Skadden

As President Xi's Power Grows, So Does China's Presence on World Stage

Contributing Partners

Christopher W. Betts / Hong Kong

Steve Kwok / Hong Kong

Of Counsel

Antony Dapiran / Hong Kong

In October 2017 at the Chinese Communist Party National Congress, President Xi Jinping consolidated his hold on power and cemented himself as what many commentators are calling the most powerful Chinese leader since Mao Zedong.

President Xi came to power when he replaced Hu Jintao as general secretary of the Chinese Communist Party at the 18th Party Congress in 2012 and, in accordance with tradition, assumed the role of president at the subsequent meeting of China's parliament. By convention, Chinese leaders serve two five-year terms, and so at the 19th Party Congress last year, President Xi was expected to appoint a likely successor to a senior leadership role. However, this did not happen, triggering speculation that he was preparing to serve beyond the customary two terms.

President Xi's position was further bolstered when the Congress unanimously elected to write his signature ideological theory — "Xi Jinping Thought on Socialism With Chinese Characteristics for a New Era" — into the party Constitution, the first time since Mao that a Chinese leader has received such recognition. All the signs indicate that, whether in a formal leadership role or from behind the scenes, President Xi will continue to wield influence in China for a long time to come.

As a result, his priorities will continue to play a significant role in Chinese policy. President Xi wants a greater leadership role for China internationally, and the Congress endorsed this enthusiastically. It also endorsed continued policies of "socialist modernization" and building China into a "moderately prosperous society," all while maintaining strict party control.

Under President Xi, we expect to see an increasingly muscular China on the world stage as well as limited liberalization within the country. (For example, the internet will continue to be tightly controlled.) We may see limited further opening of opportunities for foreign investors — China recently announced some relaxation of the rules restricting foreign investment in financial institutions — but these opportunities likely would be measured and only sufficient to justify China's position as an ostensible promoter of an open global trading order.

Government Role in Outbound, Inbound Activity

In late 2016, China imposed new restrictions on outbound foreign investments, including a cap on renminbi-denominated loans issued outside China and a requirement that the loans be registered in China. In November 2016, China also imposed new limits on the amount of renminbi that Chinese companies can remit overseas. These restrictions, together with a desire to curb what some commentators have considered overly exuberant bidding for foreign assets, significantly impacted M&A volumes in greater China throughout 2017. China outbound M&A decreased from $217.2 billion to $126.1 billion. As domestic financing for outbound acquisitions also became more difficult to obtain, a number of China-based conglomerates that had been particularly active in overseas markets in prior years saw their M&A activities impacted as Chinese banking regulators requested that lenders review loans made to them. Outbound investment in 2017 dropped 30 percent from 2016 as a result of these restrictions.

The biggest development regarding inbound M&A was the first significant liberalization of China's financial sector in 10 years. In November 2017, China's

This article is from Skadden's *2018 Insights*.

Four Times Square
New York, NY 10036
212.735.3000

deputy finance minister announced that over the next five years foreign ownership restrictions will be relaxed to allow foreign firms to hold majority stakes in joint ventures with mainland Chinese securities companies and life insurance joint ventures and remove caps on foreign banks' stakes in Chinese banks and asset managers. Foreign players in the insurance and investment banking businesses currently must operate through joint ventures with domestic companies, while foreign banks (other than those based in Hong Kong) are forbidden from holding controlling interests in Chinese domestic banks. Foreign financial institutions and insurance companies likely will review their medium- to long-term strategies in China and potentially work toward securing control once regulations allow.

Technology, Infrastructure Drive Activity in 2017

Meanwhile, the value of domestic (including inbound) M&A dropped by a smaller amount, from $382.7 billion to $318.8 billion. The still-robust level of activity was driven by several emerging themes, including a growing number of projects linked to the "One Belt, One Road" policy and a significant focus on investment in emerging technology sectors.

One Belt, One Road

After four years of seemingly being little more than a slogan, China's One Belt, One Road initiative began to take shape in 2017. At the Belt and Road Forum held in Beijing in May 2017, heads of state from 29 countries as well as ministerial-level representatives from dozens more gathered to hear China promote the One Belt, One Road initiative and discuss international investment cooperation projects under it.

