

China Alert on 25 February 2011

China's New National Security Review Procedures for Mergers and Acquisitions Involving Foreign Investors: A New Hurdle for Foreign Investors or China Just Putting Existing Practice To Paper?

On 12 February 2011, the General Office of China's State Council released new rules to introduce a national security review system for mergers and acquisitions ("**M&A**") of companies within China involving foreign investors. 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 various categories of inbound M&A transactions involving foreign investors. The Security Review Circular will come into effect 30 days after the date of its promulgation.

This new regime for controlling foreign investments, which will be independent of the existing merger review procedure under the *People's Republic of China Anti-Monopoly Law* ("**AML**"), appears to present yet another regulatory hurdle for foreign companies wishing to acquire Chinese companies. It is not clear from the Security Review Circular whether all foreign investors carrying out an M&A transaction in China which technically falls within the acquisition structures caught by the Security Review Circular will have to file, or just those that involve the relevant industry sectors caught by the Security Review Circular, namely Category A Targets and Category B Targets (each as defined below).

Targeted sectors

Under the Security Review Circular, whether a National Security Review is required depends not only on the structure of the M&A transaction (see below) but also on the nature of the business carried on by the target: 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 A Target**") then provided:

- (a) it involves an M&A transaction within the scope regulated by the Security Review Circular; and
- (b) the target is a Category A Target,

it will be subject to National Security Review, regardless of all other factors. So the National Security Review procedures will apply, even if, for example, the foreign investor only seeks to acquire a small minority stake held by a Chinese party in an existing foreign-invested enterprise ("**FIE**") or the amount involved is very small. By way of example, smaller transactions are exempted under the similar review process carried out by Australia's Foreign Investment Review Board ("**FIRB**").

On the other hand, where the target of an M&A transaction involves agricultural products, energy sources and resources, infrastructure, transportation services, technologies, and equipment manufacturing (each a "**Category B Target**") and the M&A transaction structure is within the scope regulated by the Security Review Circular, it will only be caught where the transaction meets the following three criteria:

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- (a) the Category B Target is involved in important/key/critical products or technologies etc.;
 - (b) they are related to national security; and
 - (c) where the foreign investor will acquire "actual control" over the target company as a result of the M&A transaction.

"**Actual control**" is defined in the Security Review Circular to mean either:

- (a) the situation where as a result of the M&A transaction one or more foreign investor acquires at least 50 percent of the shares in the target company, or despite acquiring less than 50 percent of the target company, such foreign investor(s) nonetheless acquires the ability to exercise significant influence over the shareholders resolutions or board resolutions of the target company; or
- (b) other situations where the foreign investor is able to exercise control over the operational decisions, finance, personnel, technologies, and so forth of the domestic company as a result of the M&A transaction.

