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Emerging Policies in China's Merger Control Process: MOFCOM'S Continued Focus on Far-Reaching Conditions

I. Introduction

In April 2013, two keenly awaited MOFCOM merger decisions illustrated China's continued focus on utilising far-reaching behavioural conditions, especially in commodity transactions, which aim to strategically protect supply into China.

These recent conditional approvals, namely *Marubeni/Gavilon*, and *Glencore/Xstrata*, involved significant behavioural conditions being imposed, notwithstanding the fact that neither of the transactions in question resulted in very high market shares in China. They did, however, involve potentially sensitive sectors which require high levels of supply of primary resources into China, highlighting the importance of national interest and strategic industrial policy goals in MOFCOM's merger review process. While some previous merger decisions have been criticised for lack of reasoning, it is clear that MOFCOM is now moving towards a more transparent approach in its merger control review process, in terms of guidance, providing a more comprehensive analysis in merger decisions, and publishing a full text of the conditions it has accepted.

This alert considers the implications of MOFCOM's emerging policy imposing far-reaching behavioural conditions, which can be expensive to implement and monitor. In addition to examining these recent cases in more detail, it assesses other similar recent conditional approvals, analysing the potential effects for future international M&A transactions involving Chinese merger review from a practical perspective.

II. MOFCOM's Recent Merger Approvals: Far-Reaching Conditions Imposed

1. Marubeni/Gavilon (2013)

On April 22, 2013, MOFCOM conditionally approved this important agricultural deal, following a merger notification initially lodged by the parties with MOFCOM in June 2012, but repeatedly delayed as MOFCOM extended its review process and a re-notification was made in January 2013. The same transaction was cleared in the EU and US without conditions. The deal involved the acquisition of Gavilon, a US company which stores and distributes grains and oilseeds, by Marubeni, a Japanese diversified trading company which exports grain to China with a well-established distribution network within China.

MOFCOM imposed detailed behavioural 'hold-separate' conditions on the deal, requiring Marubeni to structure and operate each company's soya bean business separately. This obliged Marubeni to:

- establish two independent subsidiaries as the Marubeni and Gavilon operations relating to soya bean exports and sales to China, involving two separate operating teams, which must retain independent operations;

- prohibit the exchange of competitive information between the two subsidiaries, backed up by a mandatory firewall;
- prohibit the Marubeni subsidiary's purchase of soya beans from the Gavilon subsidiary, except on an arm's length basis; and
- appoint a supervising trustee.

The parties may make a reasoned submission to MOFCOM to apply to have the first three requirements withdrawn two years after MOFCOM's decision takes effect.

MOFCOM commented that such conditions were needed, otherwise the deal would be able to 'eliminate or limit' competition in China's soya bean import market. MOFCOM noted that the supply of soya beans into China is highly dependant on imports (i.e. 80% of 2012 supplies). However, Marubeni's market share in the supply of soya beans to China amounted to no more than 18% (while Gavilon's was not specifically defined in the decision but appears to have been around 1%), and the merged entity continued to face a number of strong international competitors on the market. Such market characteristics would not normally present strong competition concerns, but MOFCOM's conditions indicate that the *Marubeni/Gavilon* merger was considered to negatively affect China's soya bean supply market, by strengthening Marubeni's access to global soya bean resources.

2. Glencore/Xstrata (2013)

On April 16, 2013, MOFCOM conditionally approved the *Glencore/Xstrata* merger after a lengthy review process lasting around 12 months, including a re-notification. This marked the last of a number of approvals required from international merger control agencies. The transaction involved Glencore, the world's biggest commodity trader, with worldwide activities in the production and trade of a wide range of commodities and raw materials including metals and minerals, energy products and agricultural products. The other party, Xstrata, is a natural resources group, which is active in alloys, coal, copper, nickel and zinc. Prior to the transaction, Glencore already held a minority equity interest in Xstrata.

In this case, MOFCOM imposed far-reaching and detailed conditions in comparison to the approach taken by some of its international counterparts. These conditions included both behavioural and structural requirements:

- Behavioural - certain supply and pricing requirements for Chinese customers to ensure competitive supply, for a period of eight years from January 1, 2013, such as:
  - a continued offer to supply 900,000 metric tonnes of copper concentrate annually under long-term contracts, priced on the basis of benchmark mechanisms agreed with MOFCOM; and
  - a continued offer to supply zinc concentrate and lead concentrate at 'fair and reasonable' rates; and
- Structural - the extra-territorial divestment of Las Bambas copper mine in Peru (currently owned by Xstrata) by September 2014, at a minimum price.

While this transaction was generally recognised as raising complex issues across a number of jurisdictions, significant market share and other competition concerns were not so clear cut in the Chinese market to support such far-reaching combined behavioural and extra-territorial structural conditions. In terms of copper concentrate, the combination of Glencore and Xstrata accounted for around only 18% supply, with a number of other strong competitors active on the market. Consequently, the imposition of such conditions suggests a rather aggressive interpretation undertaken by MOFCOM, in view of the strategic imports at issue and China's dependency on them.

3. Other recent MOFCOM decisions

Despite statements by MOFCOM officials in previous conferences mentioning that their decisions in selected cases should not be interpreted as future trends, other recent MOFCOM merger decisions indicate at least a trajectory where industrial policy goals seem to influence MOFCOM's merger review process.

i) Western Digital/Hitachi GST and Seagate/Samsung (2012)

The *Western Digital/Hitachi GST* and *Seagate/Samsung* mergers represented the first examples where MOFCOM approved 'hold-separate' behavioural conditions, based on industrial policy concerns, in order to protect domestic companies.