One of President Xi's signature initiatives, One Belt, One Road comprises two zones:

- the 21st Century Maritime Silk Road — covering the sea lanes and related land-based infrastructure from China across the South China Sea, throughout the Pacific and Indian oceans, and all the way to the Mediterranean; and
- the Silk Road Economic Belt — covering the land corridor from China through the central Asian landmass to Europe, roughly following the route of the old Silk Road.

The plan is for China to invest extensively in infrastructure projects along the two zones. Funding will come from Chinese financial institutions, the Silk Road Fund (a new Chinese $40 billion sovereign wealth fund) and two new multilateral international development banks — the Asian Infrastructure Investment Bank and the New Development Bank (formerly BRICS bank) — each aiming to raise $100 billion in funds. While specific plans remain hazy, the expectation is that the initiative will involve big money, potentially into the trillions of dollars over the next decade.

For China, the initiative serves economic as well as geostrategic purposes. Investment projects forming part of the initiative will support Chinese companies in their attempts to globalize, soak up excess Chinese industrial capacity (particularly in steel) and provide a major labor export market. Financing the projects also is expected to provide an alternative channel for China to diversify its vast foreign exchange reserves and promote the renminbi's role as an international trading and reserve currency. But the strategic goals are equally important: securing China's trade routes and supplies of key resources as well as increasing China's global influence, thereby enhancing its claims to global leadership.

For companies operating in the infrastructure and related industries, One Belt, One Road offers significant opportunities. China is looking to spend, and any project that can be reasonably seen as falling within the scope of the initiative stands to receive generous financing packages from Chinese lenders. Governments from developing nations throughout the two zones also are signing on enthusiastically, hoping to fund their own countries' infrastructure needs with Chinese money. Expectations are that the projects will be facilitated, the legal path will be smoothed and approvals will be fast-tracked in countries across the region.

Technology Sector Developments

On the technology front, many of the world's largest "unicorns" are now Chinese companies, with several raising significant capital in new investment rounds in 2017, most notably the $5.5 billion raised by Didi Chuxing. China's incumbent technology giants (Baidu, Alibaba and Tencent, often referred to collectively as "BAT") engaged in a number of major transactions during 2017, including two material acquisitions by Alibaba involving Hong Kong-listed companies operating retail businesses in China, which would appear to represent further steps in Alibaba's plan to merge its online operations with offline businesses.

Strong growth in the technology and new economy sectors also drove the greater Chinese equity markets, which remained buoyant throughout most of 2017, with Hong Kong's main Hang Seng Index exceeding 30,000 in November 2017 — a 10-year peak. Several deals — including initial public offerings (IPOs) by ZhongAn Online Insurance, China Literature and Yixin Group — achieved such significant levels of oversubscription from Hong Kong retail investors that they each locked up more than 10 percent of Hong Kong's entire monetary base during the course of their offerings. The success of the ZhongAn IPO — the first fintech IPO in Hong Kong — is likely to drive further deal activity in the fintech space in 2018.

Changes to Chinese Exchanges Could Spur Additional Capital Markets Activity

On December 15, 2017, the Hong Kong Stock Exchange announced that it was proposing amendments to Hong Kong's Listing Rules that would permit companies with dual-class share structures to list in Hong Kong. A historical aversion to such structures is perceived to have led to Alibaba's decision to list in New York. While this proposal remains subject to a consultation process expected to be undertaken in the first half of 2018, if implemented, Hong Kong could become an attractive listing venue for new economy companies with founders who retain control through shares with super-voting rights despite having had their economic interest significantly diluted through various rounds of funding.

