

## Client Alert.

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# China's New National Security Review Process for Foreign Acquisitions: Crossing the River by Feeling the Stones

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China's State Council recently released long-anticipated guidelines, entitled the Notice on the Establishment of the Security Review System for Foreign Mergers and Acquisitions of Domestic Enterprises 《关于建立外国投资者并购境内企业安全审查制度的通知》 (the Notice), for the establishment of a panel review process for acquisitions by foreign investors of domestic enterprises that have national security implications. The Notice is dated February 3, 2011, and will become effective on March 5, 2011 – 30 days after its promulgation.

The State Council has put in place a review system that follows to a significant degree the national security review procedure undertaken by the Committee on Foreign Investment in the United States (CFIUS). The announcement by the State Council of the security review system coincides with CFIUS's recent high-profile ruling against an acquisition in the United States by Chinese telecommunications equipment manufacturer Huawei, although it is unlikely the events are connected.

On February 16, 2011, the National Development and Reform Commission (NDRC) published informal questions and answers 《国家发展改革委有关负责人就建立外资并购安全审查制度答记者问》 (the Q&A) regarding the Notice. The Q&A aligns the establishment of the security review system with China's continuing economic and regulatory development.

While the Notice and the Q&A are short on detail in respect of the specific scope of transactions that are likely to be subject to review as well as the specific procedures that the review process will follow, a general framework for the review process is presented. NDRC and the Ministry of Commerce (MOFCOM), the two agencies empowered by the State Council to lead the review process, as well as a multiagency review panel to be established by the NDRC and MOFCOM (Panel), have been granted fairly broad discretion to determine these matters. This broad discretion within the general framework may mean, as a practical matter, that the review process will be developed through experience, "crossing the river by feeling the stones" (摸着石头过河), to borrow Deng Xiaoping's famous adage.

A brief overview of the guidelines follows.

### BACKGROUND

The acquisition of equity interests in and assets of domestic or foreign-invested enterprises (FIEs) in China is subject to the oversight of MOFCOM. Under the current Regulations on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors, promulgated by MOFCOM and five other Chinese government agencies on August 8, 2006, and subsequently amended by MOFCOM on June 22, 2009 《关于外国投资者并购境内企业的规定》 (M&A Rules)<sup>i</sup>, MOFCOM has the authority to review transactions involving key industries or famous brands and transactions affecting

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national security. Parties to such transactions are required to submit an application to MOFCOM for review of the transaction. Despite such a requirement, the M&A Rules are silent on the security review mechanisms and procedures. The Notice provides initial guidance on the relevant mechanisms and processes to be adopted by authorizing the Panel to review relevant transactions and stipulating general timeframes for the completion of such reviews. The Q&A emphasizes that the security review will be a part of the existing system for foreign investment approval.

According to the Notice, the effects of the transaction will be analyzed by the Panel in terms of not only national security, but also effects on economic and social stability, technological development, and production capacity.

## TRANSACTIONS

The Notice broadly states that the following types of transactions will be subject to security review:

- “mergers and acquisitions of a domestic enterprise by a foreign investor” involving defense and military industries, enterprises adjacent to key or sensitive military facilities, and other industries relevant to national security; and
- “mergers and acquisitions of a domestic enterprise by a foreign investor” involving a change of “actual control” of an enterprise in key agricultural, energy, basic infrastructure, transportation, technology, and equipment manufacturing sectors.

The term “mergers and acquisitions of a domestic enterprise by a foreign investor” in turn is loosely defined in the Notice as:

- equity transactions – for a secondary transfer of an equity interest held by a Chinese shareholder of a domestic enterprise or an FIE to a foreign investor or the capital increase (or subscription of new equity) by a foreign investor in an existing FIE or domestic company; and
- asset transactions – for the direct purchase of the assets of a domestic enterprise or FIE, or the indirect acquisition of such assets through an FIE by a foreign investor.

“Actual control” is defined in the Notice as:

- an aggregate shareholding by foreign investors, their parent companies, or subsidiaries of over 50% in the target company;
- the ability to otherwise exercise material influence over the decisions of shareholders or the board of directors of the target company through its or their voting rights; or
- the transfer to foreign investors of control of a domestic enterprise’s management decisions, policies, finances, human resources, or technologies.

The Notice does not provide specific guidance regarding the meaning of “material influence” over voting rights or further information on the transfer of control. As with reviews under CFIUS, the Panel is likely to analyze whether there is “actual control” based on the specific nature of the transaction.

We note that Panel review under the Notice for industries unrelated to national defense (i.e., for key agricultural, energy, basic infrastructure, transportation, technology and equipment manufacturing sectors) is triggered only where there is an acquisition of actual control by foreign investors. However, any foreign acquisition related to the defense and military industries will trigger such Panel review whether or not there will be a change in actual control. Physical proximity to a sensitive military installation is also a relevant criterion.

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We also note that the scope of “mergers and acquisitions of a domestic enterprise by a foreign investor” described in the Notice is broader than the current scope of transactions described under the M&A Rules. For example, a secondary transfer by a Chinese shareholder of its equity interest in an existing FIE to a foreign investor and a capital increase (or subscription to new equity) by a foreign investor in an existing FIE are both covered under the Notice but are not covered by the M&A Rules.