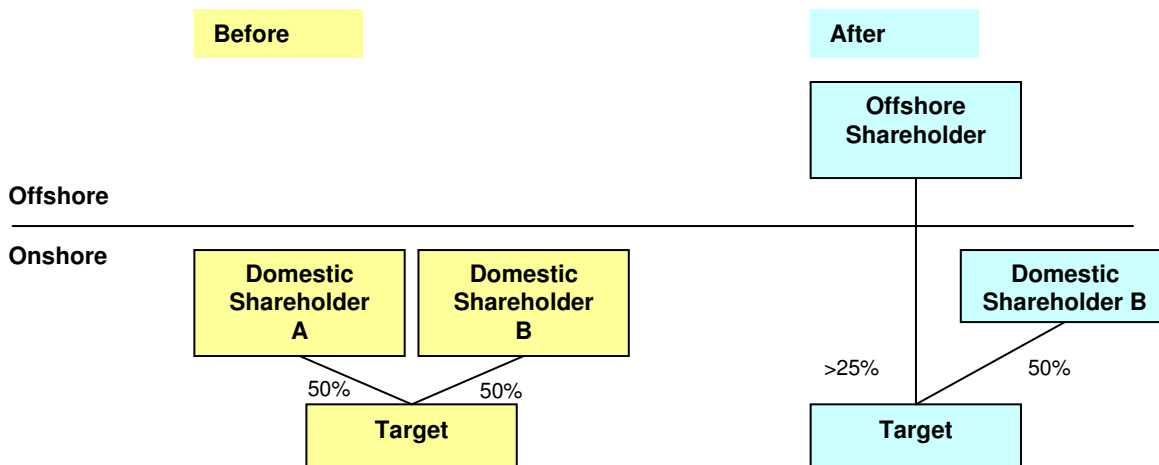
Types of Transactions Caught

Both share sales and asset purchases are caught by the Security Review Circular. As there is no definition of "assets" given, the Security Review Circular could potentially encompass a wide range of asset acquisitions, including those relating to intellectual property rights portfolios.

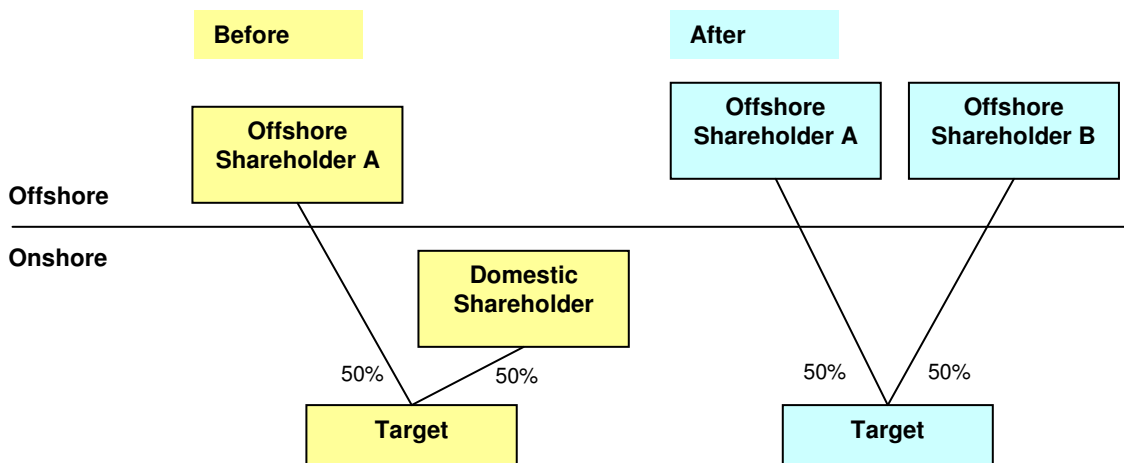
The following four main types of structures are caught¹:

- (a) 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. We have presumed that this reference to turning into an FIE refers to the commonly accepted definition of an FIE hence acquiring 25% or more of the equity interests, although this is not made clear on the face of the Security Review Circular.

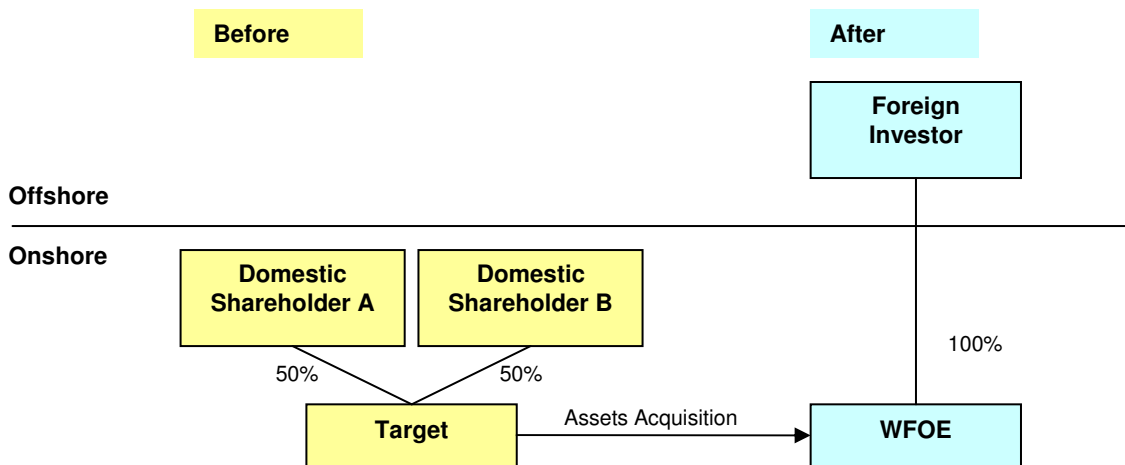
¹ The shareholdings are for illustrative purposes only and are not stipulated in the Security Review Circular except where stated in this note.



