

China's State Council Issues Notice on National Security Review of Foreign Acquisitions

On March 5, 2011, a new national security regime regulating foreign acquisitions of Chinese enterprises will enter into force. This regime was created by a Notice on Establishing Security Review Mechanism regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the “Notice”) issued by the General Office of China’s State Council on February 3, 2011.¹ Similar regimes exist in other jurisdictions, including Australia, Canada, Germany, Russia and the United States. As with many Chinese rules, however, the Notice is opaque and discretionary and seems likely to result in uncertainty.

I. BACKGROUND

Chinese authorities have been eager to establish a formal process for reviewing national security issues since the Anti-Monopoly Law (the “AML”) entered into force in 2008.² The AML provides that a foreign investor’s acquisition of a Chinese enterprise that “concerns national security” is subject to separate national security review, in addition to antitrust review. In August 2008, the National Development and Reform Commission (“NDRC”) announced plans to form a committee to review the national security effects of foreign acquisitions of domestic enterprises, but it provided few details.³ In June 2010, NDRC, the Ministry of Commerce (“MOFCOM”) and the Legal Office of the State Council published for comment draft regulations on the Security Review System for Mergers & Acquisitions of Domestic Enterprises by Foreign Investors. Subsequently, in December 2010, MOFCOM stated that it intended to combine its foreign investment administration,

¹ See http://www.gov.cn/zwqk/2011-02/12/content_1802467.htm.

² Although the 2006 Rules for M&A of Domestic Enterprises by Foreign Investors appear to be the first measures providing for national security review of foreign investments, these rules do not set out detailed procedures, and these rules have not been publicly invoked by MOFCOM to block any transactions.

³ See <http://zfxgk.ndrc.gov.cn/PublicItemView.aspx?ItemID={2050a9f4-cd8e-41de-836e-e2ea2a9950d5}>.

merger control review, and national security review tasks to safeguard the security of Chinese industries.⁴

II. THE NOTICE

The Notice defines the scope of the new national security review system, provides for the creation of a new reviewing body, sets out the applicable procedure and defines the remedies that may be imposed.

A. SCOPE OF REVIEW

The Notice covers two categories of target companies:

- Military industry enterprises and supporting firms, enterprises located near major and sensitive military facilities and other entities related to national defense or security.
- Enterprises in security-related sectors, such as “essential” agricultural products, “essential” energy and resources, “essential” infrastructure, “essential” transportation, “key” technology and “major” equipment manufacture. These terms are undefined, raising difficulties for a foreign investor’s assessment of whether a transaction should be notified for national security review.

Investments in target companies engaged in “security-related sectors” will trigger a national security review only if they may result in foreign investors acquiring “actual control” of the relevant Chinese enterprise.⁵

Four types of investment will be caught by the new regime: (i) purchases or subscriptions of shares of a non-foreign invested enterprise (FIE) that transforms the enterprise into an FIE; (ii) acquisitions of shares of an existing FIE from a Chinese shareholder or subscriptions for capital increases of existing FIEs; (iii) establishment of an FIE to purchase and operate assets or to purchase shares from a Chinese enterprise; and (iv)

⁴ See <http://tzswj.mofcom.gov.cn/aarticle/e/201012/20101207323857.html?973429390=691026738>.

⁵ Acquisition of “actual control” includes the following scenarios: (i) acquiring a > 50% interest; (ii) acquiring a < 50% interest conferring a significant degree of influence over resolutions to be adopted by shareholders or the board; and (iii) other circumstances where a foreign investor obtains actual control over business decision-making, finance, human resources or key technology.

to purchase assets directly from a Chinese enterprise and establish an FIE to hold and operate such assets.

The Notice does not apply to foreign acquisitions that involve changes of ownership in State-owned property or to acquisitions of Chinese financial institutions. Notably, the Notice treats investors from Hong Kong, Macao and Taiwan as foreign investors.

B. REVIEWING BODY

An inter-ministerial joint committee (the “Committee”) will be established to conduct national security reviews. The Committee will be led by NDRC and MOFCOM and overseen by the State Council. The Committee may engage other authorities in its review process.

The Committee will assess whether a foreign acquisition will impact (i) domestic production capacity or equipment and facilities required for national defense; (ii) the stability of the national economy; (iii) social order; or (iv) the capacity to research and develop key technologies. However, the criteria on which the Committee will base its assessment are vague.

C. PROCEDURE AND TIMING

Notification forms will be submitted to MOFCOM, which will have five working days to refer the matter to the Committee. Like MOFCOM’s merger control review process, the Committee’s national security review is divided into two phases, the general review process (Phase I) and the special review process (Phase II).

The Committee’s Phase I review can last up to 30 working days. If the Committee determines that the transaction will trigger a national security concern, the review will enter Phase II, which can last up to 60 working days. In case of disagreement among the Committee members, the matter will be submitted to the State Council, which will not be subject to a deadline. Since the Notice allows parties to withdraw their notifications, the deadline could effectively be extended by withdrawal followed by refiling.

D. REMEDIES

If the Committee considers that a transaction has impacted or may impact national security, the Committee may require a transaction to be unwound or take other measures, such as transferring shares or assets to eliminate that impact. Unlike merger review decisions, decisions imposing remedies in the national security review are not required to be published.

Importantly, the Notice allows third parties to petition MOFCOM to conduct the review, increasing the risk that a transaction may be unwound. The risk of remedies being imposed after closing may create an incentive for foreign investors to apply for national security review in case of doubt.

III. CONCLUSION

The introduction of the new national security review mechanism fills one of the remaining gaps in the implementation of the AML.

The Notice details the procedure for such reviews, but it is ambiguous with respect to a number of important concepts. The ambiguity in the determination of which targets will trigger a national security review, combined with the possibility for a transaction to be unwound after closing if a notification is not made, may lead foreign investors to err on the side of caution and to make national security notifications in case of doubt.

The relationship between national security review and merger control review under the AML may also give rise to questions, since the same transaction may be subject to both. Although the two review procedures will presumably be conducted in parallel, this is not clear from the Notice.

As has been the case in other jurisdictions, the application of the new national security review in particular cases is likely to be influenced by political sensitivities. The practical implications of China's new national security review process will only become clear in the coming years, when a body of practice has developed.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Antitrust and Competition in the "Practices" section of our website at <http://www.clearygottlieb.com>.

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