

## New Rules Issued Regarding China's Security Review Process For Foreign Investment

On 16 February 2011, Mayer Brown JSM issued a legal update regarding a new circular published by China's legislature, the State Council, titled *Circular of the General Office of the State Council on Establishment of a Security Review System Regarding M&A of Domestic Enterprises by Foreign Investors* ("Circular 6"). Circular 6 implemented a new national security review process for certain foreign investment transactions in China. The update is available here: <http://www.mayerbrown.com/publications/article.asp?id=10450>

The new security review process under Circular 6 commenced on 5 March 2011. Just two days later, China's Ministry of Commerce ("Mofcom") published *Interim Rules of the Ministry of Commerce on Issues Relating to Implementation of Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors* ("Mofcom Rules"). The Mofcom Rules supplement Circular 6 by providing guidance on key aspects of the new security review process, including the notification method as well as the actual review process and timing.

In this update we briefly explain the background to China's new security review process for foreign investment transactions, summarise the key content of the Mofcom Rules, and explain what is now known (and what remains unknown) about the scope and procedures of the review process.

### International context

Many developed economies have 'security review' procedures relating to proposed foreign acquisitions of domestic enterprises. For example, the U.S. Committee on Foreign Investment in the United States (CFIUS) and the Foreign Investment Review Board (FIRB) of Australia are each charged with undertaking security-related reviews of certain proposed foreign investments in their respective jurisdictions.

These reviews have impacted China outbound deals on several occasions. For example:

- in 2005, CFIUS review effectively resulted in rejection of a US\$18.5 billion bid by China National Offshore Oil Corporation (CNOOC) to takeover the U.S. energy group Unocal;
- in 2009 FIRB rejected China Nonferrous Metal Mining (Group) Co. Ltd's proposed acquisition of certain mining assets of OZ Minerals Ltd; and
- more recently, in March 2011, CFIUS effectively compelled Huawei Technologies to divest 3Leaf Systems due to national security concerns.

In this context, it is not surprising that China has identified a need to broaden the scope of its power to review foreign investments, and to introduce a more transparent regime for reviewing and potentially rejecting inbound investment on national security grounds. Although the Chinese authorities have effectively had such review powers in different guises

for a number of years (as discussed further below), it has been clear for some time that the Chinese authorities believed there was a need for further regulation in this area. The recent impetus to develop a more coherent and open framework for security review may have stemmed in part from a desire to avoid accusations of hypocrisy given increasing calls from the Chinese authorities in recent times for other countries to be more transparent regarding their security review processes.

### The lead up to China's new security review regime

As mentioned above, the Chinese authorities have effectively had such review powers in different guises for a number of years. For example, Article 19 of the *Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors 2003* ("2003 M&A Regulations") listed national economic security as a consideration in review of foreign acquisitions in China. Then when the 2003 M&A Regulations were revised in 2006 ("2006 M&A Regulations") a new Article 12 introduced a requirement for foreign investors to report to Mofcom cross-border M&A deals in which a foreign investor obtained control of a domestic China enterprise and the acquisition involved key industries, may impact on national economic security, or may result in transfer of a famous trademark or traditional China brand.

Although the impact of Article 12 of the 2006 M&A Regulations was limited, in part because the Chinese authorities did not clarify precisely when, how and in what form relevant reports had to be made, some foreign investment transactions were understood to be adversely impacted by the new review process. Perhaps the most famous example was private equity firm Carlyle Group's attempted acquisition of an 85% stake in China heavy machinery manufacturer

Xugong Group Construction Machinery during the period 2005-2008. This deal was eventually abandoned after Mofcom proved reluctant to grant approval to the deal due to what had been reported as economic security concerns, even after Carlyle Group lowered its proposed acquisition stake several times (eventually to a 45% minority stake).

