

PRACTICE GUIDES

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# China M&A

Third Edition

Contributing editor

Richard Pu



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## Practice Guide

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# 2

## Risk analysis: M&A transactions in China

**Jerry Hansen, Weng Yee Ng and Yueting Wang<sup>1</sup>**

From the day Deng Xiaoping opened China's doors to the international market, China has, and continues to be, one of the countries that holds great appeal to foreign investors. This interest has given rise to an exponential increase in the volume of M&A transactions involving Chinese companies, some of which have been great success stories, while others have been never-ending challenges for the investors. There are good reasons why foreign investors are not put off by those challenges, and continue to strengthen their presence in China: access to a massive market, lower cost of labour and rapid technological advances, to name a few.

Accessing China's large market and labour pool, however, is not without risk. China has long been associated with high levels of corruption and is one of the BRIC (Brazil, Russia, India and China) countries often cited as having higher risk. Frequently, at least in the compliance context, the term 'BRIC countries' carries the negative connotation of being high risk. However, the BRIC countries are, as we all appreciate, the economies anticipated to represent nearly half of global GDP by 2050. So, there are clearly good reasons to seek to invest in these countries, even with the risks and challenges associated.

In general, the most common risks are those related to the political or regulatory climate in China, including the United States' continual trade negotiations and the current alleged risks related to certain Chinese companies (eg, Huawei, TikTok and Alibaba); the documented historical bribery and corruption risks; and financial risks relating to the ability to move monies in and out of China; among other operational risks.

Recently, covid-19 concerns have been added to the risks highlighted above, and while such risks are more global in scale and not specific to China, such risks are applicable to transactions in China. In Q1 2021, China's outbound M&A activities rebounded strongly and the number of deals more than doubled despite dipping to a historical low in 2020 because of the pandemic.<sup>2</sup>

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<sup>1</sup> Jerry Hansen is a partner, Weng Yee Ng is a director and Yueting Wang is a senior associate at Forensic Risk Alliance Ltd.

<sup>2</sup> [www.fitchratings.com/research/corporate-finance/china-corporates-snapshot-july-2021-chinas-outbound-m-as-rebound-in-1q21-on-large-deals-29-07-2021](https://www.fitchratings.com/research/corporate-finance/china-corporates-snapshot-july-2021-chinas-outbound-m-as-rebound-in-1q21-on-large-deals-29-07-2021).

Generally speaking, the covid-19 pandemic has had a significant impact on M&A transactions globally and will going forward, including risks associated with financial reporting impacted by covid-19 lockdowns, restrictions, government assistance and similar risks.

This chapter takes a closer look at several specific risks within these general categories of carrying out M&A deals in China. Notwithstanding these risks, with awareness of these challenges, and proper planning to address them, investing in China can be a viable and rewarding option for companies and investors seeking to expand into Asia.

## **Key considerations and risks of doing deals and investing in China**

### **Bribery and corruption risks**

The 2020 Transparency International Corruption Perceptions Index gave China a score of 42 out of 100,<sup>3</sup> the same rating as Argentina, Bahrain, Kuwait and the Solomon Islands, and just above countries such as Benin, Lesotho and Guyana. Despite the crackdown on 'tigers and flies', an anti-corruption campaign initiated by President Xi in 2012, it appears that corruption continues to be endemic within the country and remains a key concern for potential investors.

Reasons cited for bribery and corruption risks in China include a restricted press or media, ambiguous interpretation of the law, importance of the state and burdensome bureaucracy. Another reason for high levels of bribery and corruption risks in China mentioned in many academic papers and the media is *guanxi* (loosely translated as relationships). This practice of giving and receiving gifts and favours could very easily slide towards more nefarious facilitation payments or bribes. For Chinese companies operating under enforced extraterritorial laws, such as the Foreign Corrupt Practices Act (FCPA) or the UK Bribery Act, this is especially problematic.

Several FCPA settlements have involved an allegation of bribery and corruption occurring in China. Recent examples include the following:

- in January 2021, Deutsche Bank AG agreed to pay over US\$43 million in disgorgement and pre-judgment interest to settle the Securities and Exchange Commission (SEC) charges that it violated the books and records and internal controls provisions of the FCPA in connection with improper payments to intermediaries in China, the UAE, Italy and Saudi Arabia;<sup>4</sup>
- in September 2020, a Los Angeles-based direct selling company, Herbalife Nutrition Ltd, settled by paying over US\$67 million to resolve SEC charges that it violated the books and records and internal accounting provisions of the FCPA arising out of a bribery scheme orchestrated by its Chinese subsidiary;<sup>5</sup> and
- in February 2020, Ohio-based pharmaceutical company Cardinal Health agreed to pay in excess of US\$8 million to resolve charges that it violated the books, records and internal accounting controls provisions of the FCPA in connection with its operations in China.

Prior to 2018, there were concerns that Chinese multinational companies may have had the advantage over foreign investors who were subject to stricter and wider-ranging anti-bribery

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3 A score of 0 means highly corrupt, while a score of 100 means very clean. 'Corruption Perceptions Index 2020', Transparency International, [www.transparency.org/en/cpi/2020/index](http://www.transparency.org/en/cpi/2020/index), accessed 27 August 2021.

4 [www.sec.gov/news/press-release/2021-3](http://www.sec.gov/news/press-release/2021-3).

5 [www.sec.gov/news/press-release/2020-197](http://www.sec.gov/news/press-release/2020-197).

and corruption laws. In response, in early 2018, China passed an amendment to the Anti-Unfair Competition Law explicitly prohibiting indirect bribery through third parties.<sup>6</sup> This Law, if enforced, has the potential to level the playing field somewhat for foreign investors.

Recent regulatory changes and the government's focus on anti-corruption are signals that things are changing. Notwithstanding such changes, investors need to remain keenly aware of corruption risks when investing in China, both before and after any merger or acquisition.

