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New Security Review System for Acquisition of Domestic Enterprises by Foreign Investors

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On 3 February 2011, the General Office of the State Council issued the *Notice on Establishing a Security Review System for Acquisition of Domestic Enterprises by Foreign Investors* (Guo Ban Fa (2011) No. 6) (the "**Notice**"), which is to be implemented on 5 March 2011. The Notice, together with foreign investment industry policies and competition policies, form the three major aspects of the foreign direct investment regulatory framework in China.

The *PRC Anti-monopoly Law* (Zhu Xi Ling No. 68), implemented on August 1, 2008 (the "**AML**") and the *Provisions for the Acquisition of Domestic Enterprises by Foreign Investors* (Shang Wu Bu Ling 2009 No. 6), implemented on June 22, 2009 (the "**M&A Rules**") both stipulate that parties involved in a deal where a foreign investor acquires a domestic enterprise engaged in key industries, which results in the foreign investor obtaining actual control and affects or may affect the security of the national economy, must first apply with the Ministry of Commerce (the "**MOFCOM**") for approval. However, the above requirement lacks specifics regarding the required approval process, such as approval scope, procedure and time limits, which caused difficulties in actually carrying out the application and approval process. The new Notice offers details regarding the security review process by clarifying the scope and content of review, and the review mechanism and procedures. The specific provisions of the Notice are summarized below.

The Definitional Scope of "acquisition by a foreign investor"

- A foreign investor acquiring equity interest in an enterprise which is not a foreign-invested enterprise (an "**FIE**") or subscribing for capital increase of a non-FIE;
- A foreign investor acquiring the equity interest of an onshore FIE from a Chinese shareholder or subscribing to the capital increase of an FIE;

- The establishment of an FIE by a foreign investor through which such foreign investor acquires the equity interest, or acquires and operates the assets, of a domestic enterprise;

- A foreign investor directly acquires a domestic enterprise resulting in its assets being operated by an FIE.

It should be kept in mind that the Notice expands the original definitional scope under the M&A Rules, by including certain acquisition of FIEs in addition to the acquisition of domestic enterprises.

The Definitional Scope of Industries subject to Security Review

- Military enterprises or military-related product manufacturers, enterprises located around key sensitive military facilities, or other enterprises related to national security; and

- A foreign investor acquiring an onshore enterprise engaged in important agricultural products, major energy sources and resources, key infrastructural facilities, important transportation services, key technologies and important equipment manufactures related to national security, and whose controlling rights might be acquired by the foreign investor.

This scope subject to security review is relatively broad and may require further guidance from the competent authorities as to the detailed industry and product catalogues. At the same time, it is important to note that foreign investors acquiring domestic financial institutions are subject to separate regulations.

The Notice also specifies that the "controlling rights" mentioned in the second item above refers to where the foreign investor becomes the controlling shareholder or the actual controlling entity via acquisition of the domestic enterprise, including the following scenarios:

- The foreign investor, or its controlling parent company or its controlled subsidiary, holds 50% or more of the total equity interest after the acquisition;

- The aggregate equity interest held by multiple foreign investors amounts to 50% or more of the total equity interest post-acquisition;

- The foreign investor does not hold 50% or more of the total equity interest post-acquisition, but has sufficient voting rights to materially affect resolutions of shareholders' meetings, stockholders meetings or the board of directors;

- Other scenarios where control of the domestic enterprise's operational policies, finances, human resource matters, technologies, etc has been transferred to the foreign investor.

The aforementioned definitional standard for "obtaining actual control" is comparatively broad. In particular, the specific meaning of the fourth item, which refers to "other scenarios", requires further consideration.

