

China

September 12, 2011

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## China Finalizes National Security Review Rules for Inbound M&A Transactions

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*In August 2011, the Chinese government finalized the long-anticipated national security review mechanism for the purpose of regulating inbound merger and acquisition transactions in some sensitive and important industries. The PRC Anti-Monopoly Law enacted in 2008 already contained references to national security review. This time, the security review procedure is formalized. Even though the security review might not be interminable, ongoing and pending M&A transactions subject to security review will likely take a longer time to complete. Some even fear that national security review may kill some deals.*

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### Background

On February 3, 2011, the State Council issued its *Notice of the General Office of the State Council on Launching the Security Review Mechanism for Mergers and Acquisition of Domestic Enterprise by Foreign Investors* (the "Notice"), which came into effect on March 5, 2011.

An *Interim Regulation of Ministry of Commerce on Implementation of the Security Review Mechanism for Merger and Acquisitions of Domestic Enterprise by Foreign Investors* was promulgated by the Ministry of Commerce ("MOFCOM"). The interim regulation was effective from March 5, 2011, through August 31, 2011.

On August 25, 2011, MOFCOM issued its *Regulation of the Ministry of Commerce on Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the "Regulation"), which came into effect on September 1, 2011.

### Transactions Subject to Review

The acquisition of specified businesses and the acquisition of actual control of other sensitive businesses, as enumerated in the Notice, by one or more foreign investors will be subject to security review.

The Notice distinguishes between what can be viewed as ultra-sensitive industries from sensitive industries. The ultra-sensitive industries include defense and military enterprises; enterprises located near key and sensitive military facilities; and other entities related to national defense and security. Any acquisition of an interest (which need not be more than 50% or a controlling interest) in any of these businesses will be subject to security review.

Other sensitive industries listed in the Notice include key farm products; key energy and resources; and key infrastructure, transportation, technology and major equipment manufacturing industries. The Notice has not defined what “key” or “major” means. Any acquisition of actual control of businesses in these key or major industries will be subject to review. “Acquisition of actual control” generally means the acquisition of more than 50% of the equity or voting rights and also includes any transaction that results in the transfer of the actual control of a domestic enterprise’s operational, financial and personnel decisions or the enterprise’s technology to foreign investors.

The Regulation states that in considering whether a transaction falls within the scope of security review, MOFCOM will look at the substance and actual impact and not the form of the transaction. In addition, the Regulation states that foreign investors may not try to circumvent security review by arrangements such as nominee holding structures, trust arrangements, multilayer investment and reinvestment structures, leasing or lending or other contractual control arrangements. This statement can be read as a prohibition of VIE arrangements for industries and businesses which may subject to security review. As a result, some fear that the VIE structure may be an unacceptable form of foreign investment in PRC businesses subject to security review, which may force some deals to be renegotiated, restructured or simply terminated until further guidance is available.

### Review Authorities

MOFCOM is the gatekeeper of the security system. It is responsible for preliminary review of potential covered transactions. If MOFCOM determines that a potential covered transaction is subject to security review, it will forward the application for substantive review by the Ministerial Panel, a joint panel consisting of representatives of MOFCOM, the National Development and Reform Commission and other relevant departments.

In reviewing a covered transaction, the Ministerial Panel will consider the impact of the transaction on national defense, national economic stability, social order and research and development capabilities of major technologies affecting national security.

Where state-owned equity and assets are involved, laws governing state-owned asset management will apply as well.

The security review for inbound M&A transactions involving financial institutions will be separately regulated.

### Security Review Process

#### Initiation of Security Review

- **Self Reporting:** Any foreign investor involved in an M&A transaction which may potentially be a subject of security review can voluntarily file an application for review with MOFCOM.

- **Referred Reporting:** If a local counterpart of MOFCOM, during its review of an M&A transaction application, finds the M&A transaction subject to security review, such agency will report the transaction to MOFCOM and issue a written notice requiring the foreign investor to file an application with MOFCOM.
- **Review Requested by Other Parties:** Concerned government departments, national industrial associations, competitors and upstream and downstream enterprises that believe a particular M&A transaction should be subject to a security review can submit a request to the Ministerial Panel, through MOFCOM, for security review.

### Timeline for Review

Before officially filing a security review application, foreign investors may request a consultation with MOFCOM regarding procedural issues relating to the M&A transaction that the foreign investors plan to engage in. It is not a mandatory procedure and the consultation does not have any binding effect.

After a foreign investor files an application for security review, MOFCOM has 15 working days after acceptance of the application to advise the foreign investor whether the proposed transaction will be submitted for review by the Ministerial Panel. If MOFCOM has not responded to the foreign investor after the 15-day period, the transaction can proceed.

If MOFCOM determines that the transaction is subject to review, whether it is a self-reported transaction or a review requested by a third party, MOFCOM has five working days to notify the Ministerial Panel.

The Ministerial Panel then has five working days to solicit opinions from the relevant departments, which in turn have 20 working days to submit their written opinions to the Ministerial Panel. The Ministerial Panel has five working days after receipt of the written opinions to take action.

Unless a relevant authority finds impact on national security, the Ministerial Panel will notify MOFCOM in writing within the five-working-day period, and MOFCOM will notify the applicant and the local department within five working days after receipt of the Panel's written decision.

If any relevant authority finds an impact on national security, the Ministerial Panel will initiate a special review. The Panel will have 60 working days (longer if the transaction is submitted to the State Council for determination) to issue its approval, disapproval or approval conditioned on the parties taking specified remedial actions.

### Concluding Remarks

The national security review system was only created earlier this year. The PRC authorities do not make public any information on transactions reviewed, so it is difficult to evaluate the impact of the new review process on inbound M&A transactions. However, in view of the broadly worded and non-exhaustive list of industries listed in the Notice, foreign investors planning to engage in M&A transactions in China should consider early in the planning stage whether the target may be in a sensitive sector. Although the pre-application consultation with MOFCOM permitted by the Regulation only relates to "procedural issues," foreign investors may consider taking advantage of this mechanism if they have concerns that a contemplated M&A transaction may be subject to security review.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the authors:

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