China Announces 8th Conditional Anti-monopoly Clearance

On 31 October 2011, the Anti-Monopoly Bureau of China’s Ministry of Commerce (Mofcom) issued its eight conditional clearance decision. The decision, which concerns the proposed acquisition by Alpha Private Equity Fund V (“Alpha V”) of textile factory machinery manufacturer Savio Macchine Tessili S.P.A. (“Savio”), sheds light on some important aspects of China’s merger control regime.

In this legal update we summarise the decision, relevant aspects of Mofcom’s review process, and key take-outs for the business sector and antitrust practitioners.

**Background - The proposed transaction and participants**

Alpha V is a private equity fund investing in, among other industry sectors, the recycling of non-ferrous metals, sales of household textiles and production and sales of textile machinery. A special purpose vehicle, Penelope Company Limited, was established by the fund to acquire the shares in Savio.

Savio is a producer of textiles machinery. Through its wholly-owned subsidiary Loepfe, it is engaged in the production of electronic yarn clearers for automatic winders (which are essentially devices that clean yarn when it is being wound, ensuring it is less likely to contain faults). Another manufacturer of such equipment is Uster Technologies Co., Ltd. (“Uster”), a company in which Alpha V is the largest shareholder with a 27.9% equity stake.

**Mofcom’s findings on the market, position of the parties therein, and effect of the proposed acquisition**

Mofcom determined that Savio and Uster are in fact the only two manufacturers of electronic yarn clearers for automatic winders in the world (with a 47.7% and 52.3% market share globally, and a similar market share split in China, for 2010).

As Mofcom considered that it was possible Alpha V (as indirect owner of Savio and major shareholder in Uster) may be able to coordinate the business operations of these two competitors, effectively creating a market monopoly, it determined that the proposed transaction may have the effects of eliminating or restricting competition.

**Mofcom’s broader findings in relation to the relevant market**

According to its decision statement, Mofcom solicited opinions from a wide range of entities during the review process. Specifically, the decision statement notes that views were solicited from relevant government authorities, trade associations, competitors in the same industry and downstream enterprises.

Based on the information it gathered, Mofcom identified that there were significant barriers to new entry into the relevant market. In particular, the decision statement indicates that Mofcom considers that it would be difficult for new entrants to access certain patents, know-how and business secrets that would play a key role in the research and development process.
development and production of electronic yarn clearers. It was also noted by Mofcom that economies of scale are very important in the relevant industry, giving the established participants a distinct advantage that may (based on historical analysis of market entry attempts) deter prospective new entrants or prove difficult for them to match.

Based on this, Mofcom appears to have determined that any attempted coordination of the conduct of Savio and Uster and exploitation of their resulting monopoly position would be unlikely to be constrained by the possibility of new entry to the market.

The conditions imposed

According to the decision statement, the transaction parties offered to take certain steps to address the concerns Mofcom had identified. Mofcom agreed with the approach, and incorporated these into its approval decision in the form of the following conditions that must be satisfied by Alpha V:

a. it must transfer its equity in Uster to one or more independent third parties within six months;

b. it must report to Mofcom the identity of the transferee(s), trading volume and transaction date;

c. it must not participate in or influence the business operation of Uster prior to the transfer; and

d. it must appoint an independent supervising trustee to supervise the equity transfer.

As is usual for such conditions, Mofcom will have the right to supervise and examine their implementation, and may intervene again if it is not satisfied that the actions of Alpha V sufficiently address the identified competition concerns.

Key take-outs

Control element

As noted above, Mofcom appears to have determined that Alpha V may be in a position to influence the strategic commercial behaviour of Uster despite holding only a 27.9% equity stake in the company. In coming to this conclusion, Mofcom had regard to matters such as the relevant shareholding structure of Uster, the voting mechanisms at Uster’s shareholders’ meetings, the historic attendance records of such shareholders’ meetings, and the composition and voting mechanism of Uster’s board of directors.

It is not necessarily surprising that Mofcom came to the conclusion it did, but it does provide some illumination on a critical area of China’s merger control regime.