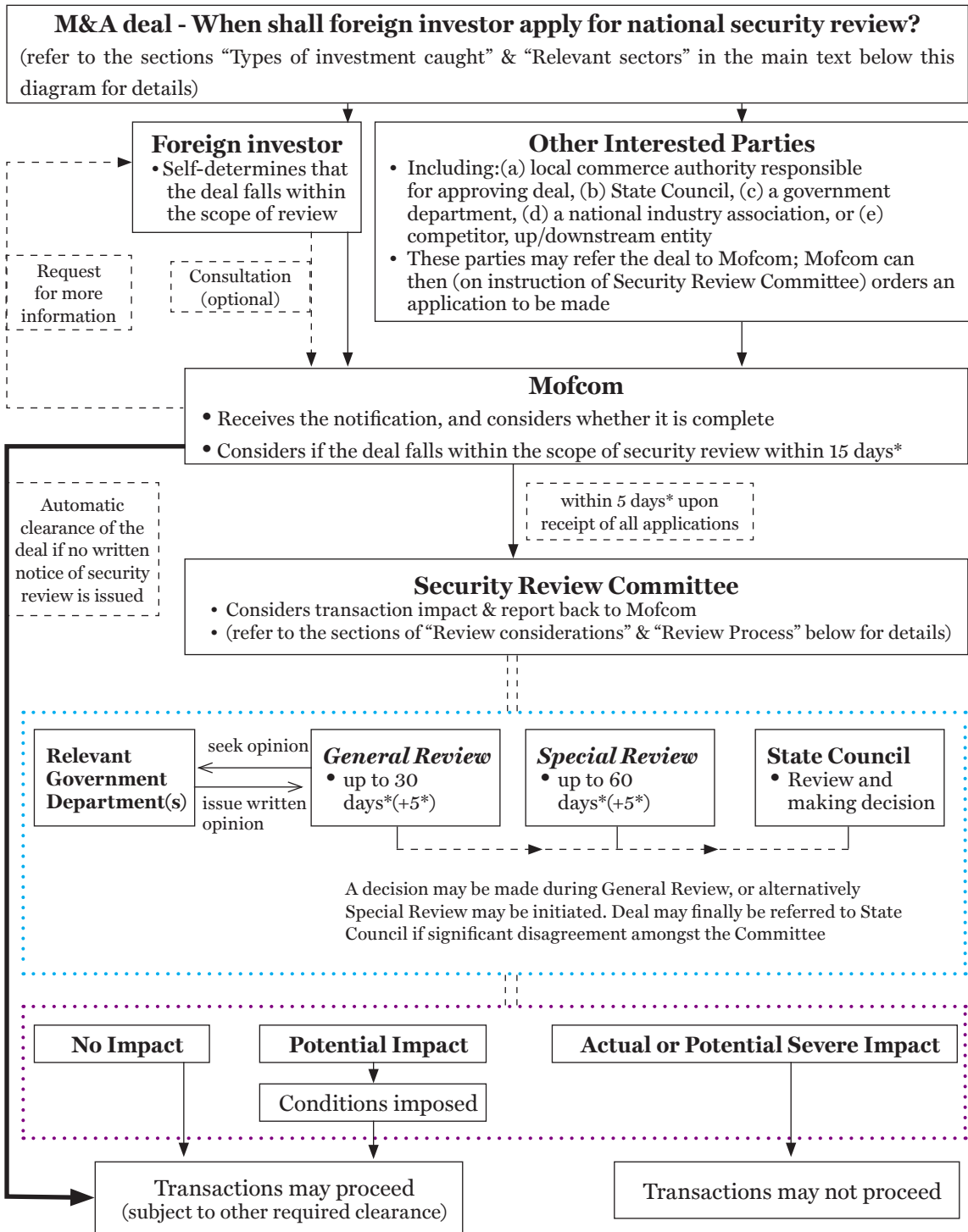
China codified national security screening requirements in national legislation for the first time in August 2007, with the inclusion in the newly promulgated Anti-Monopoly Law ("AML") of an Article (Article 31) which stipulated that foreign mergers with, and acquisitions of, domestic companies should undergo national security review "according to relevant laws and regulations". However, no new regulations or measures were introduced to provide details for the review process contemplated by this clause during the period 2007-2010.

### Introduction of Circular 6 and the Mofcom Rules

With the commencement of Circular 6 on 5 March 2011, followed by the coming into effect of the new Mofcom Rules for the period 5 March to 31 August 2011, foreign investors have finally been provided with some substantial clarity in relation to when and via what procedures foreign investment transactions will undergo security review. However, as explained below, some significant uncertainties remain about the actual scope of the new review procedures.

#### REVIEW PROCEDURE

The flow chart below outlines in basic form key aspects of the security review process under Circular 6 and the Mofcom Rules.



