

National Security Review of Mergers and Acquisitions in China by Foreign Investors

On February 3, 2011, the State Council of the People's Republic of China (PRC) issued a new regulation to implement the requirement for national security reviews of mergers and acquisitions involving domestic enterprises by foreign investors. The regulation, entitled *Circular of the General Office of the State Council on the Establishment of Security Review System Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the Circular), will come into effect in March 2011.

The Circular provides for the establishment of a new inter-ministerial-national-security-review committee under the State Council (the Committee), which will be comprised of members from the National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM) and other competent agencies.

According to the Circular, the Committee's national security reviews will apply to proposed mergers and acquisitions that would result in foreign investors obtaining actual control of domestic enterprises involved in military, national defense and security sectors, enterprises that are located near key and sensitive military facilities, key domestic areas such as agriculture, energy and resources, infrastructure, transport, technology and material equipment manufacturing. However, the new rules are silent on what constitutes "key" or "material" and, therefore, leave substantial discretion to the Chinese authorities. Similarly, the definition of "actual control" is left open ended in the Circular and includes circumstances where, upon completion of the proposed transaction, 50% or more of the enterprise's equity interests will be held by foreign investors or voting rights sufficient to have a significant impact on the enterprise's decision-making will be held by foreign investors (even though their ownership holdings are less than 50% of the enterprise's equity interests) or the actual controlling right in the business decision making, financial affairs, human resources and technologies of the enterprise may be transitioned to the foreign investor. This leaves open the possibility that minority acquisitions may be subject to review, particularly if the acquisition is in a sensitive industry.

As contemplated by the Circular, the new national security review process will consider the impact of the proposed transaction on national security, including domestic manufacturing and service capacity, national economic stability, the basic living of the people and R&D capacity for key technologies related to national security. The process would begin with a preliminary screening conducted upon application to MOFCOM initiated by the foreign investors in a proposed transaction. Chinese government agencies, national trade unions/associations, competitors, and upstream and downstream enterprises are also entitled to initiate a national security review of a proposed transaction by the Committee through an application to MOFCOM. The Circular did not specify the documentary and content submission requirements of the application process. In addition, it is not yet clear whether the application and screening process will be part of existing general foreign investment approval procedures and whether MOFCOM will delegate this function to its local branches.

For more information about this client alert, please contact:

Richard V. Smith
M&A Group Lead
Partner, San Francisco
+1 415 773 5830
rsmith@orrick.com

Mark Seneca
Partner, Silicon Valley
+1 650 289 7169
mseneca@orrick.com

Jeannie Shin
Partner, San Francisco
+1 415 773 5719
jshin@orrick.com

Elizabeth Cole
Partner, Shanghai
+86 21 6709 7119
ecole@orrick.com

For more information about Orrick's practices, including our **M&A** and **China** practices, please visit www.orrick.com.

It is also not clear whether the Circular will indirectly broaden the approval process for foreign M&A transaction. The Circular seems to expand the definition of “acquisition of domestic enterprises by foreign investors” set out in the *Tentative Provisions for the Acquisition of Domestic Enterprises by Foreign Investors* in 2003, which were later confirmed in 2006 (M&A Provisions) by describing two new acquisition structures as acquisitions of domestic enterprises to be monitored by authorities:

- a foreign investor establishes a foreign-invested enterprise and purchases, through such enterprise, the equity of a domestic enterprise (Re-investment); and
- a foreign investor purchases the domestic shareholder's equity in a joint venture, or subscribes a foreign-invested enterprise's increased capital (JV Buyout).

Accordingly, we expect to provide additional updates in the near future as further details regarding the implementation of these new regulations are provided by the relevant Chinese authorities.

The Circular did specify that MOFCOM will transfer to the Committee all applications determined to fall within the purview of the national security review regulations within 5 working days. The Committee will first complete a “general review” of the proposed transaction. If after the general review, the Committee concludes that the proposed transaction may have an impact on national security, the Committee will conduct a “special review” of the proposed transaction. If after the special review, the Committee concludes that the proposed transaction may have a material impact on national security (including economic and social stability), the Committee will so notify MOFCOM and the parties to the proposed transaction will be required to terminate the transaction or implement other measures or modifications to eliminate the impact of the proposed transaction on national security. Based on the review periods set out in the Circular, a transaction subject to “special review” could take 6 months or more to be reviewed and approved or rejected.

The concept of national security reviews in the PRC was first introduced pursuant to the M&A Provisions. In addition, the PRC government codified the rule that a foreign-related acquisition may be subject to national security review in the *Anti-monopoly Law of the PRC* in 2008. However, these previous rules and regulations were conceptual directives that lacked implementation details and processes. The Circular is significant in that it outlines for the first time specific authorities, mechanisms and procedures for implementing national security reviews of mergers and acquisitions involving foreign investors.

We will continue to monitor the development and implementation of these new regulations and will provide further updates as supporting policy pronouncements are issued by the relevant PRC governmental agencies. In the meantime, please contact us should you have any questions regarding national security reviews in the PRC.