China Establishes National Security Review Procedures for Acquisitions of Domestic Enterprises and Assets by Foreign Investors

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INTRODUCTION

As China continues its rapid pace of economic development, there is increasing interest among foreign investors to acquire local Chinese enterprises and assets. Control of local enterprises and assets by foreign investors may involve matters of national security for China. As a result, the Chinese government has issued a set of procedures designed to strengthen its review of acquisitions by foreign investors in sensitive sectors which may significantly increase the amount of time it takes for foreign investors to get a transaction approved by the Chinese government. If the Chinese government finds that a transaction has national security implications, the procedures grant it broad powers to amend the terms of the transaction or even cancel it.

We recommend that foreign investors interested in investing in China familiarize themselves with the contents of this memorandum and obtain legal counsel to advise them on the risks and implications of China’s new national security regulations.

New National Security Regulations

The General Office of the State Council (“State Council”) issued the Notice on Establishing a Security Review System for Acquisition of Domestic Enterprises by Foreign Investors (国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知) on 3 February 2011. It took effect on 3 March 2011 and established an extensive national security review process whenever a foreign investor seeks to acquire a local enterprise or asset (on each such occasion, a “Security Review”).

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1 The Security Regulations (国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知) was promulgated by the General Office of the State Council on 3 February 2011 and came into effect as of 3 March 2011.
Acquisitions and Private Equity Investments Impacted by Security Review

Generally speaking, the Security Review applies to a broad range of transactions resulting in significant foreign influence in certain domestic sectors that are deemed by the PRC government to have national security implications. This includes acquisitions and investments in energy, resources, and weapons manufacturing. Moreover, acquisitions and investments in ordinarily unrelated sectors will be deemed to hold national security implications if they are located near key or sensitive military facilities.

When conducting a Security review, the issue of control is very important. Transactions that will result in over 50% foreign ownership or in de facto control of a domestic enterprise in sensitive sectors will be particularly scrutinized during the Security Review. More information about the scope of application of the Security Regulations is provided below.

Agencies Conducting the Security Review

The agencies conducting a Security Review include the Ministry of Commerce ("MOFCOM") and the National Development and Reform Commission ("NDRC"). The State Council is the final authority.\(^2\)

Regulators conducting the Security Review will analyze the impact of the proposed acquisition on China’s national defense, economic stability, social order, and key technologies.\(^3\)

SCOPE OF APPLICATION OF THE SECURITY REGULATIONS

When regulators conduct a Security Review, they first analyze whether the transaction will take place in a sector that is covered under the Security Regulations. Second, after determining that the transaction is in a covered sector, regulators assess the type of transaction involved. If the type of transaction is within the scope of investigation, the final step is to assess the level of control and future impact that a foreign investor or investors will be able to gain over a domestic enterprise.

Sectors Affected

The Security Regulations apply to foreign acquisitions of domestic interests in the military sector including any enterprises that are near key or sensitive military facilities and other entities related to China’s national defense. They also cover foreign investors who acquire control over domestic enterprises in industries deemed to have a significant connection to China’s national security such as agricultural products, energy, resources, infrastructure, transportation services, technology, and equipment manufacturing. The Security Regulations give regulators wide

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\(^2\) Ibid., Article 3, Paragraph 2.

\(^3\) Ibid., Article 1, Paragraph 2.
discretion to rescind or add stipulations to a proposed transaction on national security grounds.4

Types of Transactions
Several types of transactions that fall within the scope of the Security Regulations:

1. directly purchasing equity shares in a domestic enterprise5;
2. purchasing shares of a local shareholder with equity in a foreign-invested enterprise ("FIE")6;
3. purchasing assets or equity from a domestic enterprise through a FIE7; and
4. directly purchasing assets of a domestic enterprise8.

Level of Control
The issue of control is another important variable in determining whether a given transaction will be subject to a Security Review. If actual control of the domestic enterprise passes to foreign investors in any merger or acquisition scenario involving the sectors and transactions listed above, then the transaction will be subject to a Security Review. Actual control by a foreign investor of a domestic enterprise occurs when:

1. the total number of shares held by a foreign investor, its parent holding company, and any controlled subsidiary companies is greater than or equal to 50%9;
2. the total number of shares held by multiple foreign investors is greater than or equal to 50%10;
3. the total number of shares held by a foreign investor is less than 50% but the voting power of the held shares is enough to have a material impact on the resolution of the shareholders’ meeting, the general assembly of shareholders, or the board of directors11; or
4. when a foreign investor obtains de facto control of a domestic enterprise with regards to its business decisions, financial affairs, personnel, technologies, etc. through any other means not listed above12.

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4 Ibid., Article 1, Paragraph 1.
5 Ibid., Article 1, Paragraph 2, Section 1.
6 Ibid., Article 1, Paragraph 2, Section 2.
7 Ibid., Article 1, Paragraph 2, Section 3.
8 Ibid., Article 1, Paragraph 2, Section 4.
9 Ibid., Article 1, Paragraph 3, Section 1.
10 Ibid., Article 1, Paragraph 3, Section 2.
11 Ibid., Article 1, Paragraph 3, Section 3.
12 Ibid., Article 1, Paragraph 3, Section 4.
The key point that government regulators will examine is how much influence a foreign investor has over the domestic enterprise and whether such influence is tantamount to de facto control over the domestic enterprise’s business decisions, finances, human resources, or key technologies largely irrespective of the means used to obtain such influence.

THE SECURITY REVIEW PROCESS

Special Joint Committee
Led by the State Council, the NRDC and MOFCOM will organize a special committee ("Joint Committee") comprised of relevant agencies to oversee investments by foreign investors which fall within the scope of the Security Regulations.\(^\text{13}\).