\*working days

Although this is not made definitively clear in Circular 6 and the Mofcom Rules, it appears foreign investors will initially have to ‘self assess’ whether their foreign investment transactions need to be reported to Mofcom under the new security review process, by reference to whether the transaction involves a relevant type of foreign investment and concerns a relevant sector. The key factors to be considered for this purpose are summarised below:

#### TYPES OF INVESTMENT CAUGHT

The following types of investment may be the subject of security reviews:

- a. Foreign investment in a domestic enterprise which is a non-FIE (in the form of acquiring equity or subscribing to the capital increase), thereby transforming it into an FIE
- b. Acquisition of Chinese shareholder held equity in an FIE, or subscribing to the capital increase of an FIE
- c. Acquisition of assets or equity from a domestic enterprise (either a non-FIE or an FIE) through an FIE
- d. Acquisition of assets of a domestic enterprise (either a non-FIE or an FIE) and operating such assets through a newly established FIE

#### RELEVANT SECTORS

The second criterion for judging whether a M&A deal is subject to security review is whether an investment of the type described above satisfies any of the following descriptions:

1. The investment involves a foreign investor making an “Acquisition of” national defence enterprises such as military industrial enterprises, enterprises in the vicinity of key or sensitive military installations, and other entities in relation to national defence, or
2. The investment involves a foreign investor “Acquiring control of” domestic enterprises that have a bearing on national security

in areas such as important agricultural products, vital energy and resources, essential infrastructure, crucial transportation services, key technologies, major equipment manufacturing.

While the exact purpose of the distinction between the two types of transaction situations set out above is not entirely clear, it appears the Chinese authorities intend to set a lower threshold for the required notifications where foreign investment transactions relate to enterprises connected with military and defence interests.

The term “acquisition of control” is defined in Circular 6 as “becoming a controlling shareholder or an actual controller of the domestic company acquired”. Further, Circular 6 makes it clear that an acquisition of control can arise through equity investment or the ability to impact board meetings or shareholder meetings, such as in the following situations:

- a. a foreign investor together with its parent holding company and/or its holding subsidiary holds 50% or more of the total shares in a relevant domestic enterprise following the relevant transaction;
- b. several foreign investors hold an aggregate of 50% or more of the total shares in a relevant domestic enterprise following the relevant transaction;
- c. even though the foreign investor does not hold 50% or more of the total shares following the M&A, the voting rights attached to the shares held by the foreign investor in a relevant domestic enterprise are sufficient to have a major influence on the resolutions of any shareholder meeting, annual general meeting, or board meeting of that enterprise;
- d. other circumstances exist which may lead to the transfer of the actual control of matters such as business decision-making, finance, personnel and technology of the domestic enterprise to the foreign investor.

If a foreign investment transaction meets the investment and sector criteria set out above, the relevant foreign investor will be required to notify certain details of the transaction to Mofcom (“Security Review Notification”) by way of application to initiate the national security review process. It remains unclear whether a separate Security Review Notification is required if an anti-monopoly notification is also submitted, but at this stage (based on informal statements by Chinese officials) that appears not to be the case.

Given the broad and non-exhaustive wording of the criteria, it seems there will be doubt in many cases as to whether a particular proposed foreign investment transaction does require a Security Review Notification – at least until further guidance or information on this aspect is published. In the interim, Circular 6 usefully provides that foreign investors may engage in consultation with Mofcom to obtain required clarity.

Other interested parties, including other PRC government departments, national industry associations, and enterprises in the same industry, can also request Mofcom to initiate a national security review process in relation to a foreign investment transaction. If Mofcom does initiate such process in response to such a request, it will direct the foreign investor to make a Security Review Notification if such notification has not already been made. The risk of such a direction coming ‘late’ in the process of implementing a proposed foreign investment transaction may cause some foreign investors to take a proactive approach in terms of self-assessing that a Security Review Notification is required so as to commence the security review process as quickly as possible (particularly given the potentially lengthy formal review process, described further below).

## Required contents of a Security Review Notification

A significant volume of information is required to be submitted to Mofcom in a Security Review Notification, including detailed information relating to the transaction and the transaction parties. However, in contrast to the process of anti-monopoly notification, applicants are not required to analyse or forecast the effect of the proposed transaction on the industry or market concerned or provide significant general industry or market data. Instead, the information to be provided in a Security Review Notification is mostly factual in nature and confined to the topics of the participating parties and the transaction itself.

