The People's Republic Strikes Back? China Issues National Security Review Regulations for Foreign-Funded M&A

Nearly five years after issuing the first rules on the subject,[1] and following several years of merger control business concentration filings,[2] on February 3, 2011 the PRC State Council promulgated the *Circular on Establishing the Security Examination System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知) (the "Security Review Circular" or the "Circular"). The Circular, which takes effect March 3, 2011, also serves to implement Article 31 of the PRC Anti-Monopoly Law (AML), which took effect in August 2008.

The Security Review Circular both establishes general national security review procedures for various categories of foreign investments and provides for establishment of the "Inter-Ministerial Joint Conference on Security Review of Mergers and Acquisitions of Domestic Enterprises by foreign Investors" (外国投资者并购境内企业安全审查部际联席会议) (the "Joint Conference"). The Circular's issuance follows several high-profile rejections (or voluntary termination) of proposed Chinese acquisitions on national security grounds in the U.S. and elsewhere.

The Security Review Circular leaves many questions unanswered. Most prominent is whether the Circular will bring greater procedural transparency to an opaque and unstructured process or, consistent with Chinese perceptions of the Committee on Foreign Investment in the United States (CFIUS), serve mainly to establish a highly politicized forum for protectionist interests.

Key Observations and Questions

Impact on Deal Timing. Even assuming no clerical or bureaucratic delays, the Circular could mean additional waiting periods of at least 30 working days in the case of an "ordinary review", and an additional 65-70 working days in the case of a "special review." In the event the Joint Conference refers the transaction to the State Council for a decision, there are no time limits imposed on the process.

A Shrinking Safe Harbor? Sensitive industry sectors aside, the Security Circular applies to a broader range of transactions than the 2006 Provisions on Mergers of Acquisitions of Domestic Enterprises by foreign Investors (关于外国投资者并购境内企业的规定) (commonly known as "Circular 10"). Circular 10 generally excludes from special filing and approval requirements acquisition and restructuring of foreign invested enterprises (FIEs). The Security Review Circular, by contrast, explicitly applies to acquisition of a Chinese party's equity interest in an FIE as well as subscriptions of new equity in an existing FIE.

Limited Scope. The Circular defers review of transactions involving "new fixed asset investments" and changes to "state-owned property rights" to their legacy regulatory regimes, and anticipates new regulations for financial institution M&A. Consequently, security review in the case of foreign acquisition activity in much of the Chinese economy will continue to remain largely out of view — for better or worse.

Are VIE Structures Really Exempt? "Variable interest equity" (VIE) structures, whereby a foreign company utilizes various contractual and security arrangements through a controlled PRC subsidiary to exert sufficient control over management and revenues of a Chinese domestic company to qualify for consolidated financial reporting under U.S. GAAP, are frequently used in connection with cross-border VC investments and overseas capital raising. On its face, the Circular does not appear to cover VIE structures in situations where the buyer does not actually make an investment of record in the domestic target. Given the broad intent of Article 31 of the AML, and the fact that VIE structures are readily apparent from SEC filings, China's regulators may not leave this apparent loophole open for long.

Potential Chilling Effect on PE and VC Investments. When foreign PE or VC funds make minority investments in Chinese companies, they typically insist on pre-emptive rights to obtain additional equity or acquire the company on a proposed change of control, as well as veto powers over certain key board decisions. These could potentially run afoul of the very broad definition of "actual control rights" under the Circular.

Unlikely Retroactive Effect. Although the Circular also calls for aborting transactions that are already in process, as well as remedying existing security issues by forced divestitures of completed investments, MOFCOM has informally stated that they will not review transactions closing before it takes effect. This could change, however, given major adverse policy changes.

Risk of Inconsistency with Industrial Policy? The Chinese Central government has for many years applied its industrial policy to foreign direct investment through the periodically updated Foreign Investment Guidance Catalog. Will the broad and discretionary nature of the new security review procedures result in restricting certain areas of investment that were previously fully open?