### China's social credit system

China's social credit system (SCS) has been on the radar for many since the State Council released the Planning Outline for the Construction of a Social Credit System (2014–2020) in 2014, which has since guided the development of the SCS. The SCS has been the subject of many international news articles because of its controversial features, such as judging and scoring individuals for their perceived behaviour and trustworthiness (for example, poor driving or posting fake news online would result in a deduction of points).<sup>7</sup>

This matters for investors because the system applies to companies as well as individuals, and is expected to have a significant impact on compliance matters. For example, a low credit score may result in companies being blacklisted, which is a key element for consideration when investing in Chinese companies and when conducting third-party due diligence. A low credit score or penalties for a low score may also result in denial of licences, permits, credit facilities or eligibility to participate in certain public procurement tenders.<sup>8</sup>

While 2020 was the original target year for the implementation of China's SCS, the implementation was delayed due to a range of factors, including covid-19. In January 2021, the National Development Reform Commission (NDRC) released a national guidance document for credit information reporting to encourage the standardisation of credit information domestically. In July 2021, two draft documents were released in relation to the SCS: the National Social Credit Information Basic Catalogue and the National Basic List of Punishment Measures for Untrustworthiness.<sup>9</sup>

### Successor liability risk

The overarching corruption risk in the M&A context is successor liability. Successor liability is the risk of acquiring a company that is covered by the FCPA, or other similar anti-corruption

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6 'Third-Party Screening and Monitoring Are Critical for Health Care and Life Science Companies', Lexology, [www.lexology.com/library/detail.aspx?g=34185af8-46f3-4b2c-b54d-7e7402aa485f](http://www.lexology.com/library/detail.aspx?g=34185af8-46f3-4b2c-b54d-7e7402aa485f), accessed 26 September 2019.

7 Alexandra Ma and Katie Canales, 'China's 'social credit' system ranks citizens and punishes them with throttled internet speeds and flight bans if the Communist Party deems them untrustworthy', *Business Insider*, [www.businessinsider.com/china-social-credit-system-punishments-and-rewards-explained-2018-4?r=US&IR=T](http://www.businessinsider.com/china-social-credit-system-punishments-and-rewards-explained-2018-4?r=US&IR=T), accessed 8 September 2021.

8 Alexander Chipman Koty, 'China's Corporate Social Credit System: What Businesses Need to Know', *China Briefing*, [www.china-briefing.com/news/chinas-corporate-social-credit-system-how-it-works/](http://www.china-briefing.com/news/chinas-corporate-social-credit-system-how-it-works/), accessed 8 September 2021.

9 Nicole Kobie, 'The complicated truth about China's social credit system', *Wired*, [www.wired.co.uk/article/china-social-credit-system-explained](http://www.wired.co.uk/article/china-social-credit-system-explained), accessed 8 September 2021.

regulations, which has already violated those laws, thereby exposing the acquirer to potential liability based on pre-acquisition acts over which it had no control.

Examples of corruption risk arising from successor liability include the following.

- Pfizer's settlement with the Department of Justice (DOJ) and the SEC in 2012 encompassed FCPA violations by its subsidiary Wyeth relating to bribes paid to government doctors in China that primarily occurred prior to Pfizer's acquisition of Wyeth in 2009;<sup>10</sup> and
- in July 2016, Johnson Controls settled with the SEC for over US\$14 million for allegations that a wholly owned Chinese subsidiary had used ghost suppliers to make improper payments in China to employees of government-owned shipyards, shipowners and other third parties to obtain and retain business.<sup>11</sup> That Chinese subsidiary was acquired by Johnson Controls in 2005 as part of its acquisition of York International.

Such potential risks to transaction parties deserve significant attention. A lack of knowledge of such potential issues and/or risks is not a defence, especially if the acquiring company has not performed sufficient due diligence to attempt to identify such issues. The DOJ and SEC's Resource Guide to the US FCPA (Guide), originally released in November 2012 and subsequently updated in July 2020, emphasises the importance of pre-closing due diligence and post-closing integration of the target into the acquirer's compliance and internal control programmes. The Guide advocates:

- a risk-based analysis of the target's customer base;
- an analysis of the target's go-to-market strategy and approach;
- a review of the target's legal, accounting and compliance departments;
- a review of the target's sales and financial data, customer contracts and third-party agreements (including high-risk third parties such as distributors and agents); and
- interviews with target management, not limited to those in charge of legal, sales and audit functions.<sup>12</sup>

At the same time, companies need to be aware of some of the more significant challenges encountered when performing due diligence, including:

- level of access to (the target's) books and records;
- low quality or limited availability of publicly available information;
- fragmented information sources;
- discrepancies between company information at state and national levels;
- disorganised, incomplete and unreliable information; and
- press restrictions.

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10 'FCPA Liability in M&A: lessons from Pfizer settlements', Lexology, [www.lexology.com/library/detail.aspx?g=37e21b8f-bfdc-47ac-9289-f84e6cc53660](http://www.lexology.com/library/detail.aspx?g=37e21b8f-bfdc-47ac-9289-f84e6cc53660), accessed 11 September 2019.

11 Richard L Cassin, 'Johnson Controls pays SEC \$14 million to settle China bribe case, receives DOJ Pilot Program declination', The FCPA Blog, 12 July 2016, [www.fcpablog.com/blog/2016/7/12/johnson-controls-pays-sec-14-million-to-settle-china-bribe-c.html](http://www.fcpablog.com/blog/2016/7/12/johnson-controls-pays-sec-14-million-to-settle-china-bribe-c.html).

12 'A Resource Guide to the U.S. Foreign Corrupt Practices Act', Criminal Division of the US Department of Justice and the Enforcement Division of the US Securities and Exchange Commission, [www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf](http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf), accessed 27 August 2020.

### Third-party due diligence

Third-party risks in China include all of the most common risks – bribery, corruption, fraud, money laundering and conflict of interest – all of which necessitate appropriate due diligence to safeguard transaction parties and companies.

