

## Guarding State-owned Assets — the PRC Enterprise State-owned Assets Law

By Su Zheng\* and Hu Ping\*\*

China Bulletin March 2009

### I. First Law Governing State-owned Assets in China

The *Enterprise State-owned Assets Law of the People's Republic of China* ("**State-owned Assets Law**") was adopted on the fifth session of 11th Standing Committee of the National People's Congress on October 28, 2008 and will become effective on May 1, 2009. The State-owned Assets Law, which had been drafted and deliberated for more than ten years, is China's first law addressing state-owned assets. Before the promulgation of the State-owned Assets Law, the *Interim Regulations on Supervision and Administration of Enterprise State-Owned Assets* ("**Interim Regulations**"), a set of administrative regulations promulgated by the State Council on May 27, 2003, had been the regulations governing state-owned assets with the highest authority since the establishment of the State-owned Assets Supervision and Administration Commission under the State Council ("**SASAC**") in 2003. The promulgation of the State-owned Assets Law fills the gap of state-level legislation on state-owned assets in China's legal regime and formalizes the mandatory administration and regulation of state-owned assets in China.

The promulgation of the State-owned Assets Law did not draw much attention compared with the Property Rights Law, which attracted extensive academic discussions, or compared with the Anti-monopoly Law, which caused panic among the industrial oligarchs. One of the reasons for such a subdued public reaction is that the State-owned Assets Law mainly focuses on summarizing existing regulations and rules regarding the administration of state-owned assets. It is silent on matters that the public is concerned about, such as the supervision of offshore state-owned assets and executive compensation at state-owned enterprises ("**SOEs**"). Nevertheless, the State-owned Assets Law is important because it recapitulates the SOE reform and development of the last three decades. The law also amalgamates old regulations and suggests future directions for the administration of state-owned assets.

### II. Protecting the Rights and Interests of State-owned Assets and Preventing the Loss of State-owned Assets

#### A. The *State-owned Assets Law* is now applicable to Financial Enterprises<sup>1</sup>

According to the division of power between the SASAC and the Ministry of Finance ("**MOF**"), the SASAC governs industrial capital and the MOF governs financial capital<sup>2</sup>. Neither the *Interim Regulations* nor the *Interim Administrative Measures for the Transfer of State-owned Equity and Assets of Enterprises* promulgated in 2003 apply to financial enterprises. However, the absence of a specific law or regulation addressing the transfer and supervision of the state-owned assets of financial enterprises has caused a lack of standard practices. For example, when a financial enterprise transfers its equity or assets, the enterprise can either auction them in an equity and asset exchange<sup>3</sup> or transfer them by agreement. The State-owned Assets Law provides in its supplemental provisions that "as for the supervision and administration of state-owned assets of financial enterprises, where other laws or administrative regulations provide otherwise, such laws and regulations shall prevail." This provision implies that the State-owned Assets Law applies to financial enterprises. The law has also established the principle that state-owned equity or assets

shall only be auctioned in equity exchanges. Such principles lay the legal groundwork for future implementing rules governing the transfer of state-owned assets of financial enterprises.

#### B. Three situations where SOE executives shall not hold posts in two or more enterprises

As the individuals who manage and operate the assets of SOEs, the senior management of an SOE is crucial to maintaining the rights and interests of state-owned assets. The State-owned Assets Law<sup>4</sup> explicitly requires that the senior management of SOEs should not hold posts in two or more enterprises in three situations:

1. The directors and senior managers of a wholly state-owned enterprise ("**WSOE**") or a wholly state-owned company ("**WSOC**") shall not hold office in other enterprises without the approval of competent state-owned assets supervision authority. The directors and senior managers of a state-controlled company or a company with a state-owned minority interest shall not take positions in other enterprises engaging in similar businesses without the approval of a shareholders' meeting or general shareholders' meeting.
2. The chairman of a WSOC must not serve as the manager of that company without the approval of the institutions or organizations empowered by the government to administrate and supervise state-owned assets.<sup>5</sup> The chairman of a state-controlled company must have the approval of a shareholders' meeting or general shareholders' meeting before serving as the manager of that company.
3. The directors and senior managers of SOEs shall not take positions as supervisors in the same company.