Meanwhile, the late 2016 abolition of trading quotas under the Shanghai-Hong Kong Stock Connect scheme, which provides mainland Chinese investors with a mechanism to invest in Hong Kong-listed securities, also has given strong impetus to the Hong Kong market, resulting in net capital inflows of $81.7 billion as of the end of October 2017. Additionally, China's domestic A-share market hovered between 3,000 and 3,500 points for most of the year, significantly below the peaks of above 5,000 points in 2015 but with a stability unseen in recent years. Debt markets remained active, with around 4,600 fixed-income offerings in greater China compared to approximately 2,500 in 2016 — albeit with an overall value of approximately $1.5 trillion compared to $2.5 trillion in 2016. Deal volumes were driven in part by issuers looking to take advantage of current low rates before anticipated increases in future years. The successful $1.35 billion issue of senior notes in two tranches due 2024 and 2027, respectively, by Wynn Macau was one of the more notable transactions in the Hong Kong debt capital markets during the year that sought to take advantage of the low-rate environment.

Globalized Nature of Enforcement Requires Coordinated Response

Two factors have contributed to the increasingly globalized nature of law enforcement. First, a number of jurisdictions, with the United States in the lead, are taking increasingly aggressive positions on jurisdiction. For example, a foreign corporation or executive may become subject to the U.S. Foreign Corrupt Practices Act based on any of the following, so long as the authorities can show that it furthers the alleged bribery: a single meeting in the U.S., a money transfer that goes through a U.S. bank account or an email that passes through a server located in the U.S. Other criminal and regulatory statutes can be similarly expansive. Corporations that do not ordinarily think of themselves as having a U.S. presence sometimes are unpleasantly surprised that their fleeting U.S. contacts were sufficient to allow the U.S. authorities to assert jurisdiction over them.

For its part, China's corruption watchdog, the Central Commission for Discipline Inspection (CCDI), published guidance in December 2017 directing Chinese state-owned enterprises (SOEs) to implement safeguards to combat corruption in their foreign operations. According to a statement on the CCDI's website, SOEs need to "deeply understand the important urgency of controlling overseas risks" to "ensure the safety of China's assets, make our state enterprises strong and excellent, and cultivate world-class enterprises that are globally competitive." Until recently, China's anti-corruption campaign had focused on SOEs' domestic operations. This new directive may signal that, similar to their U.S. counterparts, the Chinese authorities are paying increasing attention to and cracking down on corrupt conduct overseas.

Second, like never before, law enforcement authorities are paying very close attention to enforcement activities in jurisdictions outside their own, and enforcement activity in one jurisdiction often generates spillover effects in another. The nature of the spillover varies. Sometimes, countries coordinate — as evidenced most recently by the Telia Company's $965 million global settlement in September 2017 with the U.S. and Dutch authorities for bribery-related offenses. Sometimes a jurisdiction piggybacks on another's already-completed investigation — as PTC learned in 2016 when, shortly after its settlement with the U.S. Department of Justice and U.S. Securities and Exchange Commission, the Chinese authorities requested information about PTC's operations in China.

And sometimes one jurisdiction's information demand runs afoul of another's laws and policies. This dilemma arises with increasing frequency for international auditing firms encountering competing demands by the U.S. accounting watchdog — the Public Company Accounting Oversight Board (PCAOB) — and the Chinese regulatory authorities. The PCAOB may request the production of audit work papers relating to certain Chinese auditing clients, and the Chinese authorities may forbid compliance with the demand on grounds of Chinese state secrecy laws. A memorandum of understanding (MOU) designed to resolve such impasses was entered into in 2013 between the PCAOB and the Chinese authorities. Nevertheless, in the past two years, two Hong Kong-based auditing firms, Crowe Horwath and PKF International, were sanctioned by the PCAOB for their alleged failure to comply, with the PCAOB rejecting these firms' argument that the MOU was the appropriate channel to initiate and resolve these document production requests and notwithstanding express objections by the Chinese authorities.

Practically speaking, what this means for multinational companies is that a regulatory inquiry from one jurisdiction is often no longer a self-contained event. Passively responding to an authority's information requests without thinking ahead and considering the implications in other jurisdictions can be a perilous strategy. Instead, companies are well-advised to, at the very outset of a government inquiry, consider the potential legal ramifications of its responses and sketch out a coordinated strategy.