Western Digital, Hitachi GST, Seagate and Samsung, were each among the world's five largest manufacturers of data storage drives at the time, with products including HDDs of varying sizes and capacities used in desktop computers, notebooks, and enterprise servers. MOFCOM approved the two closely timed mergers, but included various hold-separate and firewall conditions. In the case of *Western Digital/Hitachi GST* this involved a complex and far-reaching hold-separate requirement to maintain Hitachi GST as an independent competitor in the global HDD market, requiring independent manufacture, pricing and marketing. Western Digital and Hitachi GST were also prevented from substantially altering their business models or coercing customers into exclusively purchasing their HDDs.

MOFCOM appeared to be concerned that China has the greatest number of consumers who buy computers and that these consumers would potentially suffer the most from increased HDD prices. Indeed, China is also home to large numbers of manufacturers which incorporate HDDs in their computer products. As such, the hold-separate requirements in both these cases highlight MOFCOM's intention to maintain the competitive status quo of the market – which was essentially to preserve separate players in the global HDD market. MOFCOM provided for the possibility of review of these conditions after 18 months in its *Seagate/Samsung* decision, and 24 months in *Western Digital/Hitachi GST*.

ii) Silvinit/Uralkali (2011)

The *Silvinit/Uralkali* decision illustrates another example of MOFCOM approving a merger with strict behavioural conditions, involving a sensitive commodity supplied to China's agricultural industry, similar to *Marubeni/Gavilon*. The deal involved Silvinit and Uralkali, two Russian leading potash producers in the global fertilizer industry. China is one of the largest importers of potassium chloride worldwide (with half of China's demand satisfied by imports). Since more than 50% of China's imports came from the two parties and their affiliated trade companies, MOFCOM reasoned that the merger would create a monopoly in the supply of potash imports through cross-border trade.

MOFCOM therefore imposed a number of behavioural conditions under its approval decision, including requirements that the merged entity must:

- maintain its established sales process and procedures when supplying potash to customers in China, including the maintenance of direct and diligent trade and supply by rail or sea;
- continue to meet the potash demands of its Chinese customers, in both volume and product range;

- continue to apply traditional price negotiation procedures, taking account of the current/historical trading situation and unique features of the Chinese market; and
- appoint a monitoring trustee.

MOFCOM offered explanations regarding China's high level of dependence on imports of the commodity, and made specific reference to Chinese importers having to purchase imports from a single entity post-transaction. Furthermore, the strict behavioural supply, quantity and price conditions approved by MOFCOM indicate the agency's continued focus on safeguarding Chinese strategic interests.

III. Practical Outcomes for M&A Transactions Requiring MOFCOM Clearance

The above decisions illustrate MOFCOM's increasing tendency to utilise far-reaching remedies to clear mergers in China, where proposed deals are strategically important global transactions, and especially involve commodities upon which China is reliant. As discussed above, MOFCOM continues to adopt an interventionist approach to global deals despite relatively low market shares in China. Indeed, MOFCOM recently highlighted that relatively low market shares arising from a merger do not necessarily prevent anti-competitive effects, and similarly do not prevent MOFCOM from imposing restrictive conditions.

Legislative Basis

Looking to the legislative basis for this approach, Chinese Anti-Monopoly Law explicitly allows for the consideration of a transaction's impact on China's national economic development. Moreover, it seems that from a procedural perspective, MOFCOM's Anti-trust division is much less independent than other international competition agencies, meaning that separate Chinese ministries have a greater ability to influence the outcome of MOFCOM's merger decisions. In practice this means that China's industrial policy aims and protection of access to natural resources are given due consideration in addition to the competition analysis. However, MOFCOM recently commented that while industrial policies may be considered, conditions imposed are primarily driven by competition concerns (in relation to both conditional clearances in *Marubeni/Gavilon* and *Glencore/Xstrata*).

Behavioural Conditions and Commodity Deals

An increase in the use of hold-separate conditions is emerging, in addition to the imposition of supply and pricing requirements, in order to secure supply and pricing deals for Chinese customers. However, as demonstrated above, the specific cases have largely involved sensitive sectors in China, which are highly dependent on foreign companies and/or imports. It is therefore unlikely that such far-reaching behavioural conditions would be imposed on all international deals. What is clear, however, is that deals involving commodity markets which are strategically important to China are likely to have to consider behavioural conditions at an early stage, even if relatively low market shares are involved.

Increased Transparency

Until recently, MOFCOM has not been very forthcoming in terms of guidance regarding conditions. However, as observed in K&L Gates' recent alert on MOFCOM's consultation on proposed Guidance on Conditions,[1] it is welcomed that MOFCOM appears to be taking an increasingly sophisticated and transparent approach in its merger control review process, providing more insight on the practice and processes for parties who wish to propose both structural and behavioural conditions. The same can also be said in relation to its increasingly detailed merger decisions, such as *Glencore/Xstrata*, which included a detailed explanation of the conditions. This offers a valuable insight into MOFCOM's analysis and its due consideration of conditions in practice for future merging parties.

Early Contact With MOFCOM

Finally, as noted, MOFCOM conditionally cleared a number of the above mergers following a lengthy review, and in some cases this even required the parties to re-submit their merger application. This illustrates the importance of undertaking contacts with MOFCOM at an early stage of a notifiable transaction, especially where it involves the supply of key commodities in China. Conditions may well be required to be negotiated in order to get the transaction past MOFCOM, even where other anti-trust agencies have already cleared the same deal without issue. Such a process can take time, and merger parties should factor this into their transaction timetable.

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1 For more information on MOFCOM's recent consultation on its proposed guidance on conditions, namely 'Provisions on the Additional Restrictive Conditions for the Concentrations of Undertakings – Draft for Comments', please refer to K&L Gates Alert at http://www.klgates.com/mofcom-opens-public-consultation-on-detailed-merger-remedies-proposals-04-18-2013/ .