While competition authorities in a number of other mature regimes have published extensive guidance on the circumstances in which minority shareholders may be deemed to be in a position to exercise significant control over their invested companies in the context of merger review, China has not yet done so. A January 2009 draft of Mofcom’s now-finalised Measures for the Notification of Concentrations of Business Operators (“Notification Measures”) did provide that a minority shareholder could be deemed to control an invested business where it had the ability (through contractual rights or other means) to do any of the following:

- decide the nomination of one or more directors or other core members of the target;
- decide the target’s financial budget, operation and sales, product pricing or significant investment;
- make decisions on significant management and operational matters, for the target,
however this wording was removed when the Notification Measures were finalised later in 2009. Accordingly, in the continued absence of formal guidance from Mofcom on this aspect, many practitioners have been consulting the guidance of foreign regimes and using this guidance as a basis for determination of the issue in the Chinese context. As evidenced by the case under discussion, this can be a particularly important issue for private equity funds in particular, who often hold stakes in more than one company in specific industry sectors.

Given that the factors taken into account by Mofcom when it was deciding this issue in the context of the latest decision broadly accord with the types of factors referenced as relevant in the guidance of foreign competition authorities such as the European Commission, there would seem to be merit in continuing this approach - although case-by-case consultation with Mofcom on such issues is always prudent.

Notably, this is not a matter confined in relevance to assessment of the effects of a proposed transaction. It is also relevant to the issue of determining when a proposed transaction must be notified, as:

• in essence, only acquisitions that result in the acquired obtaining a degree of control over the target must be notified - if the business operators participating in such a transaction meet applicable turnover thresholds; and
• in applying the aforementioned thresholds, it is necessary to take into account not only the turnover of the directly participating business operators, but also their broader corporate group - the scope of which in summary is in essence determined by reference to which entities are directly or indirectly controlled by the ultimate parents of a participating business operator.

Accordingly, this decision may be seen as shedding some light (or at least confirmation) on factors to consider when identifying ‘control’ relationships in these additional contexts, and further underlines how important it will be for Mofcom to issue definitive guidance on the topic in due course.

It is also interesting to note that Mofcom’s position on whether Alpha V would be able to coordinate the business operations of both Savio and Uster does not appear to have been absolute. Specifically, the decision statement notes that Mofcom considered this possibility could not be discounted, and thereby indicates that Mofcom was not satisfied on the alternative view from either its own investigations or on the basis of the information provided by the parties. This should serve as a reminder to business operators who need to file transactions in China about the often heavy evidentiary burden they may be required to satisfy on such aspects to achieve a positive review outcome, particularly as Mofcom’s own investigation resources can be stretched at times due to the high volume of transactions it now reviews.

**REVIEW TIMING**

Mofcom’s formal review process in relation to this transaction lasted 8 weeks. This is shorter than the average formal review period for transactions in respect of which conditionals are imposed, but is broadly consistent with the average duration for all of Mofcom’s overall reviews.

It is important that business operators who need to file transactions in China keep in mind the potential for lengthy delays in securing approvals (conditionals or otherwise), and reflect this in deal terms and general transaction planning. It is not just the formal review period that need to be accommodated, but also the time for preparation of the filing and for awaiting its acceptance by Mofcom. Indeed, prior to the formal review period commencing in this case, there was a period of approximately seven weeks between initial submission of the filing and Mofcom’s acceptance that the filing was complete. During this period, the parties were requested to submit
Concluding comments

Although this is only Mofcom’s second conditional approval decision of 2011, it comes during a period when there are increasing signs of a more active approach being taken by Mofcom in the area of merger review.

In addition to reviewing an increasing number of transactions, and strengthening cooperation with international competition authorities in this field, Mofcom is also producing new implementing regulations to further clarify and formalise key aspects of the regime.

For example, it is understood comments from experts were recently sought on Mofcom’s Provisions on Conditional Clearance of Concentration (expected to be finalised in 2012). Two other key promulgations, the Interim Measures for Investigating and Disposing of Suspected Monopolistic Concentrations of Undertakings below the Thresholds for Notification and the Interim Measures for Investigating and Disposing of Suspected Concentration of Undertakings Failing to File Notification in Accordance with the Law, are expected to be issued even sooner - and these may pave the way for Mofcom to start actively penalising parties who infringe the notification obligation or other aspects of China’s merger control regime.

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