A few examples of corruption risks arising from third parties are provided below. Based on these very few examples, it is clear that performing sufficient due diligence around third parties prior to making an acquisition or investment is worth the cost.

- In 2012, Morgan Stanley's real estate and fund advisory practice colluded with a former chairman of a Chinese state-owned enterprise (SOE), where US\$1.8 million worth of finder's fees were owed to third parties in exchange for business brought to Morgan Stanley.<sup>13</sup>
- In 2014, the UK Serious Fraud Office started a formal criminal investigation into GlaxoSmithKline's operations in China and several other countries where allegations included the engagement of third-party vendors to disguise illegal payments.<sup>14</sup>
- In 2018, United Technologies Corporation agreed with the SEC to pay US\$13.9 million for violations by its subsidiaries Pratt & Whitney, which paid commissions to a third-party agent via a joint venture to sell jet engines to state-owned airlines, and Otis Elevator Company, which paid a kickback to an official of a state-owned bank to win a contract to install lifts in one of the bank's branches. There were also accusations of improperly funding leisure travel for foreign officials from China and other countries.<sup>15</sup>
- In 2018, Michigan-based medical device manufacturer Stryker agreed to pay the SEC US\$7.8 million for FCPA violations, including employment of unauthorised sub-distributors.<sup>16</sup>
- In 2019, Sweden-based telecommunications company Telefonaktiebolaget Ericsson was charged with engaging in a large-scale bribery scheme involving the use of sham consultants to secretly channel funds to government officials in multiple countries, including China.<sup>17</sup>
- In 2019, US-based retailer Walmart agreed to pay a combined amount of over US\$282 million as a result of failure to operate a sufficiently robust anti-corruption compliance programme for more than a decade, thereby allowing its subsidiaries, including in China, to employ third-party intermediaries who paid foreign government officials without reasonable assurances of compliance with the FCPA.<sup>18</sup>

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13 Mark Jenkins, Sunny Chu and Christopher Meadors, 'FCPA compliance in China', *Fraud Magazine*, March 2014, [www.fraud-magazine.com/article.aspx?id=4294982094](http://www.fraud-magazine.com/article.aspx?id=4294982094).

14 'GlaxoSmithKline PLC investigation', UK Serious Fraud Office press release, 27 May 2014, [www.sfo.gov.uk/2014/05/27/glaxosmithkline-plc-investigation/](http://www.sfo.gov.uk/2014/05/27/glaxosmithkline-plc-investigation/).

15 'United Technologies Charged with Violating FCPA', US Securities and Exchange Commission press release 2018-188, 12 September 2018, [www.sec.gov/news/press-release/2018-188](http://www.sec.gov/news/press-release/2018-188).

16 'SEC Charges Stryker a Second Time for FCPA Violation', US Securities and Exchange Commission press release 2018-222, 28 September 2018, [www.sec.gov/news/press-release/2018-222](http://www.sec.gov/news/press-release/2018-222).

17 'SEC Charges Multinational Telecommunications Company with FCPA Violations', US Securities and Exchange Commission press release 2019-254, 6 December 2019, [www.sec.gov/news/press-release/2019-254](http://www.sec.gov/news/press-release/2019-254).

18 'Walmart Charged with FCPA Violations', US Securities and Exchange Commission press release 2019-102, 20 June 2019, [www.sec.gov/news/press-release/2019-102](http://www.sec.gov/news/press-release/2019-102).

## Considerations regarding the types of M&A transactions

The common M&A transaction structures for foreign investors in China include majority-equity subsidiaries, joint ventures and minority investments where the risk and the decision-making rights lie with local management. These different types of investments bring different challenges to the foreign investor in China.

Where one investor might think that having a minority stake (ie, where the foreign investor does not make operational decisions) in the company is the least risky form of investment, another may believe that a majority equity interest is the safest as the majority owner is able to dictate how the entity is run. The ultimate selection is up to the specific investor, but each type of investment has its own set of risks and benefits of which investors should be aware.

Below are some potential risks, grouped by type of investment.

Minority investments	Joint ventures	Majority-owned subsidiaries
<ul style="list-style-type: none"> <li>• Inability to make operational decisions</li> <li>• Inability to deploy consistent group-level policies and procedures</li> <li>• No access to operational matters and financial results; for example, financial results are limited to published audited financial statements only</li> <li>• No access to books and records, and no right to audit</li> </ul>	<p>Depending on the terms and conditions set forth within the shareholders' agreement, there may be:</p> <ul style="list-style-type: none"> <li>• some restrictions on decision-making at the operational level;</li> <li>• some limitation on deployment of consistent group-level policies and procedures;</li> <li>• limited visibility of the operations and financial results;</li> <li>• no or limited access to books and records; and</li> <li>• no or limited right to audit</li> </ul>	<p>Although the foreign holding company is able to deploy aligned policies and procedures, there may be:</p> <ul style="list-style-type: none"> <li>• challenges in repatriation of funds from the entity; and</li> <li>• entire responsibility for any violations of laws and regulations by the entity</li> </ul>

These risks are further heightened when the majority equity owner or the joint venture partner is an SOE because access to books and records, financial information and operational details are more often than not significantly restricted.

## Data privacy and data security risks

A part of any M&A deal is access to data and this necessary access continues after the investment is made. Access to data brings its own set of risks and concerns both inside and outside China. The Personal Information Security Specification is China's national standard on the collection and processing of personal information.

In March 2020, the State Administration of Market Regulation and the Standardisation Administration of China jointly released the new Information Security Technology – Personal Information Security Specifications (New Personal Information Specifications), which became effective in October 2020.

The New Personal Information Specifications are applicable to personal information processing activities conducted by entities operating in China, as well as supervision, administration and assessment activities conducted by the regulated bodies. It also added the requirements for voluntary choice of multiple business functions of a product or services, collection, storage and sharing of personal biometric information, restrictions on data aggregation and commercialisation, and protection of the data subject's rights.