Generally, a foreign investor looking to acquire a local enterprise must submit an application to MOFCOM for review if its proposed transaction has national security implications\(^\text{14}\). Many times, it is unclear whether a transaction will affect China’s national security. In those situations, it is important to obtain legal counsel before proceeding with the transaction.

In addition, the State Council, a national trade association, an enterprise in the same industry, or even an upstream or downstream enterprise may also submit an application to MOFCOM with regards to a proposed transaction by a foreign investor if it determines that the transaction has national security implications\(^\text{15}\).

Within five (5) business days of receiving the submitted application, if MOFCOM determines that the transaction falls within the scope of Security Review, it will request members of the Joint Committee to review the transaction\(^\text{16}\). The Joint Committee process is described in further detail below.

General Review Phase of the Joint Committee
A Security Review by the Joint Committee consists of two phases: a General Review phase ("General Review") and a Special Review phase ("Special Review")\(^\text{17}\). When conducting the General Review, the Joint Committee consults with other relevant authorities on the possible impact of the proposed transaction. Within five (5) business days of receiving a MOFCOM request to initiate Security Review, the Joint Committee will solicit in writing the opinions of all the relevant departments. The departments have twenty (20) business days to respond. Within five (5) business days of receipt of all the responses, the Joint Committee will assess the opinions and if all of them stipulate that the proposed transaction does not affect China’s national security interests, a Special Review will not be required and the members of the Joint

\(^{13}\) Ibid., Article 3, Paragraph 2.
\(^{14}\) Ibid., Article 4, Paragraph 1.
\(^{15}\) Ibid., Article 4, Paragraph 2.
\(^{16}\) Ibid., Article 4, Paragraph 1.
\(^{17}\) Ibid., Article 4, Paragraph 3, Section 1.
Committee will draft and send MOFCOM their own review opinions. MOFCOM will then forward this information to the applicant.

**Special Review Phase of the Joint Committee**
However, if even one department holds that the transaction may affect China’s national security, the members of the Joint Committee will commence a Special Review within five (5) business days of receiving such notice. The Security Regulations stipulate that the members of the Joint Committee must complete Special Review within sixty (60) business days from the date of starting the Special Review or request the State Council to make a decision.

**Length of Review Processes**
A Security Review can take as long as thirty-five (35) business days when only a general review is required and up to ninety-five (95) business days in the case of a special review. The Security Regulations do not specify a timetable when a Security Review requires a State Council final decision.

**REMEDIAL MEASURES**
If the various agencies taking part in a Security Review find that the proposed transaction may involve a threat to China’s national security interests, the Joint Committee will request MOFCOM and other relevant agencies to either cancel the transaction or request the foreign investor to take remedial measures to remove the identified threat to national security. The foreign investor can also, throughout the Security Review, apply to MOFCOM to amend the proposed transaction or cancel it.

**POUNTS OF CONCERN**

**Possible Retroactive Application of the Security Regulations**
Many foreign investors are concerned about the possible retroactive application of the Security Regulations. It is not clear at this point whether the government will apply the Security Regulations retroactively to transactions that are still pending or have already obtained full regulatory approval. It is advisable, given the current uncertainties, to submit a Security Review application to MOFCOM for any acquisition in a sensitive sector (listed in the Security Regulations) where the sale agreement is executed but full regulatory approval is pending.

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18 Ibid., Article 4, Paragraph 3, Section 2.
19 Ibid., Article 4, Paragraph 5.
20 Ibid., Article 4, Paragraph 3, Section 3.
21 Ibid., Article 4, Paragraph 6.
22 Ibid., Article 4, Paragraph 4.
Unclear Terms
The Security Regulations contain many unclear terms, which may lead to apprehension about how the regulations will be applied. For example, foreign investors interested in purchasing a minority stake in a local enterprise may find it very difficult to assess whether they will be subject to a Security Review. What constitutes 'significant influence' or 'actual control' is not very well defined within the Security Regulations. This implies that even a small ownership stake in a local enterprise within a sensitive sector may trigger a Security Review.

Too Many Parties Able to Petition for a Security Review
Even if MOFCOM and the Joint Committee do not initially see the need to implement a Security Review, the Security Regulations permit a wide range of government departments, trade associations, enterprises operating in the same industry as the investment target, as well as enterprises in upstream and downstream sectors to petition MOFCOM to do so. This makes it much more likely that a transaction will be subject to a Security Review and a more lengthy approval process.

Transaction Approval Strategy Affected by Uncertainty of Security Review Implementation
Informing governmental authorities about a possible national security risk involved in a proposed transaction, particularly in situations involving the purchase of a minority interest, risks bringing attention to a matter that would not ordinarily require oversight by MOFCOM and the Joint Committee. Such a course of action would lengthen the approval process for the transaction and may enhance the risk that the transaction will be terminated or significantly changed. On the other hand, not notifying the relevant authorities at the outset invites the risk of intervention and termination of the transaction after significant time, effort, and capital has been expended. There are no clear guidelines and these two risks need to be balanced and assessed on a case-by-case basis.
CONCLUSION

Presently, it appears that the Security Regulations give the PRC government broad powers to: (1) define what transactions may affect national security interests, (2) prevent transactions from taking place that are deemed to be detrimental to national security interests, and (3) change the terms of a transaction or even cancel it to mitigate any potential national security threats.

Foreign investors looking to acquire enterprises or assets in China would be well-advised to prepare for a more complex and prolonged transaction approval process. We recommend the parties discuss these issues at the outset of a transaction and negotiate in advance an arrangement for allocating the burden of risk and costs should a Security Review terminate or change the terms of a proposed transaction.

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