

China Implements a Security Review System for Certain Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

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The Chinese State Council has officially implemented a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the “Review System”) based on a set of interim rules (the “Rules”) issued earlier this year.

Mergers and acquisitions by foreign acquirers (“M&A”) will be reviewed under the Review System based on factors such as the target’s industry, the type of M&A, and the right to de facto control. Foreign acquirers must submit an application to China’s Ministry of Commerce (“MOFCOM”) for review prior to certain mergers or acquisitions of a domestic enterprise.

1. Scope and Substance of Review

M&A involving certain industries must be reviewed for national security reasons (the “Restricted Industries”). The Restricted Industries include national defense, transportation services, key technology, and significant agricultural products, energy and natural resources, infrastructure, and heavy equipment manufacturing. For M&A of national defense-related enterprises, foreign acquirers must apply for a security review regardless of whether such acquirers will assume control after the M&A. For all other M&A in the Restricted Industries, security review is required only if foreign acquirers will take over control.

Pursuant to the Review System, assessment will be based on the impact of a transaction on a) national defense, b) economic stability, c) basic social order, and 4) capability for research and development of key national defense technology. In addition

to the review criteria explicitly stated, MOFCOM will be looking beyond the form of a transaction, and it will assess whether substantively, the transaction falls into the scope of the Review System and impacts the above aspects. Further, the Rules specifically state that a foreign acquirer cannot circumvent the Review System by using mechanisms such as variable interest entities, loans, and shareholding on behalf of others.

The Review System has already targeted a large scope of transactions, but it may only widen as the question of which areas of the Restricted Industries will be considered “significant” is expected to be clarified in practice. The Rules indicated that Chinese authorities are no longer turning a blind eye to circumvention mechanisms such as the VIE, and that they will be under additional scrutiny.

2. Types of Mergers and Acquisitions

Within the Restricted Industries, the Review System will focus on certain types of M&A (the “Restricted Transactions”). The Restricted Transactions include foreign acquirers 1) turning a domestic enterprise into a foreign-invested enterprise (“FIE”), 2) purchasing shares of an FIE from Chinese shareholders, 3) purchasing a domestic enterprise’s assets and continuing its operations through an FIE, or 4) purchasing all the assets of a domestic enterprise directly, then establishing an FIE to run the enterprise’s operations.

The fourth situation above adds to the three types of M&A that is under scrutiny from China’s antitrust laws. Because of the antitrust implications, foreign acquirers should be diligent in applying for a security review when they acquire all the assets of a domestic company. Further, foreign direct investment will also be subject to the Review System.

3. Control Rights

The Review System also examines M&A where a foreign acquirer gains de facto control (“Control”). These include situations where after an M&A, 1) the foreign acquirers, its affiliates, or a group of foreign acquirers, hold over 50% of the shares in a domestic company; 2) the voting rights of the foreign acquirers give them de facto control even if they hold less than 50% of the shares of a domestic company; or 3) foreign acquirers have veto rights in major corporate decisions such as those relating to the operations of the business, financing, personnel changes, or technology transfers.

4. The Review Process

MOFCOM will be responsible for leading an interdepartmental conference where applications under the Review System will be processed. Applications should be submitted towards the beginning of the M&A process so that they can proceed simultaneously. Further, if an M&A is not within scope of the Review System, then related industry associations and enterprises affected by the M&A have the option of requesting review, and the Review System may be triggered at MOFCOM's discretion.

The security review involves two steps. First is a general review, and second is a special review. During the general review, if the conference can unanimously agree that the M&A will not impact national security, then the conference will issue a written report stating such a decision within 2 months of the application submission. If the M&A fails the general review, it will proceed to special review, which will further analyze the transaction and come to a decision approximately 4 months after the application submission. During this time, applicants may continue negotiating the terms of the M&A or even call off the deal. However, the closing of a transaction may take place only after the Review System has been successfully completed.

The Rules state that applicants may informally discuss their transactions with MOFCOM prior to the formal application so that applicants may streamline the review process by getting a preliminary sense of the transaction aspects that may concern MOFCOM the most. Foreign acquirers should take into account this time-consuming process prior to engaging in M&A within the Restricted Industries.

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