

To: Our Clients and Friends

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New National Security Review Could Add Another Regulatory Hurdle for Mergers and Acquisitions in China

On February 3, the General Office of the PRC State Council promulgated a new notice that will increase government regulation on the mergers and acquisitions (“M&A”) of Chinese domestic companies by foreign investors. The circular, “Notice Regarding the Establishment of National Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors” (the “Notice”), will come into effect on March 5, 2011 and will establish an inter-ministerial panel (the “Panel”) to perform national security reviews on certain M&A transactions.

Key aspects of the Notice are summarized below:

Scope of the Security Review

The scope of the new security review covers the following:

- M&As of domestic military industry or military industry supporting enterprises by foreign investors;
- Enterprises located near key or sensitive military facilities;
- Other entities relating to national defense security; and
- Important agriculture, important energy and resource, important infrastructure, important transport service, key technology, material assembly manufacturing domestic enterprises that affect national security where foreign investors could obtain actual controlling rights.

The Notice outlines the following transactions as an M&A of a domestic enterprise by a foreign investor:

- A foreign investor purchases equity in a domestic non-foreign invested enterprise or subscribes to the capital increase of a domestic non-foreign invested enterprise, which transforms the said enterprise into a foreign-invested enterprise (“FIE”);
- A foreign investor purchases the equity held by Chinese shareholders in a domestic FIE, or subscribes to a capital increase of a domestic FIE in China;
- A foreign investor establishes an FIE then purchases and operates the assets of a domestic enterprise through the FIE, or uses the FIE to purchase equity in a domestic enterprise; or
- A foreign investor directly purchases the assets of a domestic enterprise to invest and establish an FIE to operate such assets.

According to the Notice, a foreign investor obtains the actual controlling rights of a domestic enterprise through an M&A when it becomes the controlling shareholder or obtains actual control in the following circumstances:

- A foreign investor and its controlling parent company and/or controlling subsidiary hold a total stake of 50% or more in the target company after the M&A;
- Multiple foreign investors together hold a stake of 50% or more in the target company after the M&A;
- A foreign investor holds less than a 50% stake in the target company after the M&A, but the actual voting rights of the foreign investor are sufficient to exert a major impact on a shareholder's meeting or the board of directors. The Notice does not specify in what circumstance a minority shareholder may have sufficient voting rights to exert a major impact; or
- Other circumstances that may result in the control of certain functions of the domestic enterprise, such as business decision-making, financial affairs, human resources, and technologies, being transferred to the foreign investor. The Notice does not explain what can be categorized as technologies. It is unlikely to cover all technologies developed or licensed to the domestic enterprise. We expect the government will issue new guidelines to clarify this point in the near future.

Security Review Considerations

The Panel will consider the following factors when examining M&As of domestic enterprises by foreign investors:

- The impact of the transaction on national defense security, including China's capability to manufacture products and provide services, or capability to provide the relevant equipment and facilities needed for national defense security;
- The impact of the transaction on the stable operation of the national economy;
- The impact of the transaction on the basic social order; and
- The impact of the transaction on the capacity to research and develop key technologies related to national security.

Review Body

The Panel will be established and operate under the State Council and be headed by the National Development and Reform Commission and the Ministry of Commerce ("MOFCOM"), along with other departments that may be relevant to M&A transactions by foreign investors.

Security Review Procedure

Foreign investors engaging in an M&A of a domestic enterprise should make an application with MOFCOM in accordance with this Notice. If the transaction falls under the scope of a national security review as outlined by the Notice, MOFCOM will file a request for a security review with the Panel within five working days. The Notice does not specify a dollar amount or any threshold beyond which an application with MOFCOM will become necessary. However, it is unlikely referring to every M&A transaction. This would be very

burdensome and we expect the government will issue new guidelines to clarify this point in the near future.

Other entities can also apply through MOFCOM to review an M&A transaction, including agencies of the State Council, national trade associations, competing enterprises in the same trade, and upstream and downstream enterprises. The Panel can initiate the review if it agrees that a review is necessary.

The Panel will start with a general review. Within five working days after receiving MOFCOM's application, the Panel needs to solicit written opinions from relevant government departments. These departments will have 20 working days to issue their opinions. If the consensus is that the M&A will not impact national security, the Panel will issue its review opinion within five working days upon receiving all the department opinions and inform MOFCOM in writing. Therefore, a general review that ultimately approves an M&A should take no more than 30 working days before the Panel submits its opinion to MOFCOM.

MOFCOM is responsible for notifying the applicant of the Panel's security review opinion, although the Notice does not clarify how long it will take MOFCOM to inform the applicant.

Special Review

The Panel will conduct a special review for M&A transactions that do not pass the general review. If any departments believe that the M&A could impact national security, the Panel will initiate such special review procedures within five working days upon receiving the written opinions. For the special review the Panel will organize a security assessment on the M&A transaction and conduct the review in consideration of the received opinions.

Once the Panel initiates special review procedures, it will have 60 working days to either complete the review, or in the event of a major divergence in views, report to the State Council.

If a M&A transaction is found to have exerted, or is likely to exert a major impact on national security, the Panel has the authority to require MOFCOM and other government departments to terminate the transaction, or take other measures such as transferring relevant equity or assets to eliminate the impact of the M&A on China's national security.

Impact

Previously, foreign investors conducting an M&A had two major considerations. First, the M&A had to comply with Chinese guidelines regulating whether the targeted industry was open to foreign investment. Second, the M&A transaction could not violate Chinese antimonopoly law. Foreign investors will now need to also consider whether to report the M&A transaction to MOFCOM for a national security review.

The Notice will likely add additional transaction costs and unpredictability to M&As by foreign investors. However we cannot presently evaluate how significant these burdens will be due to the Notice's vague wording. Furthermore, the Notice does not provide an

obligation to report threshold, lacks an explanation of its broad review scope, and does not include any safe harbor.

On February 17, a spokesperson for MOFCOM stated that the ministry is currently preparing more detailed and operable implementation rules and guidelines. We can therefore expect more detailed guidelines to be released within the next few weeks.

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