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October 17, 2011

## China Establishes National Security Review System for Inbound M&A Transactions

On August 25, 2011, the Ministry of Commerce (“MOFCOM”) promulgated the *Provisions of the Ministry of Commerce on the Implementation of Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors* (“Provisions”). The Provisions came into effect on September 1, 2011 and replaced interim regulations issued by MOFCOM early this year, which had a trial period from March 5, 2011 through August 31, 2011 (the “Interim Regulations”). Compared with the Interim Regulations, no significant changes are introduced by the Provisions; however, the Provisions formalize the procedures of the national security review for inbound M&A transactions by foreign investors.

### Legislation Development

On August 8, 2006, MOFCOM, together with five other government authorities, promulgated the *Rules on the Merger and Acquisition of Domestic Enterprises by Foreign Investors* (“M&A Rules”). The M&A Rules, for the first time, called for notification and review of an inbound M&A transaction that might have an impact on China’s “national economic security”.

Subsequent to the M&A Rules, the PRC Anti-Monopoly Law enacted in 2008 (“AML”) required a broader “national security” review when a foreign investor participates in the concentration of business operators by merging or acquiring a domestic enterprise or by any other means where national security is involved.

On February 3, 2011, the General Office of the PRC State Council issued the *Notice on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (“Notice”). The Notice came into effect on March 5, 2011 and formally established the national security review system for inbound M&A transactions by foreign investors.

On March 4, 2011, one day before the Notice came into effect, MOFCOM issued the Interim Regulations which provided interim rules for implementation of the national security review system as established in the Notice.

Most recently, as mentioned in the first paragraph of this article, MOFCOM finalized and issued the Provisions which, together with the Notice, formalized the national security review system of China and will have a broad impact on inbound M&A transactions by foreign investors going forward.

## Scope of Security Review

### *Industry Sectors Subject to Review*

National security review covers the following major industry sectors:

- national defense industry, including military industry enterprises and military industry supporting enterprises, enterprises located near key and sensitive military facilities, and other entities which have an impact on national defense security. Any acquisition of an interest (which need not be more than 50% or a controlling interest) in any of these businesses will be subject to security review.
- other sensitive industries, including important agricultural products, important energy and resources, important infrastructure, important transport service, key technology and major equipment manufacturing. Any acquisition of actual control of businesses in these sensitive industries will be subject to security review.

### *Transactions Subject to Review*

According to the Notice, the M&A of domestic enterprises by foreign investors refers to the following four types of transactions:

- (i) foreign investors purchase the equity interests of a Chinese enterprise or subscribe for the increased capital of a Chinese enterprise;
- (ii) foreign investors purchase the equity interests of a Chinese shareholder of a foreign-invested enterprise (FIE) in China or subscribe for the increased capital of an FIE;
- (iii) foreign investors set up an FIE and use it to purchase and operate the assets of a Chinese enterprise, or use the FIE to purchase the equity interests of a Chinese enterprise; and
- (iv) foreign investors directly purchase the assets of a Chinese enterprise and establish an FIE based on such assets to operate the assets.

### *Actual Control*

The Notice sets different thresholds for triggering security review for M&A of military-related enterprises and M&A of domestic enterprises in other sensitive industries. In the latter case, only if the foreign investor would acquire actual control over the domestic enterprise via the M&A transaction shall such transaction be subject to security review. Under the Notice, actual control over a domestic enterprise refers to a foreign investor becoming the controlling shareholder or a *de facto* controller of the domestic enterprise, which includes the following circumstances:

- a foreign investor and its parent company and subsidiaries hold in the aggregate more than 50% of the total shares of a domestic enterprise after acquisition;
- multiple foreign investors hold more than 50% of total shares of a domestic enterprise after acquisition;
- a foreign investor holds less than 50% of the total shares of a domestic enterprise after acquisition, but the voting right of the foreign investor could have material influence on the resolutions of the shareholder meeting or the resolutions of the board of directors; and
- other circumstances which may lead to a foreign investor's *de facto* control over a domestic enterprise, including its operational decisions, financing, personnel and technology.

### *No Circumvention*

The Provisions state that the issue of whether an M&A transaction by foreign investors falls within the scope of security review shall be judged based on the substance and actual impact of the transaction. In addition, the Provisions expressly prohibit the foreign investors from circumventing security review by any means, including, without limitation, nominee holding structure, trust, multilayer re-investment, leasing, lending, contractual control arrangement, and offshore transactions.