This breadth of scope is not limited by a dollar value threshold to trigger review. Instead, transactions will be evaluated based on effects on national security including the ability to produce vital goods, services, equipment, and facilities, on social order and economic stability, and on domestic research and development capabilities for national security technologies.

Since the issuing body of the Notice is the State Council, the highest executive governmental organ in China, it appears that the broadening of the scope of transactions regarded as foreign acquisitions appears authorized and intentional. Based on our informal consultations with officials at MOFCOM, we do not anticipate further regulatory guidance on the practical application of the criteria of review. However, we anticipate that further regulations may be promulgated regarding Panel processes and review procedures in the near future.

According to the Notice, separate regulations on review of acquisitions by foreign investors of domestic financial enterprises will also be issued, although it is not clear when. Acquisitions involving State-owned assets are to be dealt with in accordance with existing relevant regulations and procedures regarding State-owned assets.

## PANEL

The Notice provides that the Panel will be established and governed under the direction of the State Council and led by the NDRC and MOFCOM, in coordination with relevant agencies specific to the target industry.

The role of the Panel will be to review the relevant transaction, research and coordinate responses to issues raised during the review process, analyze the effects of the transaction on national security, and issue a ruling on the transaction. As under the CFIUS process, involving various executive government agencies ensures that different perspectives and interests are considered as part of the review.

## REVIEW

Foreign investors pursuing a transaction covered by the Notice should apply to MOFCOM for review. If MOFCOM determines that the transaction is covered by the Notice, it will then submit the case to the Panel within five working days. However, the Q&A clarifies that, while the Panel may request additional filings and information during the review process, no separate filing is required to initiate Panel review.

Given the broad scope of transactions covered by the Notice, it is likely that a foreign investor will submit its transaction to MOFCOM for review to obtain certainty that the transaction does not raise national security or other concerns covered by the Notice, or if it does, to permit the Chinese government to address any such concerns. This is the approach taken by foreign investors in the United States that routinely make CFIUS filings even though such filings are voluntary.

Government agencies, industrial associations and other enterprises in the relevant industry, such as competitors and upstream and downstream enterprises, may also recommend to MOFCOM that a transaction be submitted to the Panel.

The Notice does not discuss protection of confidential information, but does state that relevant agencies shall protect state

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and commercial secrets, as well as, among other values, promote the healthy development of foreign acquisitions and maintain national security.

## LEVELS

The Notice contemplates two levels of review: a “general” review conducted for all transactions submitted by MOFCOM, and a “special” review for those which do not pass the “general” review.

- “general” review

As part of a “general” review, the Panel solicits written comments from relevant agencies within five working days after receiving the case from MOFCOM. Comments from relevant agencies are due back to the Panel within 20 working days after they receive the request. If the relevant agencies unanimously determine the transaction does not affect national security, only a “general review” is conducted and a decision by the Panel should be made within five working days after it receives comments from the relevant agencies. Thus, in principle, the whole “general” review process should be completed within 30 working days after receiving the case from MOFCOM.

- “special” review

However, if a relevant agency believes a transaction has the potential to affect national security, the Panel is then required to conduct a security assessment under a “special” review process. This “special” level of review should be concluded within 60 working days unless the Panel has not reached consensus on a ruling, in which case the transaction is submitted to the State Council for further review.

This structure is similar to the CFIUS review process that has an initial 30-day review period and an extended 45-day investigation for transactions that are not cleared during the initial review. Transactions that remain unresolved after the 45-day investigation are presented to the President for a final determination. In the CFIUS review process it is extremely rare for a transaction to be presented to the President for a final determination. It remains to be seen whether the practice for Chinese national security reviews will be for the Panel to complete the reviews, or if it becomes common to present transactions to the State Council for a final determination.

It is also of note that the Notice allows applicants to apply to MOFCOM to revise or withdraw the transaction at any time during the review process.

## OUTCOMES

The Panel will notify MOFCOM in writing of its results, who will in turn notify applying parties of the results.

A transaction that is found to have affected or have the potential to affect national security may be prohibited, or the Panel may require the foreign investor to agree to specific mitigation measures to eliminate the effect on national security presented by the transaction.

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<sup>i</sup> For more related Morrison & Foerster’s M&A legal updates, please refer to our website [www.mofo.com](http://www.mofo.com) or visit the following links:

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China Takes First Steps in Implementing New Anti-Monopoly Law by Revising Pre-Merger Notification Filing Thresholds and Dividing Enforcement Responsibility (August 2008)

<http://www.mofo.com/pubs/xpqPublicationDetail.aspx?xpST=PubDetail&pub=8122>

People's Republic of China Passes Comprehensive Anti-Monopoly Law (September 2007)

<http://www.mofo.com/peoples-republic-of-china-passes-comprehensive-anti-monopoly-law-09-19-2007>

Amended China M&A Rules Alter the Landscape of Offshore-Onshore Restructurings in China (August 2006)

<http://www.mofo.com/pubs/xpqPublicationDetail.aspx?xpST=PubDetail&pub=7275>