#### C. Clarifying the supervision of the rights and interests of SASAC

In recent years, management buyouts ("**MBO**") and mergers and acquisitions by foreign investors have been the focus of controversies over the loss of state-owned assets. In 2005, SASAC adopted the *Provisional Rules for Management Buy-outs of State-owned Equity and Assets*, which set forth detailed rules regarding transfer procedures for such a transaction. The State-owned Assets Law, for the first time at the legislative level, establishes a series of principles including the requirement that state-owned assets and equity be appraised before being auctioned in equity and asset exchanges. The requirements for MBO are extended to close relatives<sup>6</sup> of the directors, supervisors, and senior managers of SOEs and any enterprises that these relatives own or have de facto control in. The State-owned Assets Law also provides that a related party transaction shall be annulled if the parties collude with each other in impairing the rights and interests of SASAC and its local branch offices.

### III. Lack of Supervision of Offshore State-owned Assets

In recent years, Chinese enterprises, especially large SOEs, started to venture in foreign countries, making China the source of some of the largest offshore investments in the developing world. However, many of these SOEs do not have the skills, experience, or in-depth knowledge necessary for managing and operating international businesses. China does not have effective systems to control and supervise overseas state-owned assets. The scandals of China National Aviation Fuel Group Corporation ("**CNAF**")<sup>7</sup> and China's State Regulation Center of Supplies Reserve ("**SRCSR**")<sup>8</sup> were just the beginning of a wave of state-owned asset losses. In the current financial crisis, investments made by some SOEs (including listed companies) in overseas financial institutions or financial products have incurred losses of billions of US dollars. Although

both internal and external factors have contributed to such losses, defects in the supervision system and a lack of supervision methods is one of the significant reasons why the State and investors of listed companies have sustained such losses. Some even hold the view that overseas state-owned assets remain unregulated because of the lack of sound regulations and effective supervision.

The effective regulation governing offshore state-owned assets is *Interim Measures for the Supervision of Overseas State-owned Assets* ("**Overseas Measures**") jointly promulgated by the MOF, the Ministry of Foreign Affairs ("**MFA**"), State Administration of Foreign Exchange ("**SAFE**") and the General Administration of Customs ("**GAC**") in 1999. The Overseas Measures mainly govern state-owned assets generated by offshore investment entities. As Chinese outbound investment grows, an increasing amount of funds are invested into derivatives products including futures and special purpose vehicles ("**SPVs**") which are not legal persons. Apparently, the Overseas Measures, which were enacted a decade ago, are out of date and unable to effectively fulfill its function of protecting offshore state-owned assets. Furthermore, recent reforms in government structure and function have allowed other authorities including the SASAC, the Ministry of Commerce, the National Development and Reform Commission and other industrial authorities to share the responsibility of state-owned assets supervision. The absence of a clear and unified supervision approach and the overlapping of functions among authorities have also lowered the efficiency of supervision and are likely to cause gaps in supervision. Therefore, there is urgency for China to upgrade its existing legislation on overseas state-owned assets and to clarify the corresponding supervising authority to prevent further loss of such assets. It is unfortunate that the State-owned Assets Law is silent on the supervision of offshore investments by SOEs.

#### IV. Impact on Mergers and Acquisitions by Foreign Investors

The separation of management and ownership in modern corporate structures<sup>9</sup> is a persistent headache for SOEs and the state-owned equity and assets management system. The government management mechanism, which combines the ownership of macro-control and administrative power over state-owned assets, also causes problems. Furthermore, administrative regulations and rules regarding state-owned assets are of a lower jurisdiction than laws and are often enacted by different authorities. Such practicalities have made these regulations and rules inconsistent and inoperable. For these reasons, when merging or acquiring an SOE, foreign investors or private equity funds are often overburdened with complicated approval procedures with two or more authorities, even those that may not have the proper legal authority. Foreign investors and private equity funds are also concerned about the potential difficulties in restructuring the SOE upon merger or acquisition due to the intervention of the government, and therefore, tend to avoid or react negatively to the acquisition of SOEs.