## The Review process

Once Mofcom receives a Security Review Notification, it will consider whether the notification is complete (in terms of addressing all of the content requirements set out in Circular 6). If so, it will advise the applicant (the relevant foreign investor) in writing. Otherwise, the applicant will be required to furnish the necessary further information.

Once Mofcom has advised an applicant that its Security Review Notification is considered complete, Mofcom may take up to 15 days to form a view on whether it considers the notified transaction should be sent to the new Inter-Ministerial Committee that will conduct security review (“Security Review Committee”). Once a decision on this aspect is made, Mofcom then has a further 5 days for communicating the decision to the applicant.

If a transaction is referred to it for review, the Security Review Committee will undertake a preliminary review (“General Review”) of the transaction for a period of up to 30 working days, during which time it will consult with interested government departments.

If it is determined during this General Review that the transaction does not raise national security concerns, the Security Review Committee will inform Mofcom of this decision in writing (and Mofcom then has 5 further working days to report the decision to the transaction parties).

If, however, any of the government departments that are consulted consider that the transaction does raise national security concerns, a further review will take place (“Special Review”).

According to the Mofcom Rules, Special Review may take up to 60 working days, at the end of which the Security Review Committee will deliver to Mofcom a decision in writing (which Mofcom will inform the applicant within 5 working days). However, if there is significant disagreement amongst members of the Security Review Committee as to whether the transaction does give rise to security review issues, the transaction will be referred to the State Council for further consideration. No time limit for State Council consideration is provided under the Mofcom Rules.

### Review considerations

According to Circular 6, review conducted by the Security Review Committee will focus on assessing whether a foreign investment transaction will impact any one or more of the following :

- National security (and in particular domestic production capacity, domestic services provision capacity or relevant equipment and facilities that are required for national defence)
- The stability of the national economy
- Basic social life order
- The capacity of indigenous R&D of key technologies related to national security

These are obviously very broad review criteria, and foreign investors will no doubt be concerned about the breadth of discretion the Security Review Committee has to identify security concerns in respect of the China-focused transactions.

### Decision/Remedies

If the Security Review Committee determines that a M&A transaction has no impact on national security, Mofcom will issue a clearance decision and the transaction parties may proceed (subject to other required foreign investment approval and registration procedures). If the transaction is found to have potential impact on national security, the transaction parties will be required by Mofcom to adjust the transaction and obtain national security clearance for the adjusted transaction before it implements the transaction.

However, if the Security Review Committee considers that the transaction has an actual or potential severe adverse impact on national security, it may request that Mofcom coordinate with other relevant departments to either terminate the transaction or to take such other measures as may be required to eliminate the impact of the transaction on China’s national security.

### Relationship with other foreign investment review procedures

Key aspects of the relationship between China’s new security review process and the other approval procedures that may apply to foreign investment in China remains unclear. However, while some doubt remains, at this stage it seems likely that while applications for other required foreign investment approvals may be made during the process of national security review, no such approvals will be granted before the security review process concludes. This also seems the likely position in relation to any anti-monopoly approval from Mofcom that may be required for such transactions, given that the factors Mofcom takes into account when conducting anti-monopoly review include non-competition factors such as the impact of the proposed transaction on China’s national economic development.

Definitive clarification of such matters is, it must be stressed, still to be provided.

## Conclusion

It is clear China's security review process will throw up many new challenges for foreign investors, including uncertainties about when to submit Security Review Notifications to Mofcom and potential difficulties in predicting the likely timeframe – let alone outcome – of assessments by the Security Review Committee.

At this stage, prior assessment and careful planning of security-related aspects will be key risk mitigation steps for China-related transactions. Foreign investors will need to give particular consideration to whether their transaction may be considered to relate to a sector in respect of which national security sensitivities may arise, and also whether there is any prospect of other industry participants in China seeking to refer deals to Mofcom to try and instigate security reviews (whether for legitimate or more strategic reasons). The prospect of lengthy security review may need to be accounted for in transaction documentation, and in some cases, advance determination may be appropriate of whether the transaction parties are willing to carve out sensitive parts of a transaction if those parts cause delay or concerns.

While it is expected that further guidance on the security review process will be forthcoming, it is important to note that the security review process is already operational. Consultation with Mofcom on relevant uncertainties may therefore be an urgent and essential step for many proposed foreign investment transactions in China in the short to medium term.

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