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New Review System for Foreign Investor M&A Deals With Domestic Enterprises

On February 12, 2011 China's State Council announced that the government was establishing a "ministerial joint committee" for national security reviews. The "Circular Issued by the General Office of the State Council on Establishing the Security Review Mechanism Regarding Merger and Acquisition of Domestic Enterprises by Foreign Investors" (hereinafter the Circular) was adopted by the State Council on February 3 and becomes effective on March 2, 2011.

The authorization for national security reviews is set forth in Article 31 of the Anti-Monopoly Law of the People's Republic of China, which went into effect on August 1, 2008:

Where a foreign investor participates in a concentration of business operators through a merger or acquisition of a domestic enterprise or any other method and state security is involved, a state security review shall be conducted in accordance with relevant state provisions in addition to the examination of the concentration of business operators conducted in accordance herewith.

Article 12 of the Ministry of Commerce (MOFCOM) includes Provisions on the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, which went into effect on June 22, 2009 and have similar language (although it is uncertain if the Circular supersedes the Provisions):

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If a foreign investor acquires a domestic enterprise, and, thereby, obtains de facto control thereof, and if such acquisition involves a key industry, or factors that affect or could affect the economic security of the state, or would result in a transfer of the de facto control of a domestic enterprise that owns a well-known trademark or an old Chinese trade name, the concerned parties shall report the same to the Ministry of Commerce.

If the concerned parties fail to report the transaction and the acquisition has or could have a major impact on the economic security of the state, the Ministry of Commerce may, in concert with other relevant departments, demand that the concerned parties terminate the transaction, transfer relevant equity or assets, or take other effective measures to eliminate the impact.

The Circular sets forth the standards and procedures for the review process. Security reviews are triggered when the target enterprise falls within the scope set forth in the Circular and the foreign investor may obtain actual control through the M&A transaction (Article 1.1).

Enterprises in a variety of industry sectors come under the security review process, such as military and military-supporting enterprises, enterprises that are located close to sensitive key military facilities, other enterprises that are vital to national security, and critical agricultural, energy and resources, infrastructure, transportation, technology and major equipment manufacturing enterprises related to national security (Article 1.1). It therefore appears that if the target enterprise/assets are state-owned, involve “key technologies,” or include assets that involve defense production or are near defense facilities, the government requires a national security review.

The Circular has an extensive definition of “actual control.” Foreign investors are deemed to have “actual control” when they individually or aggregately hold more than 50 percent of the shares or have de facto control over the domestic company (despite their actual equity stake). It even applies to joint ventures (JVs) with foreign investors that hold less than 50 percent of the total equity interest but have sufficient voting right to “substantially influence” the resolutions (Article 1.3).

The reviews are to be carried out by the ministerial joint committee. The committee is governed by the State Council, led by the National Development and Reform Commission (NDRC) and MOFCOM, and includes

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government agencies regulating the industries that fall under the scope of the new rules (Article 3).

As to the contents of the reviews, the Circular appears to go beyond a traditional national security review and involves scrutinizing a range of economic and social factors. In addition to national security issues, the review process may include an analysis of a transaction's impact on the national economy, productivity, social stability ("order of public life") and R&D related to key technologies. Such a review adds a layer of bureaucratic intermeddling into commercial and economic terms that have no real impact on China's defense policies, and grants the government agencies discretion to quash legitimate foreign investment transactions for protectionist reasons (Article 2).

When the committee finds a certain M&A transaction has or may have a significant impact on national security, it may request that the MOFCOM work with relevant government agencies to terminate the transaction or adopt other effective measures to eliminate the risk, such as ordering a transfer of relevant shares or assets (Article 4.6).

It is noteworthy that while the Circular applies to M&A transactions within the Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Area, it does not apply to M&A transactions between foreign investors and domestic financial institutions. Security review regulations for such transactions will be issued separately (Article 5.4, 5.5).

Overall, the review process is new and language in the Circular is vague, and further clarification from the government is required to get an understanding of how the mechanisms will work in practice.

This announcement comes right before the Committee on Foreign Investment in the United States (CFIUS) is set to make a recommendation to the Obama Administration to unravel the Huawei-3Leaf System deal.

See the attached English translations of the [National Security Review Circular](#) and the [Anti-Monopoly Law of China](#) .

The information in this bulletin was compiled by the China offices of Squire, Sanders & Dempsey.

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