In June 2021, the Standing Committee of China's National People's Congress passed the Data Security Law (DSL), which came into effect on 1 September 2021, to regulate data activities (defined to include data collection, storage, usage, processing, transmission, provision and disclosure of data), safeguard data security, promote data development and usage, protect individuals' and entities' legitimate rights and interests, and safeguard state sovereignty, state security and development interests. Collectively, the DSL, the Network Security Law and the proposed Personal Information Protection Law will form an increasingly comprehensive legal framework around information and data security in China.

Going forward, in addition to China's State Secrets Law, cross-border transfer of important data must comply with the Network Security Law and regulations issued by the Cyberspace Administrative Office and other authorities under the State Council.

Furthermore, the Personal Information Protection Law (PIPL), a comprehensive data protection law, was adopted in August 2021 and will be effective from November 2021 onwards. Global companies conducting business in China, including M&A transactions, will need to be more careful with cross-border transfers of personal information as a breach may result in costly implications, as severe violations may see fines of up to 50 million yuan or 5 per cent of the annual revenue for the prior fiscal year.<sup>19,20</sup>

Corruption risks could also be intertwined with General Data Protection Regulation issues. For example, in 2018, Dun & Bradstreet entered into a US\$8.1 million FCPA settlement with the SEC based on self-disclosed violations by two of the company's China-based subsidiaries following the SEC's allegation that the company made illicit payments to obtain data on Chinese citizens via third-party agents.<sup>21</sup> With multiple data privacy regulations to be considered and significant focus on the enforcement of these new regulations, investors must be knowledgeable in this area to avoid unintentional violations that bring serious consequences.

## Other considerations and risks of doing deals in China

### *Political climate*

When investing in a foreign country, the political climate is an important consideration because regulatory changes can potentially impact business strategy, such as operational changes and changes in laws regarding foreign ownership of businesses, among others. China is a communist country with a relatively stable political situation on the whole. The Communist Party of China (CCP) has been the sole ruling party since 1949, and there are no signs of this changing in the near future. Under President Xi Jinping's leadership, the government has gradually moved away from collective leadership and consensus-based decision-making towards a centralisation of power.

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19 'China's New Comprehensive Data Protection Law: Context, Stated Objectives, Key Provisions', Future of Privacy Forum, <https://fpf.org/blog/chinas-new-comprehensive-data-protection-law-context-stated-objectives-key-provisions/>, accessed 8 September 2021.

20 Cynthia Brumfield, 'China's PIPL privacy law imposes new data handling requirements', CSO, [www.csoonline.com/article/3631611/chinas-pipl-privacy-law-imposes-new-data-handling-requirements.html](http://www.csoonline.com/article/3631611/chinas-pipl-privacy-law-imposes-new-data-handling-requirements.html), accessed 8 September 2021.

21 'SEC Charges Dun & Bradstreet with FCPA Violations', US Securities and Exchange Commission, Administrative Proceeding, File No. 3-18446, 23 April 2018, [www.sec.gov/enforce/34-83088-s](http://www.sec.gov/enforce/34-83088-s).

Nonetheless, there are undoubtedly signs of nervousness at the top levels of government. In January 2019, during a meeting with provincial leaders of the CCP, President Xi stressed the importance of maintaining political stability and warned that slowing economic growth could result in political vulnerability. During that meeting, President Xi also put the Minister of Public Security in charge of curbing any protests that may arise.<sup>22</sup> Anti-government protests in Hong Kong, which started in June 2019, triggered by discussions on the introduction of the extradition bill that was subsequently withdrawn, have clearly changed the political landscape and dynamics, not just between Hong Kong and Beijing, but also globally. While protests and demonstrations persist in 2021, albeit not at the same scale, this continues to be an area where changes are occurring on a daily basis, and investors are wary of the impacts on businesses and investments in China.

China has, over the years, become less protectionist; however, when compared to many other countries, there is a higher degree of state involvement to navigate (implicit as well as explicit). Government intervention on the grounds of national interest and penalties to countries that are not in alignment with government foreign policy are but two examples of state involvement in doing business in China. However, not all involvement by the Chinese government is unfavourable to investors, as evidenced by new laws being established that should, if effective, have a positive impact on foreign investment in China.

One example is the Foreign Investment Law, effective since January 2020, aimed at improving the foreign investment framework in China and giving further protection to foreign investors. This Law replaces the three primary laws regulating foreign-invested enterprises (FIEs) in China: the Law on Sino-Foreign Equity Joint Ventures, the Law on Wholly Foreign-Owned Enterprises and the Law on Sino-Foreign Cooperative Joint Ventures.<sup>23</sup>

The Foreign Investment Law in China provides FIEs with the following:

- equal application of compulsory national standards;
- requirement for testing in courts before judgment on actual force of protections can be made (for example, intellectual property protections);
- free foreign exchange settlement of capital injection, capital revenue, asset disposal income, profits, royalty fees, compensation, indemnity, etc; and
- no expropriation of foreign investments, except, under special circumstances, the state may expropriate or requisition the investment of foreign investors for the public interest.

In December 2020, the NDRC and the Ministry of Commerce (MOFCOM) jointly issued the Measures for Security Review of Foreign Investment (New Measures), which came into effect

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22 Juliette Genevaz, 'Sources of Political Stress in China', War on the Rocks, 14 May 2019, [www.warontherocks.com/2019/05/sources-of-political-stress-in-china/](http://www.warontherocks.com/2019/05/sources-of-political-stress-in-china/); 'China's Xi Warns Party of "Serious Dangers" as Risks Mount', Bloomberg.com, 22 January 2019, [www.bloomberg.com/news/articles/2019-01-21/china-s-xi-calls-for-political-stability-as-economic-risks-mount](http://www.bloomberg.com/news/articles/2019-01-21/china-s-xi-calls-for-political-stability-as-economic-risks-mount).

