State Controlled Entities

The Regulation of Chinese SOEs and Italy

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In the past year, the Chinese government has eased restrictions on Chinese companies investing overseas. Italy has become a significant target for investment by large Chinese state owned companies (SOEs), particularly those directly administered by the central government (central SOEs). Under Chinese law, SOEs are subject to special regulatory regime. What does this mean for Italian companies that are targeted for acquisition, before and afterwards?

Under Chinese law, SOEs are the corporate face of government agencies. Central SOEs are the corporate face of the central government. The government appoints, manages, and supervises SOEs for the most part through the State-Owned Assets Supervision and Administration Commission (SASAC). Jiang Jiemin, the former head of SASAC was removed office in September, 2013, and was recently put on trial on corruption charges (http://blogs.wsj.com/chinarealtime/2015/04/13/why-the-trial-of-former-chinese-oil-executive-jiang-jiemin-matters/). The current head of SASAC is Wang Yi (http://en.sasac.gov.cn/n1408028/n1408658/c1469598/content.html), who comes from a Communist Party disciplinary inspection background.

As highlighted by their regulatory structure:

- SOEs are required to implement Chinese government policy in their investments and operations;
- SOE leadership is appointed on a combination of political and professional grounds;
- Corporate decision-making involves a complicated approval process and procedures for the acquisition;
- SOE leadership is monitored through typical Communist/Party methods rather than by shareholders and SOEs are subject to limited transparency

Implementing government policy

Chinese SOE law (http://www.adcommission.gov.au/cases/documents/187-GovernmentQuestionnaire-China-Attachment128.pdf) requires an SOE to comply with national industrial policies when making investments and their operations, whether domestic or overseas. The most concise statement of Chinese industrial policies for Italy can be found in the Chinese-Italian Cooperation Plan (http://www.chinacourt.org/law/detail/2014/06/id/147866.shtml) signed by leaders of both countries in 2014.

Senior leadership of SOEs

The senior management of SOEs is appointed by SASAC, generally in coordination with the personnel division of the Communist Party, the Organizational Department. Therefore business knowledge and experience may be less important than political qualifications.

Multilevel regulatory oversight

Overseas investment by SOEs has been relaxed over the past year. Under current regulations, only offshore investment projects in which the amount of Chinese investment reaches or exceeds USD 1 billion or is in a sensitive sector or sensitive jurisdiction is subject to approval by the National Development and Reform Commission. Otherwise the transaction must be registered with China's Ministry of Commerce. The Pirelli acquisition would have been one of transactions subject to government approval.

Corporate decisionmaking

These excerpts from a blogpost (https://www.ventureoutsource.com/contract-manufacturing/understanding-working-chinese-state-owned-enterprises) by a corporate executive summarize SOE corporate decision-making:

In state-owned companies, it is always a group of people at the top who make big decisions instead of one individual.

Management is always top down. Management makes the decisions and asks employees to comply and execute. Any innovation and breakthrough ideas typically originate from the management level. Managers are highly respected by subordinates and are rarely challenged.

Oversight of SOEs

Because Chinese SOEs are government owned, they are subject to monitoring in ways that are similar to other government agencies. The principal ways are:

- Inspections by the Communist Party disciplinary agency, the Central Commission for Disciplinary Inspection;
- Auditing by the National Audit Office (http://www.cnao.gov.cn/main/index.htm);

National Audit Office

Although the SOE Law requires auditing by the National Audit Office, in March, 2015, Mr. Dong Dasheng, the former head of the National Audit Office, told a Chinese national newspaper that the $698 billion (at the end of 2013) of China's SOE overseas assets were virtually unaudited (http://zqb.cyol.com/html/2015-03/03/nw.D110000zgqnb_20150303_4-04.htm). He revealed that the unspoken rule was that the National Audit Office could audit (directly or indirectly) only 57 of the 118 central SOEs, which meant that most were unaudited. He linked the lack of audit oversight to huge losses of state assets, widespread corruption, and short-term decision-making by central SOE leaders. Mr. Dong highlighted that the National Audit Office had recommended stationing its auditors in those central SOEs, but the suggestion was opposed and called on the national leadership to establish an ongoing audit system SASAC has now appointed seven audit firms, including PWC, to audit some offshore assets. By contrast, the state investment companies of Singapore are either audited (http://www.gov.sg/government/web/content/govsg/classic/factually/Factually-041012-IstheresomethingwrongwithourReserves) by the Singapore's Auditor-General or by international audit firms.

CCDI

The CCDI, which is the same institution as the Ministry of Supervision, is taking the lead in the anti-corruption drive. Overseas assets of SOEs have only recently attracted the CCDI's attention. In February, 2015, the CCDI announced (http://english.gov.cn/news/top_news/2015/03/17/content_281475072979206.htm)that 26 central SOEs were selected for the first round of inspections and released a roadmap to cover all the SOEs in key industries (http://www.jamestown.org/single/?tx_ttnews%5Btt_news%5D=43747&tx_ttnews%5BbackPid%5D=7&cHash=e35994836aac2a3b14f95d9a240902f6#.VYZwvxOqqkp). The inspection uncovered widespread corruption.

SOE transparency

Limited transparency

Chinese SOEs are subject to limited public oversight in their activities. Although the SOE law states that information about SOE investment will be made known to the public as required by law, the amount of transparency is limited.

Conclusion

Italian companies that are or have been the target of Chinese SOE investment need to monitor Chinese government developments. In the short term, some SOE executives that have not realized the direction of Chinese government policy may look to benefit themselves and their family in the course of a transaction. However, this may put the transaction at risk, as it may be selected by PWC or other auditors for review, or alternatively, by the CCDI's inspectors.

For those Italian companies that have been acquired, in whole or part by a Chinese SOE, it does not appear in the short term that the regulation or transparency of those companies will change significantly, and acculturation to the culture of the new owners will be necessary. In the longer term, the Chinese government may decide that reducing widespread corruption in SOEs will be

reduced if government auditors are stationed in SOEs and are dispatched regularly to review the finances of offshore subsidiaries. It seems less likely that Chinese legislation will be amended significantly to make the operations of offshore SOEs will be made more transparent to the public and instead foreign law reporting requirements are likely to be a more robust tool for reviewing their operations. The Chinese taxpayer and target jurisdictions would benefit from greater transparency. Singapore could be a useful model.

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