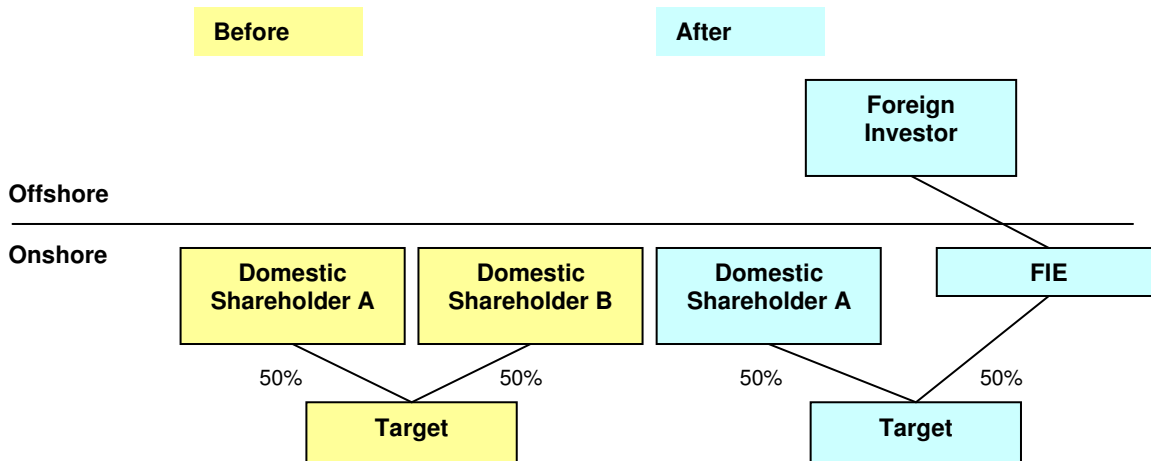
(b) A foreign investor acquires the equity interests of the Chinese shareholder in an FIE in China, or subscribes to an increase in the capital of such enterprise.



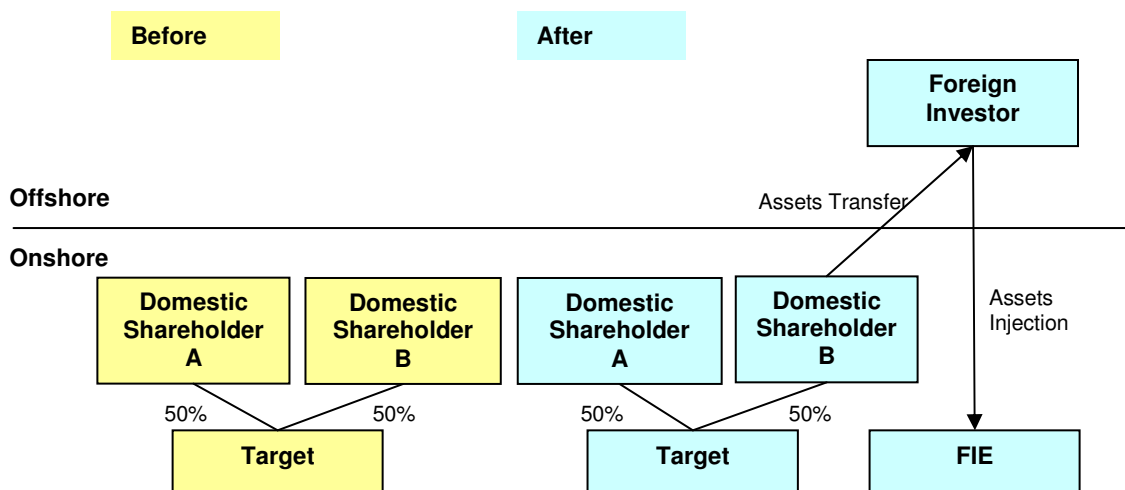
(c) A foreign investor establishes an FIE and agrees by contract to acquire and operate the assets of a Domestic Enterprise through such FIE; or the foreign investor acquires equity interests in a Domestic Enterprise through such FIE.