23 'China: Foreign Investment Law Passed', *Global Legal Monitor*, Library of Congress, 30 May 2019, [www.loc.gov/law/foreign-news/article/china-foreign-investment-law-passed/](http://www.loc.gov/law/foreign-news/article/china-foreign-investment-law-passed/).

in January 2021.<sup>24</sup> The New Measures, which require national security review by the regulators, provided a clearer legal regime for national security review comparable to the Committee of Foreign Investment in the US (CFIUS) review.

### Impact of trade war, sanctions and anti-competition

The tit-for-tat trade war between the US and China spiralled to new heights in 2020, and has generally continued under the Biden administration, but there are no indications that it has dampened enthusiasm for M&A deals in China, as seen by ExxonMobil's US\$10 billion investment in April 2020 in the construction of a chemical complex in the south-east province of Guangdong. Notwithstanding such deals, risks and concerns related to the global political climate remain relevant. Qualcomm, for example, waited almost two years after striking the US\$44 billion deal for NXP Semiconductors, a Dutch global semiconductor manufacturer, only to have to walk away from the deal in 2018 after failing to secure Chinese regulatory approval as a result of a Sino-US trade spat.<sup>25</sup>

This type of government involvement in M&A deals is not unusual for many countries, especially in the case of antitrust concerns. 2021 has to date not been short of excitement for M&A deals from an antitrust perspective. In July 2021, for example, China's State Administration of Market Regulation (SAMR) blocked Tencent Holdings Ltd's DouYu International Holdings Ltd merger with Huya Inc, which would have created a videogame-streaming behemoth worth over US\$10 billion.<sup>26</sup> In the same month, the SAMR approved Tencent's plan to privatise search engine affiliate Sogou Inc in a deal valued at around US\$2 billion.<sup>27</sup>

However, historically there has been a higher incidence of government intervention in China of the nature seen in the *Qualcomm/NXP* deal. Trade wars and sanctions only increase the likelihood of such involvement, although these are normally temporary interruptions to deals.

In May 2019, China enacted the 'unreliable entity list' (UEL), which includes individuals and foreign entities whose 'non-commercial' acts are detrimental to the interests of Chinese companies. This move was mainly in response to the US's move to add Huawei to the US Entity List.

In May 2020, in retaliation against Washington's move to block shipments of semiconductors to Huawei Technologies, China threatened to include a number of US companies on the UEL, launch investigations and impose restrictions on a number of large US corporations, including

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24 Howard Hao Wu, Tracy Wut, 'China enacts new foreign investment security review measures', Baker McKenzie, [www.bakermckenzie.com/en/insight/publications/2021/01/china-enacts-new-foreign-investment-security](http://www.bakermckenzie.com/en/insight/publications/2021/01/china-enacts-new-foreign-investment-security), accessed 8 September 2021.

25 Michael Martina and Stephen Nellis, 'Qualcomm ends \$44 billion NXP bid after failing to win China approval', Reuters, 25 July 2018, [www.reuters.com/article/us-nxp-semicondtrs-m-a-qualcomm/qualcomm-ends-44-billion-nxp-bid-after-failing-to-win-china-approval-idUSKBN1KF193](http://www.reuters.com/article/us-nxp-semicondtrs-m-a-qualcomm/qualcomm-ends-44-billion-nxp-bid-after-failing-to-win-china-approval-idUSKBN1KF193).

26 Josh Ye, 'Beijing's decision to block Tencent's Douyu-Huya merger deal marks end of freewheeling internet era in China', *South China Morning Post*, [www.scmp.com/tech/big-tech/article/3141283/beijings-decision-block-tencents-douyu-huya-merger-deal-marks-end](http://www.scmp.com/tech/big-tech/article/3141283/beijings-decision-block-tencents-douyu-huya-merger-deal-marks-end), accessed 8 September 2021.

27 Yoko Kubota, 'China clears Tencent-Sogou Deal', *WSJ*, [www.wsj.com/articles/china-clears-tencent-sogou-deal-11626159204](http://www.wsj.com/articles/china-clears-tencent-sogou-deal-11626159204), accessed 8 September 2021.

Apple.<sup>28</sup> More recently, in August 2020, the deal between the Chinese parent company of TikTok, ByteDance, and suitors for the app's US operations was further thrown off track as the Ministry of Commerce updated China's 'forbidden and restricted technology exports' by adding 23 items to the restricted list, including 'personalised information recommendation services based on data analysis, algorithms and artificial intelligence'. This recent rule change is a reminder that the Chinese government could still have a say in M&A transactions by foreign investors.

In September 2020, MOFCOM published the Provisions on Unreliable Entity list, which took effect immediately.

More recently, in June 2021, the Standing Committee of China's National People's Congress passed the Counter Foreign Sanctions Law, as China continued to resist US and EU pressure over trade, technology, Hong Kong and Xinjiang.<sup>29</sup> This law, which requires individuals and entities involved in making or implementing discriminatory measures against Chinese citizens or entities to be put on an anti-sanctions list by the Chinese government, is one of China's many acts of retaliation against foreign sanctions.

### Foreign currency transactions and profit repatriation from China

Foreign currency and China's own currency, the Chinese yuan, are regulated by China's State Administration of Foreign Exchange (SAFE). To maintain control over the fluctuation of its own currency, SAFE imposed strict restrictions on the flow of monies both in and out of China. This tight restriction, imposed on individuals as well as companies, makes it a difficult and lengthy process for monies to be remitted from China. This should obviously be an important consideration for investors and dealmakers.