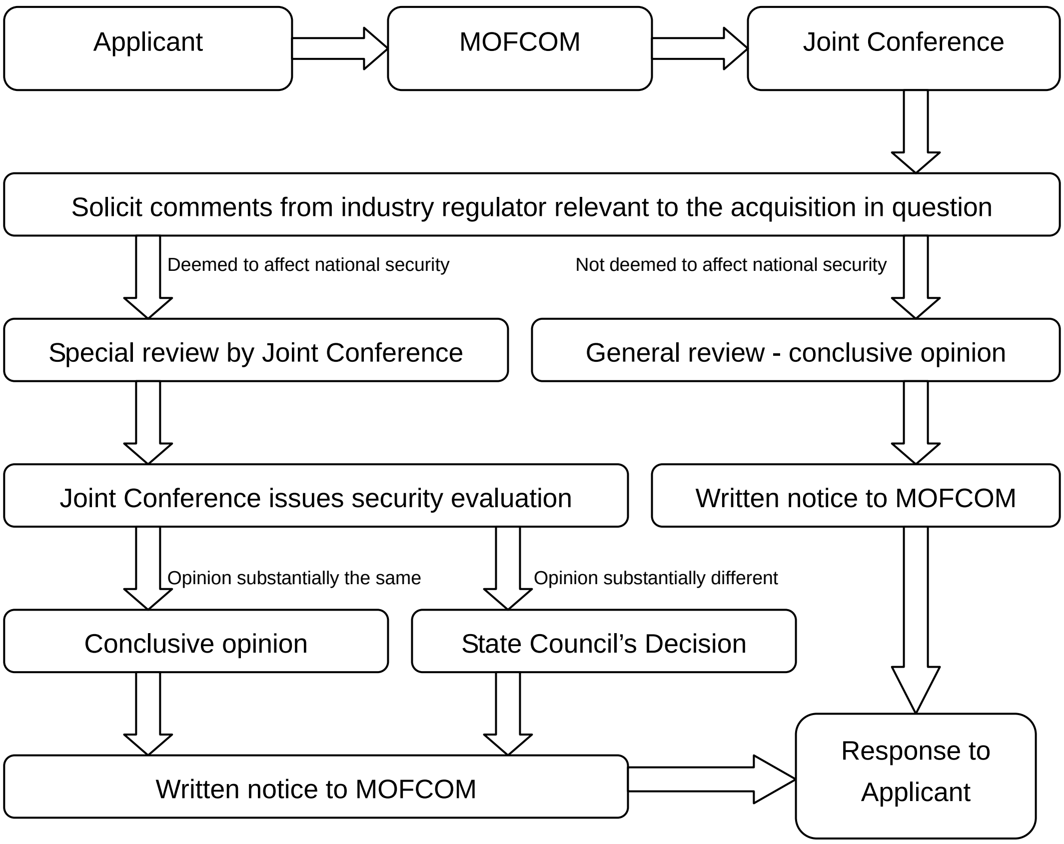
The Approval Authority

The Notice provides for the founding of an inter-ministerial joint conference for security review ("**Joint Conference**"), which will administer the review with participation by the relevant agencies in charge of the areas and industries connected with the acquisition.

The Approval Process

Pursuant to the Notice, aside from the investor's mandatory obligation to apply for MOFCOM approval, the State Council and its relevant departments, national industry associations, similar enterprises and upstream and downstream enterprises all may propose to the MOFCOM to conduct security review for the acquisition. In addition, the Joint Conference may conduct security reviews where it deems it necessary.

Where the Joint Conference proposes to the MOFCOM to conduct security review of an acquisition, a general review will be conducted, and if such general review is not passed, a special review will be carried out. A detailed review flowchart is provided below:



Consequences for Non-compliance with Security Review Requirements

The Notice stipulates that the Joint Conference shall request the MOFCOM and relevant regulators to terminate foreign investors' acquisitions which substantially affects or might substantially affect national security, or neutralize the effects on national security caused by the acquisition by appropriate equity interest or assets transfers, or other methods.

Our Comments

By release of this Notice, the PRC has now fully constructed a foreign direct investment regulatory framework based on three major aspects: industry entrance, competition, and security review policies. On the one hand, the new security review policies provided under the Notice protects organizations related to national security, important agricultural products, major energy sources and resources, and other enterprises, and on the other hand, it increases predictability and operability of the administrative approval process for acquisitions by foreign investors. Prior to acquiring domestic enterprises, foreign investors should assess whether security review per the Notice is necessary, and if necessary, the foreign investor should undertake and complete such security review pursuant to the Notice's provisions.

However, unlike the *Guidelines on Anti-monopoly Filings for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* and related regulations, some of the provisions under the Notice merely reflect general principles and are insufficiently detailed for implementation. Seeing as the Notice is only issued as a notice by the General Office of the State Council, it is foreseeable that other competent authorities will flesh out the details and operational guidelines regarding security review, such as by issuing further catalogues delineating the specific industries and products deemed to be related to national security and the national economy.

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