OR



- (d) 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:

- the production and supply of products and services and the relevant facilities necessary for national defence within China;
- national economic stability;
- order within society;
- 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 the Ministry of Commerce ("**MOFCOM**") under the overall leadership of the State Council. Other members of the Joint Conference will be determined on an *ad hoc* basis, depending on the specific industry sectors involved. This format is reminiscent of the CFIUS² regime in the United States, which, according to an NDRC press release, was one of the models for the China national security review system, as set out in the Security Review Circular. It is interesting also that NDRC clarified in the press release that National Security Review is not considered an additional

² Committee on Foreign Investment in the United States.

"administrative license" required by companies. MOFCOM will act as the liaison point coordinating between the Joint Conference and interested parties, such as the applicant for a National Security Review.

Review process

Under the Security Review Circular, foreign investors who are party to an M&A transaction which falls within the scope of M&A transactions regulated by the Security Review Circular (a "**Relevant 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. In addition, Chinese government departments, national trade associations, competitors, suppliers and customers can recommend to MOFCOM that a National Security Review be carried out in relation to an M&A transaction involving a foreign investor, as they see fit. There is no requirement that the M&A transaction meet any specific criteria in order to be reported by such interested parties, or that the latter have to satisfy certain requirements to have standing.

This wording resembles a similar provision under the AML and raises the possibility of enterprises in China reporting competitors to gain a competitive advantage and/or government bodies reporting due to protectionist motivations. The process for the Joint Conference to review a transaction submitted by MOFCOM will, like an AML merger control filing, involve a two-phase procedure, whereby a transaction may be cleared in the first phase called "general review", or, if not so cleared, it will go into a second phase, called "special 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 on the transaction, and the relevant departments are required to give their feedback within 20 business days of receipt of the Joint Conference's request for comments.

If none of the departments concerned believes that the transaction under review would endanger national security, the special review phase will not be initiated. In such case, within five business days of it receiving feedback from all the departments concerned, the Joint Conference will clear the transaction and MOFCOM will notify the applicant in writing of the outcome of the National Security Review.

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. During the special review phase, the Joint Conference will organize the members of the Joint Conference to carry out a security evaluation in relation to the M&A transaction. 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. The Joint Conference is required to complete the special review phase within 60 business days, meaning that it has to either come to a decision on its own or submit the case to the State Council for a final decision within such a period. For cases submitted to the State Council for a final decision, there is no specific timeline for the State Council to make the final decision.

During the National Security Review process, the applicant is allowed to apply to MOFCOM to amend or cancel the proposed M&A transaction. There is no indication as to whether the applicant has the right to

lobby or make formal representations to MOFCOM during the review process, so this may give rise to the need for a new type of relationship building in China with people who are responsible for the National Security Review process within various government bodies including MOFCOM, although it seems likely that this will remain essentially a closed-door process.