Currently, the most common methods of repatriating monies out of China include:

- remitting profits as dividends to the holding company;
- remitting inter-company fees to the holding company and companies within the group; and
- extending inter-company loans to companies within the group.<sup>30</sup>

Investors should be aware that SAFE has stepped up measures to stem capital outflows more generally, especially since the yuan declined to an eight-year low against the US dollar and foreign reserves fell to around US\$3 trillion in 2016. Since 2016, China's monetary authority has been imposing a series of policies to stem capital outflows, discouraging companies from engaging in non-core outbound investments and tightening inspections on citizens exchanging foreign currency. Furthermore, to show that they mean business, SAFE named and shamed

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28 'China ready to put Apple, other U.S. companies in "unreliable entity list"', Reuters, 15 May 2020, [www.reuters.com/article/us-usa-huawei-tech-china/china-ready-to-put-apple-other-u-s-companies-in-unreliable-entity-list-global-times-idUSKBN22R1X2](http://www.reuters.com/article/us-usa-huawei-tech-china/china-ready-to-put-apple-other-u-s-companies-in-unreliable-entity-list-global-times-idUSKBN22R1X2).

29 Yew Lun Tian, 'China passes law to counter foreign sanctions', Reuters, 10 June 2021, [www.reuters.com/world/china/china-passes-law-counter-foreign-sanctions-2021-06-10/](http://www.reuters.com/world/china/china-passes-law-counter-foreign-sanctions-2021-06-10/).

30 Dezan Shira & Associates, 'Profit Repatriation from China', China Briefing, 31 July 2019, [www.china-briefing.com/news/profit-repatriation-from-china/](http://www.china-briefing.com/news/profit-repatriation-from-china/).

five companies in 2017, alleging contract and invoice forgery to facilitate the remittance of over US\$200 million offshore from 2015 to 2017.<sup>31</sup>

### National secret considerations

When dealing with SOEs or handling information that may be deemed state secrets by the authorities, there is a fuzzy line between what constitutes SOE trade secrets versus state secrets. Investments and transactions involving SOEs are therefore faced with the additional challenge of needing to seek confirmation that the information they are obtaining, and possibly removing, from China is not a state secret, to avoid any violations of China's State Secrets Law. Classified information is supposed to be marked as such. If it is not marked and the person who has provided the information has failed to clarify that the information is classified, the risk remains that both the party receiving the information and the party providing it may face prosecution.<sup>32</sup>

While the Classification Provisions of 2014, which were primarily derived from US legal concepts, provided more rigorous procedures and standards for secrecy officials, they do not change the standards that courts apply when adjudicating a state secrecy claim. The bottom line is that the State Secrecy Bureau and its counterparts retain maximum flexibility in terms of the interpretation of what constitutes state secrets. Therefore, care needs to be exercised when handling data and information as a violation of the State Secrets Law could lead to imprisonment or criminal detention.

### Environmental risks

China is not immune to the focus on environmental issues and responsible investment that is already becoming a mainstream phenomenon in the global capital market. However, it does highlight that sufficient due diligence relating to potential environmental issues should be performed to mitigate the possible erosion of deal values.

The number of companies in China accused of violating environmental regulations is on the rise. China has promised zero tolerance for firms guilty of offences such as illegal waste disposal and tampering with monitoring equipment. China's Environmental Protection Law, in force since 2015, allows authorities to fine individuals and companies on a daily basis until the issue is rectified and gives regulators the authority to file criminal charges.

Domestic regulators have a part to play in driving the momentum for corporate environmental, social and governance (ESG) reporting in China. In February 2021, the China Securities Regulatory Commission (CSRC) issued a market consultation proposing a revision to investor relations guidelines, which included ESG information to a list of issues on which listed companies should update investors. This was followed by the CSRC's publication of the revised information disclosure rules relating to annual reports in June 2021.

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31 Jane Cai, 'Revealed: the sneaky ways Chinese are moving money across the border', *South China Morning Post*, 29 May 2017, [www.scmp.com/news/china/economy/article/2096032/chinas-watchdog-tracks-underground-cash-trail](http://www.scmp.com/news/china/economy/article/2096032/chinas-watchdog-tracks-underground-cash-trail).

32 Mitchell A Silk and Jillian S Ashley, 'Understanding China's State Secrets Laws', *China Business Review*, 1 January 2011, [www.chinabusinessreview.com/understanding-chinas-state-secrets-laws/](http://www.chinabusinessreview.com/understanding-chinas-state-secrets-laws/).

## Money-laundering risks

In September 2020, the Financial Action Task Force published a follow-up report on China's anti-money laundering (AML) and counter-terrorist financing system. The report states that China has made progress in addressing the technical compliance deficiencies but should enhance its implementation of AML and countering the financing of terrorism measures.<sup>33</sup> In June 2019, China's central bank issued a statement that it would strengthen cooperation with other countries to curb cross-border money-laundering activities.<sup>34</sup>

In October 2020, China issued a revised law on the central bank for consultation in order to formalise its expanded role in overseeing the financial sector through the prevention and resolving of financial risks and maintaining financial stability.<sup>35</sup>

In June 2021, the People's Bank of China (PBOC) published the draft version of the revised Anti-Money Laundering Law for public comments, where fines for certain offences would rise to as much as 10 million yuan.<sup>36</sup> Other key changes include improvement to the effectiveness of the legal framework to combat money laundering and terrorist financing, as well as the expansion of AML obligations to all individuals and organisations.<sup>37</sup>

The past two years have seen a surge in AML-related penalties, including the following:

- in February 2020, China Everbright Bank, China Minsheng Banking Corporation and brokerage Huatai Securities were fined 23.6 million yuan, 18.2 million yuan and 10.1 million yuan, respectively, for failure to adequately prevent money laundering;<sup>38</sup>
- in April 2020, the PBOC imposed another record high penalty of 116 million yuan on payment service company Allscore Payment Services for its involvement in facilitating overseas gambling;<sup>39</sup>
- in June 2020, the Chinese unit of BNP Paribas was fined US\$378,200 for failure to perform client identity verification and report large and suspicious transactions. Three of its senior executives of its Chinese subsidiary were also fined in connection with the violations;<sup>40</sup>

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33 "China's Progress in strengthening measures to tackle money laundering and terrorist financing", Follow-Up Report China – 2020, FATF, <https://www.fatf-gafi.org/publications/mutualevaluations/documents/fur-china-2020.html>.