The State-owned Assets Law improves the supervision of state-owned assets by refining the rules for SOE reforms, related party transactions, appraisal, and transfer of state-owned assets. The State-owned Assets Law also clarifies the responsibilities of SASAC and its local branch offices, and prohibits<sup>10</sup> the state-owned assets investor's interference with the operation of SOEs. All of these changes may increase the attractiveness of SOEs as acquisition targets for foreign investors.

(The article was originally written in Chinese, the English version is a translation.)

- \* Su Zheng is a partner of King & Wood's Securities Group in Beijing.
- \*\* Hu Ping is an associate of King and Wood's Securities Group in Beijing.

---

<sup>1</sup> Financial enterprises are usually state-owned companies and supervised by government authorities.

<sup>2</sup> State-owned assets refer to all property owned by the state on behalf all people as a whole and the rights associated with such property. State-owned assets include (1) operational assets contributed by the state; (2) assets used or managed by government bodies, public service units and other organizations performing administrative functions; and (3) natural resources owned by the State, such as lands, mineral resources, forests and water. Currently, China takes a varied approach towards state-owned assets, as these assets are in different forms and natures. For example, MOF supervises operational financial assets and SASAC governs operational non-financial assets. The Ministry of Railway supervises assets related to railways, and the Ministry of Land and Resources and the State Forestry Administration administer the assets related to lands and forests.

<sup>3</sup> According to the *Guidelines for the Selection and Designation of Equity and Assets Exchanges for the Auction of State-owned Assets* promulgated by SASAC on July 14, 2004 and other administrative documents, the state-owned assets of central SOEs and their subsidiaries can only be auctioned the equity and assets exchanges in Beijing, Tianjin, Shanghai and Chongqing. The state-owned assets of local SOEs shall be auctioned in the equity and assets exchanges selected and designated by the state-owned assets supervision authorities at provincial, autonomous region or municipal level according to the appraisal standards issued by SASAC.

<sup>4</sup> See Article 25 of Chapter 4 of the State-owned Assets Law.

<sup>5</sup> Such institutions or organizations include SASAC and its local branch offices and large state-owned enterprises and companies designated by SASAC.

<sup>6</sup> The State-owned Assets Law is silent on the definition of "close relatives". According to the *Opinions of the Supreme People's Court on Issues concerning the Implementation of the General Principles of the Civil Law of the People's Republic of China* (For Trial Implementation) issued on January 26, 1988, close relatives includes the spouses, parents, children, siblings, grandparents and grandchildren.

<sup>7</sup> Chen Jiulin, the former CEO of China Aviation Oil (Singapore) Ltd., a subsidiary of CNAF, engaged in illegal crude oil futures trading and incurred catastrophic losses of approximately US\$554 million in total in October 2004.

<sup>8</sup> Liu Qibing, an employee of SRCSR, sold short on as much as 130,000 tons of copper on the London Metals Exchange in the anticipation that prices would fall. His wrong bets have incurred huge losses for SRCSR.

<sup>9</sup> The absence of owner's function refers to the fact that the owner's function is absent or has not been fully and legally exercised. No authority would assess the costs and earnings of the state-owned enterprises for the interests of owner, and no one would be responsible for the profit and loss of the state-owned enterprises. Lacking of incentives control and supervision from the owners, the human beings physically manage the enterprises have no direct relevance to the profit or loss of the enterprises and are not responsible for that to the owners.

<sup>10</sup> See Article 6 of Chapter 1 of the State-owned Assets Law.