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. This could, of course, have a catastrophic impact on a transaction that has already completed, but in substance is little different from the right to unwind a transaction that is completed prior to the issuance of a MOFCOM decision under the AML. The main difference is that turnover thresholds under the State Council rules to implement the AML are relatively clear and easy to apply. Here, working out whether an agricultural products target qualifies as "key" involves a more difficult subjective assessment of the situation.

Observations

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. The first observation to make about the Security Review Circular is that there is nothing new in the concept. As early as the *Provisions on Mergers and Acquisitions of Companies within China by Foreign Investors* as revised in 2006 (the "**M&A Rules**"), there was a concept of a national security test being applied to certain M&A transactions. The only thing that observers have been waiting for is clarity on the scope of the test and a mechanism that implements the concept. It is unclear whether the security Review Circular effectively supersedes the test under the M&A Rules.³

The fact that the Security Review Circular at least makes it very clear that the national security review is separate from the merger control review under the AML is to be welcomed. In principle, competition factors and national security factors should be given separate and distinct consideration in the merger review and the national security review processes respectively. However, at the end of 2010 the Minister of MOFCOM somewhat muddied the waters by requiring MOFCOM and its local agencies to "organically combine the administration of foreign investment with the anti-monopoly review of concentrations of business operators and the national security review of foreign M&A to protect the security of domestic industries in accordance with the law."⁴ This worrying statement seems to indicate a protectionist attitude towards foreign investors, so the concern that the government departments will go beyond the scope of the reviews and look at additional political or policy factors still remains.

³ Article 12 of the M&A Rules reads: "Where a foreign investor acquires a domestic enterprise and obtains actual control, and where the acquisition involves a key industry, or involves some elements that affect, or may affect the State's economic security, or result in the transfer of actual control in a domestic enterprise holding famous trademarks or time-honored Chinese trade names, the parties must report to [central] MOFCOM on the acquisition accordingly." This raises the question of whether, as a result of the Security Review Circular, acquisitions of Chinese enterprises holding famous trademarks or time-honoured trade names no longer, of themselves, expressly trigger a National Security Review.

⁴ See Chen Deming's speech at the 2010 national commercial work conference, available at <http://www.mofcom.gov.cn/aarticle/ae/ai/201012/20101207323117.html> (last visited on February 15, 2011).

The Security Review Circular creates certain uncertainties surrounding the functioning of the new regime. The Security Review Circular appears to stipulate a mandatory filing for any M&A where the target is a Domestic Company involving foreign investors within one of the targeted sectors, but it remains unclear what specific sub-sectors should fall within the scope of sectors where a National Security Review is mandatory. For example, it is unclear which types of transportation services (airline, railway road, ship, motorbike, long-distance bus, multimodal?) would be regarded as being important enough to fall within the category of "major transportation services" and hence will be caught by the Security Review Circular. It seems unreasonable that even certain low value or transactions involving small minority stakes would be reportable. Moreover, while it is welcomed that the Security Review Circular enumerates a limited number of four elements as the basis for review without a catch-all provision, they are worded in sufficiently wide terms so as to allow virtually absolute discretion. Furthermore, the National Security Review procedure seems to go beyond a classic national security review process in that the impact of obviously political factors such as the national economy and social stability are factors to be considered.

People looking at this issue from the outside will, however, be asking why China needs another mechanism to block cross-border M&A transactions involving foreign investors, when China already has merger control review (for transactions meeting the turnover thresholds) and MOFCOM approval (for onshore transactions), which may involve the exercise of limited discretionary powers. Perhaps it is a question of China giving itself the appearance of codifying a process which has unofficially been in place for some considerable period of time. For example, observers have noted that MOFCOM may not have made the final decision in the blocking of Coca-Cola's proposed acquisition of Huiyuan Juice under the AML. 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".

Furthermore, we see the balance being heavily tipped in favour of a review going into the second phase: assuming numerous interested departments are involved in the phase one general review, how likely is it that at not a single one of them will, based on its own interests (including protecting domestic competitors) have any concerns?

