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ALERT - China Introduces Formal National Security Review Mechanism for Acquisitions of Domestic Enterprises by Foreign Investors

On February 3, 2011, the State Council of the People's Republic of China issued the "*Notice on the Establishment of Security Review Mechanism in relation to Foreign Investors' Mergers with and Acquisitions of Domestic Enterprises*" (the "**Notice**"), which was subsequently publicized earlier this week. The Notice will take effect 30 days upon its issuance (i.e., early March).

The Notice provides for a committee under the State Council, led by both the State Development and Reform Commission and the Ministry of Commerce ("**MOFCOM**"), to formally review "national security aspects" of foreign acquisitions of control over certain domestic enterprises. After an acquisition is submitted for approval and either MOFCOM or a concerned party (see below) raises a "national security" concern, the acquisition will be submitted for a first-stage "general review", where the reviewing committee will seek opinions from the relevant industry regulators in writing. Unless unanimous clearance is obtained at this stage, the review will enter the second "special" stage where the relevant regulators may be called together to attempt to reach a consensus, failing which the State Council may be called in to determine the issue.

It is apparent that this formal review regime is created in response to the recent blockages of outbound Chinese acquisitions (such as in the failed Rio Tinto and CNOOC-UNOCAL acquisitions) by international governments on "national security grounds" and is designed to parallel the process in, for example, the US. In practice, the PRC government has never lacked tools to block truly undesirable foreign acquisitions. Various other statutes have mentioned in very general terms that certain national interest issues should be looked at in deal approvals. In the Carlyle-Xugong acquisition, for example, MOFCOM delayed approval for three years until the transaction dropped, and in the CocaCola-Huiyuan deal, the antitrust review regime was expanded to block an offshore transaction. However, this is the first time that China seeks to formally establish a review mechanism and publish some guidelines on the process and evaluating criteria in these reviews.

Note that various aspects of this new regime are defined with broad scopes and somewhat vaguely, to allow wide governmental discretion on whether and how to apply this regime. Under the Notice:

- *All foreign acquisitions of domestic enterprises* should theoretically be submitted to *MOFCOM at the central level* for approval – without the normal delegation language in similar statutes – and MOFCOM will submit transactions that fall under the scope of the notice to the special committee. It is hard to imagine that MOFCOM will in practice really want to sift through all "foreign acquisitions of domestic enterprises" in the country to evaluate national security concerns; unclear as to whether this design is intended.

- The "national security" review mechanism can be initiated rather easily - by either a government ministry, a national trade association, or *any other company in the same industry or in an upstream/downstream industry*, all of whom have the power to petition MOFCOM for a review. The special governmental committee will decide whether to start the review process.

- Targets potentially triggering review include military, agriculture, energy, infrastructure, transportation, key technology and significant manufacturing targets; any target located next to sensitive military facilities; "and other entities in connection with national security"; note however that financial institutions are singled out to be "subject to separate rules."

- A qualified "acquisition" includes all types of acquisitions referred to under the 2006 Foreign Acquisition M&A Rules (both asset and share deals) *and equity acquisitions involving or using Foreign Investment Enterprises*, with no minimum acquisition thresholds specified. Hong Kong, Macau and Taiwan investors are not exempt from the review.

- "Control" is defined broadly to also include catch-all phrases such as "acquisitions of [minority] shares with the ability to exercise significant influence on the target," and "other situations causing a de facto transfer of control of [various aspects] of a domestic target" which could infer that a VIE or “Sina-model” structure will also be subject to this regime.

- The factors to be evaluated by the committee in deciding whether to grant an approval cover the "national security aspects (including impact on production capabilities, service provision, and infrastructure and facilities)", the "economic aspect", the "social aspect" and the "key technology development aspect," with no further clarifications.

The Notice also provides for some referential timelines for certain aspects of the review process.

To what extent this new national security review mechanism will in practice affect approval timelines (especially for larger, higher-profile acquisitions) as a whole - since it could potentially be easily triggered and all reviews are central-level with no delegation - cannot be ascertained at this moment. Commentators appear to generally be concerned as to how this new regime will impact the already minimal cross border acquisitions (currently estimated by some to only amount to roughly 2% of all forms of foreign investment in China, in terms of transaction amount involved) in the long term, but it may be too early to tell. The Chinese government has always had the power to withhold approval on any transaction if it really wanted to anyway; some rudimentary guidance, however vague and broad it might be, can be useful so long as it somewhat improves transparency and predictability of the process, and points out the policy emphasis. For now, investors planning on larger, higher-profile transactions can only try to keep themselves updated as this regime develops in practice and as more details and refinements become available in the future.