

LEGAL UPDATE

Edition: February 2011



China Establishes a National Security Review System for Foreign-Related Mergers and Acquisitions

On February 3, 2011, the General Office of the State Council promulgated the Circular on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, which will take effect on March 5, 2011. The Circular introduces, for the first time, the basic framework for a “national security review” system which will be applied to mergers and acquisitions in China made by foreign companies.

Security Review Authorities

According to the Circular, the State Council shall set up an “*Inter-Ministerial Joint Committee for Security Review*” (“Joint Committee”), which shall be responsible for conducting national security reviews on captured foreign-related M&A projects. The Joint Committee will be under the leadership of the State Council, and shall be composed of the National Development and Reform Commission (“NDRC”) and the Ministry of Commerce of PRC (“MOFCOM”), and joined, where applicable, by other relevant governmental entities.

Scope of the Review

Security reviews shall be required for two categories of M&A projects:-

- where the target company is a military enterprise or a supplier to a military enterprise, or an enterprise that is in the vicinity of key or sensitive military facilities, or any other entity that has a bearing on national defense and security;
- where the target company involves important agricultural products, energy and resources, infrastructures, transportation, key technologies or important equipment manufacturing industries, each of which has a bearing on national security, and where the actual control of the target company is likely to be obtained by the foreign investor. The Circular does not define the terms “key” or “important”.

Jade & Fountain is a leading full-service Chinese law firm with offices in Shanghai & Beijing. Our international outlook and native resources ensure we provide our clients with quality legal advice for all their business needs and objectives.

If you have any questions or comments regarding this article, please contact:

Lawrence Guo

Partner

Tel: (86) 10 8518 9358

lawrence.guo@jadefountain.com

It should be noted that where the target company is a Chinese financial institution, such a project would be outwith the purview of the Circular.

Initiation of Security Review

The Circular provides two methods for initiating a security review:

- 1) If a proposed acquisition falls within one of the two categories outlined in the Circular, the foreign investor should apply to MOFCOM for a security review.
- 2) A central ministry under the State Council, a national industrial association, or a competing enterprise or an upstream or downstream enterprise may request that MOFCOM initiate a security review. Upon receipt of a request for review by a third party, the Joint Committee will determine whether a security review is to be launched. Thus a third entity that is not a party to an M&A transaction may propose a security review despite having no direct interest or role in the transaction.

Contents of Security Review

According to the Circular, the national security review will consider the effect of a transaction on:

- 1) national defense and security, including domestic production capacity, domestic services capacity, and relevant equipment and facilities, all required by national defense;
- 2) the stable operation of the national economy;
- 3) the basic living order of society; and
- 4) the capabilities of research and development of key technologies in relation to national security.

Security Review Procedure

The Joint Committee will first carry out an ordinary review of a transaction, and will later launch a special review if the transaction is not cleared in the ordinary review.

-
- **Ordinary review:** In this stage, the Joint Committee will solicit written comments from other relevant authorities, and will make its decision on the basis of these comments. The time limit of an ordinary review is about 35 working days. If the relevant authority(ies) is of the view that the transaction may impact upon national security, the Joint Committee will initiate the special review procedure.
 - **Special review:** In this stage, the Joint Committee will carry out a “*security assessment*” as part of its review. If members of the Joint Committee reach an agreement, the Joint Committee will produce its review comments; failing which, the Joint Committee will petition the State Council for a decision. The time period of a special review is 60 working days.

Result of Security Review

If the Joint Committee considers that a proposed acquisition will or may cause a significant impact on national security, it should request MOFCOM, in conjunction with relevant departments, to terminate the transaction, or to take other measures, such as transferring relevant shares, assets or any other effective measures, with a view to eliminating the impact on the national security.

Impact of the National Security Review System on the Foreign M&A Market

The national security review system set forth in the Circular will supplement the existing PRC examination and approval systems which are applicable to foreign-related M&As in China. As such, it is likely to cause greater difficulty and uncertainty to those seeking approval for foreign-related M&A projects in China:-

- A foreign acquirer already needs to apply for many other regulatory approvals for a proposed acquisition in China, including foreign industrial policies approval, state-owned asset approval, securities law approval and anti-monopoly merger control clearance. The new security review system therefore serves to increase the complexity of the PRC examination and

approval systems.

- Third-party entities, in particular competitors and upstream and downstream enterprises, have the right to request that a security review be conducted. Customarily, a competitor will very likely oppose a proposed business acquisition in the same industry and it can be assumed that this will be the case in the foreign-related M&A markets in China.
- With respect to the review scope, the terms *“important agricultural products, energy and resources, infrastructures, transportation, key technologies or important equipment manufacturing industries, each of which has a bearing on the national security”* are not clearly defined in the Circular. This provides the review authorities with great discretion. It is hoped that more specific guidelines will be promulgated by the review authorities in the near future.
- Likewise, only general provisions are stipulated with respect to the contents of the security review. For example, there is no guidance as to how a foreign-related M & A project could be deemed to *“affect the stable operation of the national economy”*, or *“affect the basic living order of society”*. Unless further written guidelines or interpretations are issued, the security review process will lack transparency and will permit the review authorities to hold very broad powers.
- Clear time limits for the security review have been provided, which will assist parties to an acquisition project to organize the timing of the project. In practice, the review authority’s strict honor of these time limits will play a vital role in the success of an acquisition project.

The newly-introduced national security review system now has to be put into practice. It will require foreign companies to be more cautious and prudent in carrying out mergers and acquisitions in mainland China, and it has yet to be seen whether the impact of the new national security review system will cause some foreign direct investors to shrink back and reconsider potential mergers and acquisitions.

This publication is intended to keep our clients and friends apprised of industry, regulatory and legislative changes that may have an impact on the way business is conducted and operated in China. It is for general information only, and is not a substitute for legal consultation.