Other key aspects of the Security Review Circular that are less than ideal are:

- (a) it is not clear when the foreign investor has to file an application for National Security Review with MOFCOM;
- (b) the Security Review Circular does not state clearly whether it has suspensive effect on the underlying transaction, although the references to decisions to terminate the underlying transaction suggest that it does not require the foreign investor to make completion conditional on clearance under the Security Review Circular;
- (c) it is unclear as to whether all foreign investors involved in any M&A transaction must file an application with MOFCOM or just those whose transactions fall within the scope of the Security Review Circular (only the latter interpretation really makes sense to us);

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- (d) the Security Review Circular deploys the classic sweep of language on the scope of M&A transactions caught: "any other scenarios which would cause the rights to exercise actual control over operational decisions, financial personnel and technological affairs of a Domestic company". This leaves the application of the Security Review Circular in relation to venture capital or other transactions involving acquisitions of a Chinese-Chinese-Foreign or variable interest entity structure (commonly seen in the telecoms and internet industry) open to question.

The relatively short text of the Security Review Circular also leaves a number of procedural questions unresolved. First of all, the Security Review Circular does not provide a list of any of the required documentation for making a filing. Second, although MOFCOM is designated by the Security Review Circular to be responsible for receiving filings and communicating with applicants, it is still unclear which department under MOFCOM will be taking this role. Also, unlike the AML which requires all merger review decisions that block or impose remedies on a transaction to be published, the Security Review Circular seems to only mention that it would notify the applicant of the result. Such a lack of transparency in the process makes it difficult for the business community to understand how the new regime will operate and when to make an early decision to abandon a politically difficult acquisition.

In conclusion, we see the Security Review Circular as being a mechanism which simply adds to MOFCOM's existing arsenal of tools to block politically undesirable transactions. There is a large swathe of discretion built into the wording of the criteria when carrying out a National Security Review and precious little transparency on the outcome of the process, thereby making it very easy to couch an essentially political decision in national security terms, although the same criticisms could also be levelled at FIRB in Australia and CFIUS in the US. There is no indication of whether any appeal or review against an unfavourable National Security Review is permitted, so it appears to be a final, unappealable decision (although once again the same is true of a decision under CFIUS, for example).

Whilst overall it is always better to have the relative certainty of something on paper than nothing, with the previous highly ambiguous position under the M&A Rules and the AML being clearly unsatisfactory, it will take some time and some fairly detailed implementing rules before foreign investors are able to fully grasp the impact of, and become comfortable with this development. National Security Review may serve to add to the "China risk premium" on certain transactions; whilst some conditional clearance or prohibition decisions under the AML must be made public under the AML, there appears to be no public disclosure obligation even as to outcomes, so it will be difficult for others to learn from previous transactions in which they were not involved. Whilst there is, of course, an understandable unwillingness to disclose matters which are seen as related to national security, this adds a further variable and layer of uncertainty that will need to be factored into a business decision to invest in China through the M&A route.

Companies will need to formulate and execute a strategy to address the challenges arising from the Security Review Circular. Facing an *ad hoc* conference made up of many players with diverse and divergent interests will require preparation and out-of-the-box thinking, and tailor-made solutions. Companies will need to bring together teams of well-connected and experienced advisors, drawn from related fields such as those with experience of the approvals process for foreign direct investments in China, the merger control procedure under the AML, as well as those with hands-on experience of national security reviews in foreign jurisdictions, to answer questions, reduce review times and smooth the passage through this new procedure.

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Hogan Lovells has a team of lawyers specialising in the fields of trade, investment and regulatory issues around the globe, with experience in CFIUS and other foreign investment-related review procedures. If you are interested in obtaining an unofficial English translation of the Security Review Circular produced by Hogan Lovells, please contact Hose Mitamura in our Shanghai Office at hose.mitamura@hoganlovells.com.

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