

Understanding the Newly Implemented M&A Security Review System

(by Gregory Sy, gregsy@grandall.com.cn; Yin Yue, associate)

Abstract: Effective March 3 of this year, China has formalized a national security review system applicable to Mergers & Acquisitions in sectors affecting the country's national security, where a foreign investor acquires either a majority or otherwise controlling interest/influence in the target company. With a newly devised framework, implementing details and procedures are yet to be clarified, however, this article seeks to alert readers/potential investors to the necessity of filing for transactions falling within the new framework, as well as detail potential review timeframes which must be accounted for in deal timetables.

On February 3, 2011, the General Office of the State Council promulgated the *Notice of the General Office of the State Council on the Establishment of the Security Review System for Mergers and Acquisitions of and With Domestic Enterprises by Foreign Investors* (hereafter referred to as the “**Security Review Notice**”), effective March 3, setting the framework for a national security review system. Additionally, on March 4, the Ministry of Commerce (“**MOFCOM**”), in accordance with the Security Review Notice, issued the *Interim Provisions of MOFCOM on the Relevant Issues on the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (hereafter referred to as the “**Security Review Interim Provisions**”), providing detailed rules on the Security Review System.

Below we set out the scope, general framework and procedure for the Security Review System:

I. Scope of Security Review

The scope of applicability of the Security Review Notice is limited to those mergers and/or acquisitions (“**M&A's**”) set out below:

1. M&A's relating to the area of national defense, namely those involving the defense industry enterprises and other entities relating to national defense security; and
2. M&A's of domestic enterprises relating to areas of national security, such as important agricultural products, important energies and resources, important infrastructure facilities, important transportation services, key technologies, manufacturing of major equipment, etc., which lead to the obtaining of a controlling interest by foreign investors.

However, various concepts, including “relating to the national defense security” in Item (1), “relating to the areas of national security” and “important/key” in Item (2) are vague and left undefined. Further, the Security Review Interim Provisions provide no further clarification in this regard, leaving substantial uncertainty in interpreting the Security Review Notice, and possibly allowing for wide discretionary power by the relevant authorities as to transactions falling within its authority to review.

II. *Types of M&A's Covered*

"M&A's", as provided by the Security Review Notice, refers to any of the following:

1. A foreign investor purchasing shares of a domestic non-foreign-funded enterprise or subscribing to the increased capital of a domestic non-foreign-funded enterprise, and thus converting such domestic enterprise into a foreign-funded enterprise;
2. A foreign investor purchasing shares from the Chinese shareholder(s) of a domestic foreign-funded enterprise or subscribing to the increased capital of a domestic foreign-funded enterprise;
3. A foreign investor establishing a foreign-funded enterprise, through which it purchases the assets of a domestic enterprise and operates such assets, or through which it purchases the shares of a domestic enterprise; or
4. A foreign investor directly purchasing the assets of a domestic enterprise, and then investing such assets for the purposes of establishing a foreign-funded enterprise to operate said acquired assets.

III. *Obtaining of a "Controlling Interest" by Foreign Investors*

The Security Review Notice provides that a "controlling interest" either via share purchase or obtaining of actual control is met in the following circumstances:

1. The total shares held by a foreign investor, its parent holding company, and subsidiary post- merger or acquisition account for more than 50%;
2. The total shares held by multiple foreign investors post- merger or acquisition account for more than 50% in aggregate;
3. The total shares held by a foreign investor post- merger or acquisition account for less than 50%, but the voting power it holds based on its shareholding is sufficient to have a material impact on the resolution of the shareholders' meeting, the general assembly of shareholders, or the board of directors; or
4. Any other circumstance which leads to the transfer of the actual controlling power of a domestic enterprise in relation to business decisions, financial affairs, personnel, technologies, etc. to a foreign investor.

Items (1) and (2) in the above have definite quantitative criteria and are relatively clear in their scope; however, Items (3) and (4) cover a wide variety of circumstances in connection with the acquisition/transfer of power. In particular definitions such as "material impact" on shareholders' meetings, general assembly of shareholders, or board of directors, and "actual controlling power" of essential business operations lend to the difficulty in implementation of the Security Review Notice and again add to the uncertainty of which transactions will be required to undergo a Security Review.

IV. *Factors Considered in a Security Review*

The Security Review System generally provides for four factors to be considered by authorities:

1. Influence of the M&A transaction on national defense security, including the ability to produce domestic products and providing domestic services required for national defense and the relevant equipment and facilities;
2. Influence of the M&A transaction on the stable operation of the national economy;
3. Influence of the M&A transaction on the order of basic social life; and
4. Influence of the M&A transaction on the capacity for research and development of key technologies involving national security.

V. Reviewing Authority

The Security Review System provides that a joint meeting shall review a security filing, and members of the joint meeting shall be led by the State Council and organized by NDRC and MOFCOM.

VI. Procedures in a Security Review

A. Application

The Security Review System Notice provides that:

1. In a merger or acquisition falling within the purview of the Security Review Notice, the foreign investor shall file an application with MOFCOM; or
2. Where the relevant department of the State Council, a national industrial association, an enterprise in the same industry, or an upstream or downstream enterprise deems it necessary to conduct a security review of the merger or acquisition of a domestic enterprise by a foreign investor, it may put forward an application to MOFCOM. Members of the joint meeting may decide to conduct a security review if they then deem it necessary.

As a result, a security review will generally be initiated by the foreign investor, however, in some instances government authorities and other “whistleblowers” can also file an official request to MOFCOM for commencement of a security review.

B. Timing of a Security Review

Steps and timing of a Security Review:

Step	Timing
1. Notification to MOFCOM	
2. Determination by MOFCOM if	5 working days

transaction requires Security Review	
3. General Review: <ul style="list-style-type: none"> - Joint Committee request of opinions from other depts. - Opinions to be provided by relevant depts. - Joint Committee Decision 	5 working days 20 working days 5 working days (Total 30 working days)
4. Special review <ul style="list-style-type: none"> - Determined by the Joint Committee based on the opinions of other depts. 	60 working days

A Security Review could take place at the same time as an Anti-Monopoly Law-required review, so the additional requirement set out in the Security Review Notice should not further delay such a transaction. However, where the transaction does not otherwise require merger-control clearance, deal timetables must be adjusted accordingly. (Note that unlike an AML mandatory review where meeting concentration thresholds/effect of eliminating competition are not obvious to an examiner, under the Security Review system, where MOFCOM is both the security review lead authority and also the general foreign investment approval authority for the transaction itself, MOFCOM acting in its capacity as foreign investment approval authority will obviously understand the industry of the acquired/merged entity(ies), and is granted the right to temporarily stop any approval procedure until such time as the transaction has been cleared under a Security Review.)