Australian model is worthy of serious consideration in China).

147. 2006 Takeover Measures, *supra* note 1, art. 10(2) (providing that the specialist takeover committee can provide expert opinions on takeover issues, but the final decision is to be made by the CSRC).

words, the specialist committee only performs an advisory function. This effectively casts the CSRC into two simultaneous roles—adjudicator and investigator.

Potential challenges may arise as to the constitutionality of this arrangement, which was the case in Australia before 1991.[148] More importantly, the takeover committee still needs to rely on the laws regarding directors' duties when giving their advice, but Chinese law hardly provides such a basis at the moment.[149] Further, the U.K.-style *ex ante* shareholder approval requirement can result in serious problems of time and costs.[150] This is particularly so in China where the collective action problem is severe due to the underdevelopment of institutional investors and thus would discount the function of shareholders' meeting as an effective decision-making mechanism.[151]

This author has made a reform proposal elsewhere that the best model for dealing with takeover defenses in China would be a new system whereby shareholders could *ex post* veto the use of defenses and enumerate *ex ante* the general availability of certain defensive measures at the annual shareholders' meeting.[152] Under this *ex post* veto system, reinforced by the *ex ante* approval strategy, it seems that shareholders could gain sufficient protection while, at the same time, preserve necessary flexibility for management to efficiently respond to takeovers. This argument still holds today, but the approach of the 2006 Takeover Measures also has certain merits. It has significantly improved the previous regime by borrowing overseas experience, and it should be given an opportunity to succeed in practice. Given appropriate supporting systems and fine-tuning, it could be an acceptable model for the Chinese securities market, at least for the time being.

V. Conclusion

Along with other laws and regulations, the recently promulgated takeover regulation by the CSRC has greatly enhanced China's takeover legal regime both in terms of form and substance. This comes at time when the Chinese economy is undergoing a strategic re-

148. *See* Rowen Cross, *The Takeovers Panel Three Years On: Should We ever Go Back to the Courts?*, 21 COMPANY AND SEC. L.J. 367, 381 (2003). Although practices that would be constitutionally questionable overseas are not uncommon in China, the enforcement of laws can vary with the whims of officials. Therefore, the dual role of the CSRC may pose a potential problem in the future.

149. The company law was just recently amended to include some provisions on directors' duties. Those rules are framed in very general principles and vague terms, and therefore their implementation poses a big task in practice. *See* Justice Yongjian Zhang, *Several Issues with Respect to the Law of Directors' Duties*, Presented at the Company Law in Practice, Beijing, October 14-15, 2006.

150. Christian Kirchner & Richard Painter, *Takeover Defences Under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 AM. J. COMP. L. 451, 457 (2002) (stating the shareholder approval process is "in most cases impossible to use because the notice and preparation period for a general shareholders meeting is too long").

151. The role played by the institutional investors in China is relatively limited. As of the end of 2003, there were only seventy-one investment funds in China, and they accounted for only 10.03 percent of the total trading volume in the A-shares market in the first half of 2003. *See* Lifeng Hu, *No Longer Loss-Making: The Achievement of Funds in the First Half of 2003*, ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES NEWS], Sept. 1 2003. Recently, institutional investors have increased rapidly as a result of the 2005 shareholding structure reform. Still, Mr Fulin Shang, the chairman of the CSRC, has pointed out that despite the encouraging progress, more institutional investors are needed on the Chinese securities market. *See* Jintao Huang et al., *Shang Fulin: Resolutely Further Expanding the Group of Institutional Investors*, SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Dec. 4, 2006.

152. For a detailed discussion of the proposal, *see* Huang, *supra* note 12, at 193-196.

structuring and China's capital markets are at the birth of a new era thanks to the ongoing state share reform. The new regulation brings China's takeover law more closely into line with its counterparts in more developed economies, forming a sound basis for takeover activities in China.

The implications of the new regulation will be profound for both domestic and foreign investors looking to enter the market by takeovers. But it remains to be seen whether it will function in practice as hoped given some potential problems with the partial bid rule and the regime of takeover defenses. Indeed, the success of regulatory modernization will hinge on the ability of policymakers to remain focused on the ultimate goals of economic regulation, including investor protection, institutional safety and soundness, and systematic stability. Regulatory modernization can be achieved only through systematic consideration of current market developments and trends, and of how regulatory systems, consistent with regulatory goals, can contend with such evolution.