

## China Corporate Alert – September 2011

### New MOFCOM Rules Expand Scope of National Security Review

On August 25, 2011, the Ministry of Commerce ("**MOFCOM**") issued the *Provisions Implementing the Security Review System for Mergers and Acquisitions of Enterprises within China Involving Foreign Investors* (the "**Provisions**").

The Provisions replace the *Interim Rules* which MOFCOM had adopted shortly after the enactment of the basic text regulating the national security review process, the State Council's *Circular on Establishing the Security Review System for Mergers and Acquisitions of Enterprises within China Involving Foreign Investors* (the "**State Council Circular**"). The Provisions took effect from September 1, 2011.

Like the Interim Rules, the main goal of the Provisions is to regulate the procedure applicable to transactions falling under the scope of the national security review. The vast majority of the procedural steps and documentary requirements imposed on foreign investors are identical to those stipulated in the Interim Rules. However, there have been a few significant changes.

In particular, the Provisions include an "anti-circumvention clause" that requires analysis of the "substantive content and actual impact" of the transaction to determine whether it is caught by the national security system. Investors are prohibited from setting up indirect mechanisms – such as trusts, leasing arrangements or offshore transactions, for example – to by-pass the system. This is a significant change, particularly with respect to offshore transactions which are structured to avoid onshore Chinese regulatory approvals. Foreign private equity and venture capital investors generally prefer to invest in offshore holding companies which are set up by Mainland Chinese founders and which hold equity interests in onshore Chinese operating companies. This is for a number of reasons, including tax but also the lack of flexibility in Chinese corporate laws, which do not expressly permit or restrict the issue of convertible redeemable preference shares with each series having a distinct "basket" of rights. Under the previous State Council Circular, an acquisition of such offshore holding companies would arguably not trigger a filing with MOFCOM for national security review. In contrast, the Provisions indicate that the Chinese government will now look directly at the substance of the transaction i.e., the onshore China operations and assets, regardless of whether they are packaged in offshore structures.

The effect of this provision may go far beyond the national security area, indicating a potential policy initiative on the part of MOFCOM to target certain types of investment structures (e.g., "sino structures" widely seen in the telecoms and media sectors) which might not previously have been expressly caught under the pre-existing regulatory framework.

In addition, the Provisions essentially restate a provision previously set out in the Interim Rules containing specifics about the national security review process, pursuant to which relevant ministries, national industry associations, competitors, suppliers and customers can file a complaint with MOFCOM. This provision may indicate the importance attached to the role of third party "whistle blowers" who will assist MOFCOM in enforcing the national security system by exposing transactions that MOFCOM itself may not have uncovered. Moreover, the Provisions stipulate that MOFCOM may require interested parties to also submit relevant explanations.

Lastly, MOFCOM preserves the pre-notification consultation mechanism in the Provisions and further clarifies that this consultation is not a prerequisite to the submission of a formal application. Information disclosed during the consultation procedure does not have legal force and will not serve as the basis for the submission of a formal application.

Although neither MOFCOM nor the Joint Conference which is responsible for conducting the substantive national security review are known to have issued any decision under the new national security system to date, foreign investors will need to bear in mind the new system when planning transactions relating to China. Given that foreign investment approval procedures will be suspended until 15 days after the national security filing has been accepted, investors should consider treating the national security review as the first step in the process.

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If you would like to obtain an unofficial courtesy translation of the Provisions discussed in this Client Alert, please contact our marketing manager Gelian Xi at gelian.xi@hoganlovells.com or +86 10 6582 9559.

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