

WSGR ALERT

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CHINA UNVEILS ITS NATIONAL SECURITY REVIEW PROCESS OF FOREIGN INVESTMENTS

On February 3, 2011, the General Office of the State Council of China promulgated the *Circular on Formalizing Security Review System of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (Circular No. 6), which clarifies the mechanisms and procedures for China's national security review of foreign investments. In this WSGR Alert, we will discuss the scope of and process for China's national security review as described in Circular No. 6 and the implications for certain foreign investments and cross-border transactions in China.

Legislative Background

The concept of national security review has been a part of China's foreign investment regulations for some time, but it attracted significant public attention in 2006 when private equity firm Carlyle Group's proposed acquisition of a majority stake in Xugong Group Construction Machinery Co., Ltd., a Chinese manufacturer of heavy machinery, became the subject of a panel review organized by the Chinese Ministry of Commerce (MOFCOM). In August 2006, MOFCOM, together with several other ministries of the State Council, issued the *Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the M&A Rules). Article 12 of the M&A Rules provides that if an M&A transaction (i) would result in a foreign investor obtaining control over a domestic enterprise, and (ii) involves any key industry or is likely to have

an impact on China's economic security, the transaction parties are required to file reports to MOFCOM. MOFCOM may require termination of a transaction if the parties fail to file these reports and the transaction affects or is likely to significantly affect China's economic security. The proposed Carlyle-Xugong transaction did not obtain approval by MOFCOM even after the stake to be purchased was reduced to 45 percent. The investment eventually was abandoned by the parties in 2008.

The M&A Rules, however, did not provide implementation detail for the contemplated MOFCOM security reviews of foreign investments in Chinese enterprises. Circular No. 6 is the Chinese government's response to calls for more clarity and a formalized review mechanism.

Newly Formed Enforcement Authority

Under Circular 6, an Inter-Ministry Security Review Joint Committee of Acquisition of Domestic Enterprises by Foreign Investors (the Joint Review Committee) will be formed to review applications for acquisitions of domestic enterprises by foreign investors. The National Development and Reform Commission (NDRC) and MOFCOM will coordinate the operation of the Joint Review Committee and involve other relevant ministries in the national security reviews. It is expected that NDRC and MOFCOM will have substantial influence during the review process.

Scope and Focus of the National Security Review

Not all foreign investments in China are subject to the national security review; Circular No. 6 lists the affected industries. It also defines "acquisition of domestic enterprises by foreign investors" for security review purposes.

Affected Industries

Acquisitions of domestic enterprises by foreign investors in two categories of affected industries are subject to the security reviews under Circular No. 6:

- The first category of affected industries consists of domestic enterprises in defense and defense-related industries, enterprises located in proximity to major or sensitive military facilities, and other entities relating to national defense.
- The second category of affected industries consists of domestic enterprises involving important agricultural products, important energy and resource assets, important infrastructure, important transportation services, key technologies and major assembly, and manufacturing businesses that have national security concerns.

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Any acquisition by foreign investors of an enterprise in the first category would be subject to security review under Circular 6, while an acquisition by foreign investors of an enterprise in the second category would be subject to review only if it may result in transfer of "actual right of control" over the enterprise to one or more foreign investors.

Actual Right of Control

Under Circular 6, one or more foreign investors would be deemed to have obtained "actual right of control" over a domestic enterprise after an acquisition if they become the controlling shareholder(s) of, or in fact obtain control over, the target company. Circular No. 6 specifies that the following scenarios constitute "actual right of control":

1. After the acquisition, the foreign investors, together with their controlling parents and controlled subsidiaries, hold in the aggregate 50 percent or more of the equity interests in the target company.
2. After the acquisition, the aggregate amount of equity interests in the target company held by one or more foreign investors exceeds 50 percent.
3. The equity stake in the target company held by the foreign investors after the acquisition, although less than 50 percent, provides the foreign investors with sufficient voting rights to impose substantial influence on the resolutions made by the shareholders or the board of directors of the target company.
4. Other scenarios in which actual control over the target company's business, finance, human resource, or technology matters is transferred to the foreign investors.

Acquisition of Domestic Enterprises by Foreign Investors

The following types of transactions are deemed under Circular No. 6 to be "acquisitions of domestic enterprises by foreign investors" that may be subject to security review:

1. Foreign investors (i) acquire any existing equity interest in a non-foreign-invested company, or (ii) subscribe for any increased registered capital of a non-foreign-invested company.
2. Foreign investors (i) acquire any existing equity interest in a foreign-invested company from a Chinese shareholder, or (ii) subscribe for any increased registered capital of a foreign-invested company.
3. Foreign investors (i) establish a foreign-invested company to acquire assets from a domestic company and operate such assets, or (ii) establish a foreign-invested company to acquire equity interests in a domestic enterprise.
4. Foreign investors establish a foreign-invested company with the assets acquired from a domestic enterprise and operate such assets through such foreign-invested company.

