

China launches national security review system for foreign M&A

China's State Council, on 12 February 2011, published its *Notice on Establishing a Security Review System for Mergers and Acquisitions of Chinese Enterprises by Foreign Investors* (Notice). The long-awaited Notice establishes a national security review mechanism for acquisitions of Chinese companies by foreign investors that raise national security concerns.

National security review was first introduced by the *Provisions on the Acquisitions of Chinese Enterprises by Foreign Investors* (Foreign M&A Rules) promulgated in 2006 and then repeated in Article 31 of China's Anti-Monopoly Law (AML). Article 31 of the AML requires qualifying mergers and acquisitions by foreign investors to undergo separate national security review in addition to merger control review. However, neither the Foreign M&A Rules nor the AML provides any operational mechanism for national security review. The Notice, which will come into effect on 5 March 2011, for the first time sets out the sectors and types of transactions subject to national security review, as well as the procedure and nature of national security review.

This briefing highlights the main aspects of the national security review system under the Notice, and considers the likely impact of the Notice on foreign investors undertaking mergers and acquisitions (M&A activity) in China.

MAIN ASPECTS OF THE NOTICE

According to the Notice, a ministerial-level review committee (Committee) will be established under the State Council. The Committee will be led by the Ministry of Commerce (MOFCOM) and the National Development and Reform Commission, and will include other authorities in charge of the industry implicated by the relevant transaction.

Types of M&A activity covered by the Notice

The types of M&A activity covered by the Notice include: (i) the purchase by foreign investors of existing equity interest or shares or increased capital of Chinese non-foreign-invested enterprises and conversion of such domestic Chinese enterprises into foreign-invested enterprises (FIEs); (ii) the establishment by foreign investors of FIEs and the purchasing and operating of assets acquired from domestic Chinese enterprises through such FIEs; (iii) the purchase of equity interests or shares of domestic Chinese enterprises through FIEs; (iv) the purchase by foreign investors of assets owned by domestic Chinese enterprises and the establishment of FIEs to operate such assets; and (v) the purchase by foreign investors of equity interests or shares owned by Chinese parties in FIEs or the purchase by foreign investors of the increased capital of FIEs.

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It is worth noting that the types of M&A subject to review under the Notice is broader than that under the Foreign M&A Rules which does not contain (iii) and (v) mentioned above. For example, a foreign investor purchasing shares owned by the Chinese partner in a Sino-foreign joint venture might be subject to the national security review in accordance with the Notice but will not be subject to the Foreign M&A Rules.

Sectors subject to national security review

The Notice covers acquisitions by foreign investors of domestic Chinese companies active in the following sectors: (i) military including related activities, and companies located near key and sensitive military facilities; or (ii) key agricultural products, key energy or natural resources, key infrastructure and transportation services, key technologies and key equipment manufacturing activities that raise national security concerns, and in the case of (ii), where the foreign investor might acquire actual control of the target Chinese company through the M&A activity.

For the purposes of the Notice, an acquisition of "actual control" refers to a situation where a foreign investor (including its parent or subsidiary), or several foreign investors: (i) acquire 50 percent or more of the target company's equity interests or voting rights; (ii) have a significant influence over the target's shareholders' meeting or the board of directors, or (iii) obtain actual control over the target company's business decisions, financial affairs, personnel and/or technology or other matters.

Nature of the national security review

Under a national security review, the Committee will mainly investigate the impact of the M&A activity on national defence, national economic stability, social stability, and the R&D capacity for key technologies related to national security.

National security review process

A separate national security review is required alongside foreign investment approval for M&A activity and, if required, merger control approval. It is for MOFCOM to determine whether a given M&A activity requires national security review. If the M&A activity qualifies for national security review, MOFCOM is required to file a request for national security review with the Committee within 5 working days. The initial (or general) review process can last up to 30 working days. Applications that fail to receive approval during the general review process are subject to a special review process, which can last up to a further 60 working days. If the Committee determines that the M&A activity under review will have a significant effect on national security, it may require termination of the transaction. It may also approve the transaction subject to conditions so as to address the national security concerns. Conditions may include orders to dispose of equity interests or assets in the target Chinese company. To avoid termination, transactions can be modified during the national security review process and re-submitted for the Committee's review.

Relevant State Council departments, national industry associations, and other third parties (including competitors, customers and suppliers) may ask MOFCOM to investigate whether a foreign M&A activity raises national security concerns.

IMPACT OF THE NOTICE

The Notice establishes China's first formal process for evaluating national security issues arising from foreign investors' acquisitions of Chinese enterprises.

China's national security review mechanism has parallels with other jurisdictions such as the US, and other related foreign investment review procedures such as in Australia and Canada. The scope of China's national security review is broad and covers not only national defence concerns but also economic stability and social stability. In addition, the Notice does not set a minimum threshold, i.e. such as a size-of-party or size-of-transaction, for national security review to apply. As such, any transaction that falls within one of the identified categories under the Notice may be subject to review.

The Notice does not define "national security" nor does it define what is a "key sector". This leaves considerable discretion in the authorities' hands in terms of determining which transactions are ultimately subject to national security

review, and potentially terminating transactions. The Notice is also unclear as to whether it also applies to foreign acquisitions of offshore holding companies of Chinese subsidiaries. It remains unclear whether the Notice will apply to new M&A deals only or if previous transactions (for example those that are still pending approval) may be reviewed retroactively. The Notice further states that China will issue separate rules for national security review of foreign investors' M&A transactions involving Chinese financial institutions; however, when these rules will be issued remains unclear. The Notice leaves questions on the scope and impact of the national security review system unanswered. It is hoped that relevant implementing rules will be issued in due course to address these uncertainties.

With the implementation of the security review system, foreign investors intending to engage in M&A activity in sectors that fall within the Notice will now need to consider whether the contemplated transaction will be subject to national security review in addition to merger control review. Foreign investors should also be mindful of the opportunity that the Notice offers to third parties to initiate the national security review process.

The merger control review process in China is already prone to delays. The addition of national security review, if required, can be expected to add further delays to transaction timetables. It remains unclear at this stage how the merger control review process and the national security review process will fit alongside each other. Ultimately, this will depend on whether the M&A activity is required to be notified to MOFCOM; and if it is, foreign investors will need to consider carefully whether to conduct a parallel review or whether to "trigger" national security review first with merger control following closely behind (or vice versa).

Foreign investors will need to consider potential Chinese targets carefully and develop a coordinated strategy to address possible concerns, and consider possibly modifying the scope or the structure of the transaction so as to simplify the national security review process and secure approval.

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