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MOFCOM Issues the Official Implementation Provisions on the Security Review Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

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On 25 August 2011, the Ministry of Commerce ("**MOFCOM**") issued the *Provisions on the Implementation of the Security Review Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (Announcement No. 53, 2011) ("**Security Review Rule**"). The Security Review Rule partially modifies the *Tentative Provisions on Issues Related to the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (MOFCOM Announcement No. 8, 2011) ("**Tentative Provisions**")[1] and aims to enter into effect on the next day after its expiration. As the official add-on to the *Notice on Establishing a Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors* (Guo Ban Fa [2011] No. 6) ("**State Council Notice**")[2], the Security Review Rule provides further guidance to foreign investors on the implementation of the new security review system regarding the mergers and acquisitions ("M&A") of domestic enterprises.

Comparing the Security Review Rule with the previous Tentative Provisions, the following are the highlights of the Security Review Rule:

- **Substance over Form Concept in the Review Scope**

Although the scope of detailed industries (relevant catalogs and contents) to be governed by the Security Review Rule still remains unclear, the Security Review Rule has adopted a concept of "substance over form" in order to determine the scope of transactions that it shall govern.

By stating that "*The substance of an M&A transaction and its actual influence shall be considered in the application of the Safety Review Rule; Foreign Investors shall not substantially evade the M&A security review requirements by any means, including without limitation, by holding shares on behalf of*

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others, trust, multi-level reinvestment, leases, loans, control by agreements (variable interest entities), or overseas transactions", MOFCOM adopts in Section 9 of the Security Review Rule, the concept of "substance over form" to help determine the scope of M&A transactions entering into the security review procedure. Instead of solely focusing on the legal structures or forms of the transactions, MOFCOM further reviews the "substance" and "actual impact" of M&A transactions.

Section 9 of the Security Review Rule aims to prohibit a variety of law evasions, including holding shares on behalf of others, trust, multi-level indirect investment, leases, loans, control by agreements (such as the VIE structure of TaoBao) or offshore transactions. Such regulation, to us, fits with the previous administration policy by the MOFCOM. By stating in Section 11 of the *Provisions for the Acquisition of Domestic Enterprises by Foreign Investors* (Announcement No. 6, 2009), that any person or entity shall not evade the statutory review requirements by any means such as domestic investments by foreign investment enterprises, and that "Parties shall not evade the aforesaid requirements by trust, holding shares on behalf of others, or by other means" in Section 15 thereof, the MOFCOM has been implementing its constant policy of focusing on the substance of transactions. However, it is a detailed list of a variety of law evasion measures in the new rule that sets the Security Review Rule apart from all previous provisions and suggests that the MOFCOM will impose closer reviews on M&A transactions involving foreign investments under the new rule.

➢ The Follow-up Review on M&A Transactions

Although the Security Review Rule expressly provides that it takes up to 15 business days to complete the security review of M&A transactions, it does require certain transactions that have already passed the security review to be re-reviewed in the event that specific circumstantial changes should take place.

Section 10 of the Security Review Rule provides that "*Parties shall cease all transactions and conducts of M&A transactions of domestic enterprise by foreign investors that falls into the security review scope specified in the Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, in the event that: (a) such transaction was not submitted for review to the ministerial panel; or (b) such transaction was deemed by the ministerial panel to pose no threat to national security, and (i) such transaction has later been rearranged; or (ii) relevant agreements have been modified; or (iii) businesses of acquirer or target company have changed; or (iv) other changes have occurred (including changes of the actual controlling party)*".

The abovementioned Section requires all completed transactions to be re-reviewed in accordance with the Security Review Rule if there has occurred any changes, rearrangements or modifications in such transactions, relevant agreements, businesses or actual foreign controlling parties. Section 10 effectively holds off step transactions and offshore arrangements which were usually adopted by parties to evade the review by the Chinese government.

➢ Consultation Mechanism

The Security Review Rule retains the consultation mechanism in Section 3 of the Tentative Provisions, according to which, applicants may seek consultation with MOFCOM concerning procedural issues prior to the submission of formal applications for security review. Such consultation mechanism is similar to the consultation procedure under *Guide for Application for Anti-monopoly Review for Merger and Acquisition of Domestic Enterprises by Foreign Investors*.

Standing on the preliminary consultation structure in the Tentative Provisions, the Security Review Rule further provides that such consultation procedure before the official application is not legally biding. The Security Review Rule states that the preliminary consultation procedure shall not be considered the submission of an official application. Therefore, MOFCOM's opinion on M&A transactions obtained by the parties through consultation shall not be deemed as the official feedback, and parties are still obligated to submit the official application for the security review.

➢ **Supervision by the Approving Authority**

The Security Review Rule also emphasizes on the security review of the onshore investment by foreign-invested enterprises. Section 2 of the Security Review Rule provides that the competent local commerce departments shall cause the applicants to file security review applications with the MOFCOM, if it deems that the M&A transactions fall within scope of security review upon receiving M&A applications in accordance with the *Interim Provisions on Investment Made by Foreign-Invested Enterprises.* However, the supervision on transactions not subject to the pre-approval by the local commerce departments remains vague. To elaborate, under the current regulations, the investments by foreign-invested enterprises in the "encouraged" or "permitted industries" shall only subject to the filing of registration at relevant administrative authorities of industry and commerce, yet are not subject to the pre-approval by the local commerce departments. Similarly, by implementing a multi-level indirect investment or leasing structure, parties of M&A transactions may also be able to skip the approval process by the competent local commercial departments. In cases like these, it is yet to be clear how the department of commerce will supervise, and what legal consequences should be undertaken by parties conducting such transactions for their failure to apply for the security review. Thus, further observations need to be made on the influence of the Security Review Rule on enterprises that have so far completed offshore acquisitions or listed through VIE structures.

The Security Review Rule, stepping up from the basis of the Tentative Provisions, prohibits a variety of law evasion measures, adopts the "substance over form" concept in the application of the security review, emphasizes on the follow-up review, and determined the legal nature of the consultation mechanism. However, certain issues absent from the Tentative Provisions, such as the scope of detailed industries (relevant catalogs and contents) to be governed by the Security Review Rule, as well as how MOFCOM will supervise on the transactions not subject to the pre-approval by the commercial authorities, are yet to be touched upon.

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1 For the analysis of the *Tentative Provisions on Issues Related to the Implementation of the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors*, please refer to *MOFCOM Issues Tentative Implementation Provisions on the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors* in *Llinks Corporate Bulletin* in March, 2011. http://www.llinkslaw.com/shangchuan/2011317154334.pdf

2 For the analysis of the *Notice on Establishing a Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors*, please refer to *New Security* Review *System for Acquisition of Domestic Enterprises by Foreign Investors* in *Llinks Corporate Bulletin* in February, 2011. http://www.llinkslaw.com/shangchuan/2011216171516.pdf