It is clear that Circular No. 6 intends to cover both equity and asset transactions. However, unlike the Anti-Monopoly Law of China, Circular No. 6 does not cover acquisitions by foreign companies of another foreign company that has existing subsidiaries or assets in China. Therefore, a global M&A transaction between two foreign companies that have existing operations in China would not by itself trigger the national security review under Circular No. 6, but the transaction still may be subject to Chinese antitrust review under the Anti-Monopoly Law.

Review Process

The review process under Circular No. 6 consists of a filing (voluntary for foreign investors or mandated upon petition by certain parties in China), a general review, and a potential special review. This process is similar to that undertaken in the United States by the Committee on Foreign Investment in the United States (CFIUS). The main difference, however, is that all filings in the United States are initially voluntary.

The Filing

Any foreign investor acquiring a domestic enterprise shall voluntarily submit a security review application to MOFCOM if the acquisition is subject to the review process under Circular No. 6. Upon receiving an application from the foreign investor, MOFCOM, if it determines that the transaction is subject to security review under Circular No. 6, will submit the filing to the Joint Review Committee within five working days. In addition, relevant departments of the State Council, national trade associations, companies in the same industry as the target company, and companies in the upstream or downstream industries of the target company may petition, through MOFCOM, for the Joint Review Committee's national security review of an acquisition by a foreign investor. The Joint Review Committee has the discretion to determine whether to formally review a mandated petition. This essentially gives the relevant trade associations and industry competitors a channel to file a petition for national security review of any transactions they may oppose. Unlike the Chinese process, in the United States, although a third party may submit information to CFIUS regarding any transaction and CFIUS may use such information to make inquiries with the parties involved in the transaction, such a third-party submission cannot be used by CFIUS to initiate a formal review of such a transaction. The ability, however, for third parties to provide such information to CFIUS is

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significantly limited because CFIUS reviews are not made public.

The General Review

All voluntary applications submitted by MOFCOM and all mandated petitions that the Joint Review Committee decides to take on will be subject to general review by the Joint Review Committee. In the course of the general review process, the Joint Review Committee will solicit and collect opinions from the relevant ministries. If all relevant ministries indicate in their respective opinions (which are to be provided within 20 working days) that the transaction under review will not affect China's national security, the Joint Review Committee is to issue a written notice to MOFCOM of its decision after the general review. In practice, this consensus-driven approach could result in a prolonged review process since any ministry involved in the review is able to trigger the special review process described below.

The Special Review

If any of the ministries is of the opinion that the transaction would affect China's national security, the Joint Review Committee will commence a special review process within five working days of receiving such an opinion. In the special review, the Joint Review Committee will assess the transaction's impact on national security. If there remains any dissenting opinion among members of the Joint Review Committee after such an assessment, the Joint Review Committee is to submit the application to the State Council. The Joint Review Committee is required to finish any special review process or submit the application to the State Council within 60 working days.

Outcomes of the Security Review

MOFCOM is responsible for notifying the applicant of the Joint Review Committee's decision. In cases where the transaction is deemed to have affected or be likely to significantly affect China's national security, the Joint Review Committee is to direct MOFCOM to coordinate with other relevant governmental entities to terminate the transaction or impose other measures (e.g., reducing the equity stake being transferred or ring-fencing the sensitive assets) to mitigate the transaction's impact on national security.

Conclusion

Circular No. 6 is a major step toward formalizing the existing informal national security review mechanism of foreign investments in China. However, certain significant implementation details are still unspecified, such as the required contents of the applications and interpretation of "national security." Moreover, the thresholds in such reviews are to a certain extent inherently subjective. How exactly Circular No. 6 will be implemented and what its impact on foreign investments in the affected industries will be therefore remains to be tested by practice.

For more information on Circular No. 6 or any related matter, please contact Weiheng Chen in Hong Kong and Shanghai; Eva Wang in Shanghai; Marty Korman, Barry Taylor, Scott Anthony, or Todd Cleary in Palo Alto; Michael Ringler, Robert Ishii, Denny Kwon, or Lawrence Chu in San Francisco; or Scott Sher or Joshua Holzer in Washington, D.C.

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