

## China's New National Security Review Procedures for Mergers and Acquisitions Involving Foreign Investors

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In the Circular on Establishing the Security Review System for Mergers and Acquisitions of Enterprises within China involving Foreign Investors ("Security Review Circular") dated 3 February 2011, the State Council lays out a formal national security review process ("National Security Review") for mergers and acquisitions ("M&A") of companies within China involving foreign investors.

The key points of this rule are as follows:

- The Security Review Circular stipulates a mandatory filing for any M&A where the target is a Domestic Company involving foreign investors within one of the targeted sectors;
- Both share sales and asset purchases are caught by the Security Review Circular.
- The process for a "cross-ministerial joint conference" under the State Council ("Joint Conference") to review a transaction submitted by the Ministry of Commerce ("MOFCOM") will involve a two-phase procedure, whereby a transaction may be cleared in the first phase called "general review", or, if any of the departments concerned believes that the transaction under review may impact on national security, it will go into a second phase, called "special review", in which the Joint Conference will launch a strict security evaluation;
- Due to the Security Review Circular includes certain uncertainties, the risk that the government departments will go beyond the scope of the reviews and look at additional political or policy factors in order to protect domestic industries still remains;.
- The Security Review Circular will come into effect 30 days after the date of its promulgation.

### Detailed content on the Security Review Circular

#### • Targeted sectors:

Category A Targets: where the target is a military industry enterprise, a supporting enterprise for military industry enterprises or an enterprise located close to sensitive military facilities. Category B Targets: where the target of an M&A transaction involves agricultural products, energy sources and resources, infrastructure, transportation services, technologies, and equipment manufacturing. It will only be caught where it is involved in important/key/critical products or technologies etc, related to national security or where the foreign investor will acquire "actual control" over the target company as a result of the M&A transaction.

- **Types of Transactions Caught:**

Both share sales and asset purchases are caught by the Security Review Circular.

The following four main types of structures are caught:

1. A foreign investor acquires equity interests in a non-foreign-invested enterprise in China ("Domestic Enterprise"), or subscribes for an increase in the registered capital of a Domestic Enterprise, thereby converting the Domestic Enterprise into an FIE.
2. A foreign investor acquires the equity interests of the Chinese shareholder in an FIE in China, or subscribes to an increase in the capital of such enterprise.
3. A foreign investor establishes an FIE and agrees by contract to acquire and operate the assets of a Domestic Enterprise through such FIE; or the foreign investor acquires equity interests in a Domestic Enterprise through such FIE.
4. A foreign investor directly acquires the assets of a Domestic Enterprise and uses such assets to invest in, and establish, an FIE to operate said assets.

- **Considered factors**

Under the Security Review Circular, whether a proposed M&A transaction constitutes a threat to national security will be determined by looking at its potential impact on the following:

1. The production and supply of products and services and the relevant facilities necessary for national defence within China;
2. National economic stability;
3. Order within society;
4. China's ability to research and develop key technologies relating to national security.

- **Constitution of the National Security Reviewing Body**

A "cross-ministerial joint conference" under the State Council ("Joint Conference") will be established to carry out the national security reviews under the Security Review Circular. The Joint Conference will be led by the National Development and Reform Commission ("NDRC") and MOFCOM under the overall leadership of the State Council.

- **Review process**

Foreign investors who are party to an M&A transaction are required to file the Relevant Transaction with MOFCOM. MOFCOM must determine within five business days of receiving a filing whether or not to submit the Relevant Transaction to the Joint Conference for a national security review. During the general review phase, the Joint Conference will, within five business days of MOFCOM making a submission, seek written opinions from the relevant government departments. If any of the departments concerned believes that the transaction under review may impact on national security, within five business days of receipt of such feedback from the department concerned, the Joint Conference will launch the second "special review" phase. If the members of the Joint Conference can reach consensus on the transaction, the Joint Conference will issue a

decision and then MOFCOM will notify the applicant of such decision in writing. However, in the event that there is a "material difference of opinion" amongst the members of the Joint Conference following the conclusion of the second phase review, the matter will be submitted to the State Council for a final decision.

- **Decisions**

If an M&A transaction under review is found to have caused or is likely to have a significant negative impact on national security, the Joint Conference may instruct MOFCOM to work with other relevant departments in charge to either terminate the transaction, order transfer of shares or assets, or take other actions to eliminate the negative impact on state security.

- **Observations and implications**

The Security Review Circular introduces to China for the first time the widely anticipated national security review regime for M&A transactions of Domestic Enterprises involving foreign investors. However, there are some unclear issues as below in the Security Circular, which may increase the foreign investors' risk to launch M&A transactions in China:

A. It remains unclear what specific sub-sectors should fall within the scope of sectors where a National Security Review is mandatory;

B. While ostensibly ruled upon by MOFCOM, the matter was reportedly escalated to the State Council in what could be seen as an echo of the process under the Security Review Circular when the relevant departments fail to agree on how to deal with a transaction at the conclusion of the second phase "special review";

C. It is not clear when the foreign investor has to file an application for National Security Review with MOFCOM;

D. Whether it has suspensive effect on the underlying transaction is still uncertain,

E. The relatively short text of the Security Review Circular also includes some procedural questions, for example, the required documentation for preparing a filing is still not stated clearly, it is also not certain that which departments under MOFCOM will be responsible for the security review.

In conclusion, due to the fact that the wording of the circular is vague and the outcome of the process lacks transparency, the Security Circular seems actually as a mechanism of MOFCOM to prevent politically undesirable transactions. The foreign investors will need to formulate and execute a strategy to deal with the challenges arising from the Joint Conference formed by many players with diverse and divergent interests, which will obviously cost the foreign investors more time and more material resource to process the M&A transactions in China than before.