### **Content of Security Review**

An M&A transaction that is subject to security review will be reviewed and approved or blocked based on the following factors:

- impact of M&A transaction on the national defense security, including influence on domestic manufacturing capabilities, services and related facilities and equipment required by national defense;
- impact of M&A transaction on the steady operation of the national economy;
- impact of M&A transaction on basic social life and order; and
- impact of M&A transaction on China's ability to research and develop key technologies for national security.

### **Procedures of Security Review**

#### *Review Authorities*

According to the Notice and the Provisions, MOFCOM is responsible for the preliminary security review of M&A transactions by foreign investors. If MOFCOM determines that an M&A transaction falls within the scope of the security review, it will forward the case to the Ministerial Panel, a joint panel consisting of representatives of the National Development and Reform Commission ("NDRC"), MOFCOM and other relevant government authorities for substantive and final review.

#### *Initiation of Review*

The security review process for M&A transactions by foreign investors may be initiated by any of the following three ways:

- (i) Voluntary Filing: The foreign investor involved in an M&A transaction that may be subject to security review can voluntarily file an application for preliminary review with MOFCOM;
- (ii) Referred Reporting: The local MOFCOM will report the transaction to MOFCOM and require the foreign investor to file an application for preliminary review with MOFCOM if it finds that an M&A transaction is subject to security review.
- (iii) Request by Third Parties: Concerned government authorities, national industrial associations, competitors and upstream and downstream enterprises can submit a request to MOFCOM to conduct a security review if they believe that an M&A transaction falls within the scope of security review.

#### *Review Process and Timeline*

Before filing a formal application for security review with MOFCOM, foreign investors may request a pre-filing consultation regarding the procedural issues relating to the

proposed M&A transaction. However, this is not a mandatory procedure and the result of the consultation doesn't have any binding effect and cannot be relied on as the basis for making formal application.

After the official filing of an application for security review with MOFCOM, MOFCOM shall provide a written notification to the applicant within 15 working days as to whether the proposed M&A transaction will be submitted for review by the Ministerial Panel, during which time the M&A transaction shall be put on hold and the local MOFCOM shall not approve such M&A transaction. If the applicant has not received any response from the MOFCOM after such 15-day period, the applicant can proceed to implement the M&A transaction without considering national security issues.

If MOFCOM notifies the applicant that review is necessary, MOFCOM will forward the application to the Ministerial Panel within five working days for final review of whether the transaction falls within the scope of security review. The Ministerial Panel then has five working days to solicit opinions from the relevant government authorities, which are required to submit their written opinions to the Ministerial Panel within 20 working days.

If all relevant authorities are of the opinion that the proposed M&A transaction will have no impact on national security, the Ministerial Panel will notify MOFCOM in writing within five working days and MOFCOM will notify the applicant and local MOFCOM within another five working-day period after receipt of the Ministerial Panel's written decision.

If any relevant authority has concern about national security, the Ministerial Panel will initiate a special review process, which may take 60 working days or even longer to render a decision.

### **Decision of Security Review**

The Notice and Provisions categorize the decisions of the security review into the following three types:

- No impact on national security: The applicant may proceed to implement the proposed M&A transaction by going through the relevant approval procedures;
- Potential impact on national security: If the proposed M&A transaction may have an impact on national security, the relevant parties shall terminate such transaction and applicant shall not apply for and implement the M&A transaction without amending the terms and conditions of such transaction and going through the security review process again.
- Existing or potential material impact on national security: If the M&A transaction has already caused or may cause material impact on national security, MOFCOM shall, together with other relevant government authorities, terminate the M&A transaction, or transfer the relevant equity interests or assets, or take other effective measures so as to eliminate the influences of such M&A transaction on national security.

### **Observations**

China's national security review system has only been in place for several months. At present it is difficult to assess the impact on those inbound M&A transactions

because no information on such review has been made public by the relevant government authorities. However, there is little doubt that the implementation of this national security review system will add time and cost burden on foreign investors in connection with their M&A transactions in China. While the Notice and the Provisions provide a timeline for the review process and some level of transparency on the review procedures, uncertainty for M&A transactions has been increased because neither the Notice nor the Provisions provide a clear definition of the industries within which the security review for an M&A transaction will be triggered.

In addition, perhaps the most significant implication is that the Provisions, for the first time, explicitly prohibit the use of the VIE structure to circumvent the national security review. In the past, the VIE structure has been widely adopted to avoid China's restrictions on foreign investment in certain industries or restriction on "roundtrip investments" by Chinese domestic residents, but has never been officially endorsed by any government authorities. Many fear that this is a signal of the Chinese government's intent to regulate or even eliminate the VIE structure on a wider basis, which may force some deals that are not subject to security review to be restructured or suspended until further guidance is available.