34 'China central bank to strengthen anti-money laundering cooperation overseas', Reuters, 19 June 2019, <https://uk.reuters.com/article/uk-europe-moneylaundering-china/china-central-bank-to-strengthen-anti-money-laundering-cooperation-overseas-idUKKCN1TK0VH>.

35 "China revises central bank law to help risk fight", Reuters, Oct 23, <https://www.reuters.com/article/china-economy-pboc/china-revises-central-bank-law-to-help-risk-fight-idUKL4N2HE30M>

36 "China ups fines and widens scope of draft money laundering law", Reuters, 1 June 2021, <https://www.reuters.com/article/us-china-pboc-money-laundering-idUSKCN2DD397>

37 "China to amend its Anti-Money Laundering Law", Garrigues, 7 July 2021 [https://www.garrigues.com/en\\_GB/new/china-amend-its-anti-money-laundering-law](https://www.garrigues.com/en_GB/new/china-amend-its-anti-money-laundering-law)

38 Peng Qinqin and Guo Yingzhe, 'Central Bank Ramps Up Punishment for Money Laundering', Caixin Global, 17 February 2020, [www.caixinglobal.com/2020-02-17/central-bank-ramps-up-punishment-for-money-laundering-101516449.html](http://www.caixinglobal.com/2020-02-17/central-bank-ramps-up-punishment-for-money-laundering-101516449.html).

39 Nathan Huang, 'PBOC to Step Up Efforts in Fighting Money Laundering', Redpulse China, 13 June 2020, [www.redpulse.com/china/20200613/pboc-to-step-up-efforts-in-fighting-money-laundering-6132d4e97a](http://www.redpulse.com/china/20200613/pboc-to-step-up-efforts-in-fighting-money-laundering-6132d4e97a).

40 'BNP Paribas Chinese Unit Fined for Anti-Money Laundering Violations', RiskScreen, 2 June 2020, [www.riskscreen.com/kyc360/news/bnp-paribas-chinese-unit-fined-for-anti-money-laundering-violations/](http://www.riskscreen.com/kyc360/news/bnp-paribas-chinese-unit-fined-for-anti-money-laundering-violations/).

- in February 2021, China CITIC Bank was fined 28.9 million yuan for four anti-money-laundering-related violations, including failing to keep customers' identity information and transaction records as required; and
- in April 2021, Hong Kong authorities arrested six people suspected of money laundering involving HK\$2.5 billion through 59 personal accounts at nine banks in Hong Kong.<sup>41</sup>

As enforcement and penalties continue to increase in frequency and magnitude, foreign companies operating in China need to ensure that appropriate know-your-customer procedures and controls are in place, specifically around politically exposed persons, to mitigate money-laundering risks.

### Nepotism and princeling hires

As mentioned above, *guanxi* is an important element in doing business in China. It is the cultural norm to help one another as part of relationship building through gestures such as referring potential job opportunities to friends and families, even if they are not qualified for the job, as a repayment or reward for bringing in deals and business. The cases mentioned below illustrate the frequency of FCPA violations involving the hiring of 'princelings' (ie, the children of government officials and other favoured referrals who did not qualify for the position they were given), demonstrating the extent to which the practice is deeply rooted within the country.

- In 2016, San Diego-based Qualcomm paid US\$7.5 million to settle charges for FCPA violation through the hiring of relatives of Chinese officials who were decision makers in the selection of the company's products.<sup>42</sup>
- Also in 2016, JPMorgan Chase paid US\$264 million for engaging in a systematic bribery scheme by hiring 'princelings'.<sup>43</sup> Three years later, in 2019, JPMorgan's former Asia investment banking vice chair faced charges for offering employment to the son of a customer as a reward for favouring JPMorgan Securities Asia Pacific.
- In 2018, Credit Suisse paid a settlement of US\$77 million relating to claims that the lender's Hong Kong unit attempted to win banking business by offering jobs to friends and family of Chinese officials.<sup>44</sup>

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41 Denise Wee and John Cheng, 'Hong Kong Arrests Six in \$322 Million Money Laundering Case', 22 April 2021, [www.bloomberg.com/news/articles/2021-04-22/hong-kong-arrests-six-in-322-million-money-laundering-case](http://www.bloomberg.com/news/articles/2021-04-22/hong-kong-arrests-six-in-322-million-money-laundering-case).

42 'SEC: Qualcomm Hired Relatives of Chinese Officials to Obtain Business', US Securities and Exchange Commission press release 2016-36, 1 March 2016, [www.sec.gov/news/pressrelease/2016-36.html](http://www.sec.gov/news/pressrelease/2016-36.html).

43 'JPMorgan Chase Paying \$264 million to Settle FCPA Charges', US Securities and Exchange Commission press release 2016-241, 17 November 2016, [www.sec.gov/news/pressrelease/2016-241.html](http://www.sec.gov/news/pressrelease/2016-241.html).

44 Jonathan Stempel, 'Credit Suisse pays U.S.\$77 million to settle Asia hiring corruption probes', Reuters, 5 July 2018, [www.reuters.com/article/us-credit-suisse-settlements/credit-suisse-pays-77-million-to-settle-u-s-probes-into-china-hiring-idUSKBN1JV1XS](http://www.reuters.com/article/us-credit-suisse-settlements/credit-suisse-pays-77-million-to-settle-u-s-probes-into-china-hiring-idUSKBN1JV1XS).

- In 2019, Deutsche Bank agreed to pay over US\$16 million for FCPA violations relating to the hiring of underqualified relatives of Chinese and Russian government officials in return for business deals.<sup>45</sup>

To mitigate such risks, referred candidates should go through the company's standard hiring process without any bias in selection and evaluation, and should be able to demonstrate that they have the requisite skills and experience to perform the job. Individuals with a prior personal, family or business relationship with the referred candidates must be removed from the hiring process to eliminate bias and the risk of a conflict of interest. These issues should be considered when performing due diligence both before and after a transaction closes.

### **Steps to mitigate the risk of doing business in China**

Having taken a look at the various key risks of doing business in China, the following are some measures to consider in attempting to mitigate the risks associated with M&A in China.

#### ***Structure and strategy***

Consider the structure of the entity that best suits the business strategy; for example, how much control over the operation the investor desires or requires. Do not underestimate the complexity of setting up an entity and unwinding structural inaccuracies.

#### ***Cash flows***

Have a clear understanding of the restrictions for both the inflow and outflow of foreign monies.

#### ***Due diligence***

Perform appropriate due diligence before and after the transaction. Where possible, perform transaction testing to assess the accuracy of the verbal representations provided by the target, and ensure a proper understanding of the target's go-to-market strategy and any third parties engaged.

#### ***Understand applicable laws and regulations***

Do the homework necessary to identify and understand the various applicable rules and regulations, including pending regulations. In some cases, the entity in China may need to be compliant with two different sets of rules – one for China and one for the holding company's home country.

#### ***Utilise experienced advisers***

When it comes to data protection regulation and state secret information, handle data and information with the utmost care. Where possible, process data and information in-country and do not remove it from China. Utilising advisers (eg, attorneys, accountants and data governance professionals) can support the appropriate handling of data and assist in avoiding violations.

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45 Harry Cassin, 'Deutsche Bank pays SEC \$16 million to settle "referral hiring" FCPA violations', The FCPA Blog, 22 August 2019, [www.fcpablog.com/blog/2019/8/22/deutsche-bank-pays-sec-16-million-to-settle-referral-hiring.html](http://www.fcpablog.com/blog/2019/8/22/deutsche-bank-pays-sec-16-million-to-settle-referral-hiring.html).

### *Close monitoring*

As corruption is endemic in China, operations in-country should be closely monitored with regular audits to identify potential breaches of laws and regulations and to create a culture of compliance.

### **Conclusion**

Opportunities in China continue to appeal to foreign investors for a variety of reasons, despite the covid-19 pandemic, including advantages such as low-cost labour and materials as well as advancements in technology. With a population of approximately 1.4 billion based on United Nations data as at mid-2019, it is one of the most highly populated countries in the world.<sup>46</sup> Given these opportunities, the risks mentioned above are unlikely to discourage foreign investors who are keen to expand their business into China. Whether seeking availability of employees or resources or access to the consumer market, foreign companies stand to benefit significantly from investing in China, as long as the risk exposures are managed appropriately and mitigated where applicable and possible.

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<sup>46</sup> 'Total Population by Country 2019', World Population Review, <http://worldpopulationreview.com/countries/>, accessed 26 September 2019.

# Appendix 1

## About the Authors

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Jerry Hansen is a partner based in FRA's Dallas, Texas office. He has over 25 years of experience in accounting and forensic services including mergers and acquisition disputes, audit/accounting malpractice litigation, forensic due diligence, compliance monitorships and fraud investigations. Jerry's expertise includes serving as an expert or neutral arbitrator in resolving post-closing purchase price dispute arbitrations, providing expert and consulting services in audit and accounting malpractice matters involving the application of generally accepted accounting principles and generally accepted auditing standards, conducting all manner of forensic investigations, and providing forensic due diligence services relating to FCPA and UK Bribery Act risks. His experience covers a wide range of industries, including oil and gas, energy, real estate, technology, transportation, manufacturing, software, food services, publishing, automotive, healthcare, retail, staffing services, advertising, professional services and financial services. Jerry has previously served at a Big Four public accounting firm, a multinational consultancy and global corporations.

Jerry is a certified public accountant, licensed in Texas and California. He is the co-author of the book *M&A Disputes – A Professional Guide to Accounting Arbitrations* (Wiley 2017) and a contributing author to three additional books: *The Litigation Services Handbook*, *The Guide to Investigating Business Fraud* and *The Guide to M&A Arbitration*, as well as other articles and publications.

### **Weng Yee Ng**

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Weng Yee Ng is a director in FRA's London office. She holds more than 17 years of experience in external and internal audit and forensic accounting. Her expertise includes compliance reviews, internal investigations, litigation support (both civil and criminal), risk assessments, evaluation of compliance programmes and FCPA monitorships for both the Department of Justice and the

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Weng Yee is currently working on a risk assessment and evaluation of compliance programme for an aviation company. She has also completed compliance monitorships for a medical devices company and for a financial transaction systems manufacturer, both with global presence, a proactive anti-bribery and corruption review for an international bank, and several internal investigations into whistle-blower alerts for a CAC 40 automotive original equipment manufacturer. All of these have an Asian element, which involved in-country visits to China and other Asian countries.

Having spent over six years working in-country in Malaysia, Weng Yee possesses a first-hand understanding of the business nuances and financial and reporting practices encountered in Malaysia and in other South East Asian countries. She is multilingual in English, Malay, Cantonese and Mandarin, and is familiar with Bahasa Indonesia and Spanish.

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Yueting Wang is a senior associate in FRA's Washington, DC office. Her experience includes the FCPA investigations, anti-bribery and anti-corruption compliance reviews, and disgorgement and fine calculations.

Yueting has been providing forensic accounting support for companies operating in the manufacturing, telecommunications and medical devices industries. Yueting also worked on a two-year PCAOB monitorship, in which she was responsible for the development and execution of a risk-based methodology to assess the accounting firm's system of quality controls against PCAOB auditing standards and related professional practice standards for registered public accounting firms.

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