Inviting Protectionism - Will Trade Wars Escalate to Investment Wars? The Circular goes far beyond traditional security issues to encompass "national economic stability" and "the fundamental order of the life of society", and permits trade associations, competitors, suppliers and customers to request security reviews. Despite the Joint Conference and Ministry of Commerce (MOFCOM) serving as gatekeepers, the Circular does potentially open a procedural door to protectionist interests — and retaliation against perceived protectionism by other countries rejecting proposed Chinese acquisitions.

Scope of Application — Designated National Security Sensitive Industries

The Security Examination Circular applies to two broad categories of foreign investment:

a) "Mergers and acquisition" (hereinafter "Acquisitions", defined below) of military industrial enterprises and their ancillary enterprises, enterprises proximate to key and sensitive military facilities, and other entities related to national defense, safety and security.

b) Acquisition of enterprises in the business of important agriculture products, important energy and resources, important infrastructure, important transportation services, key technologies, and material equipment manufacturing enterprises that have a bearing on national security, where the "actual control right" (hereinafter "Actual Control", defined below) over these enterprises **may** be obtained by foreign investors.

Issues and Observations

- For the time being, it is an open question whether the Circular only applies to acquisitions of non-state owned targets and those not involving "new fixed asset investments", as these areas are to be governed by legacy regulations and government agencies outside the Joint Conference frame-work. Also, M&A of financial institutions is to be governed by subsequent security review regulations.

'Acquisition' Defined

An "Acquisition" by a foreign investor (并购境内企业) (including investors from Hong Kong, Macao and Taiwan) refers to direct investment transactions involving "foreign invested enterprises" (外商投资企业) (FIEs) as follows:

a) A foreign investor purchases an equity interest in a domestic non- FIE, or subscribes to a capital increase in a domestic non- FIE, and thus changes the domestic enterprise into an FIE;

b) A foreign investor purchases the equity interest held by a Chinese shareholder in a domestic FIE, or subscribes to a capital increase in a domestic FIE;

c) A foreign investor establishes an FIE, and through the FIE purchases by agreement the assets of a domestic enterprise and operates the target assets, or through such FIE purchases an equity interest in a domestic enterprise; or

d) A foreign investor directly purchases the assets of a domestic enterprise, and then uses such assets to establish an FIE to operate the assets.

(Note: In order for an enterprise to qualify as an FIE a foreign investor typically must own at least a 25% equity interest and have successfully completed applicable foreign investment review and approval procedures.)

Issues and Observations

- The scope of coverage of the Security Review Circular is in some respects broader than that of Circular 10. Circular 10 does not impose special approval or security review procedures on transactions involving acquisitions, capital increases in or restructuring of existing FIEs, while the Security Review Circular clearly does.

- Interestingly, a drafting issue that previously appeared in Circular 10, but that was resolved by a subsequent circular, again appears in the Security Review Circular. The specific language in question involves use of the general term "domestic enterprise" (境内企业), along with the narrower concepts

of "foreign invested enterprise" and "non-foreign invested enterprise." As currently drafted, Part 3 of Section 1.2 of the Circular could be interpreted to encompass establishment of an FIE that subsequently acquires and operates the assets of another FIE, or else acquires the shares of another FIE. It remains to be seen whether, as in the case of Circular 10, a subsequent clarification will by issued by the State Council or MOFCOM.

- In the meantime, the only clear safe harbors from a transaction standpoint would appear to be (1) acquisition of the foreign-owned equity interest of an existing FIE; (2) establishment of a greenfield FIE, and (3) investment in a non-FIE enterprise that falls short of the 25% threshold ordinarily required to achieve FIE status.

- There is also at least one noteworthy inconsistency between the Antimonopoly Law and the Circular. While the AML at Article. 20(3) includes within the scope of business concentrations "obtain[ing] control rights in other operators by means of contracting or hav[ing] decisive influence over other operators," the Security Review Circular includes this concept not under the concept of "acquisition" but rather under "actual control right." Consequently, a transaction involving establishment of a VIE structure in which effective control is asserted over a domestic company but no "Acquisition" takes place, would be outside the scope of security review at this time. This probably represents loose drafting of the Circular which we would anticipate being tightened by subsequent rules.

'Actual Control' Defined

The "actual control right" （实际控制权）means the foreign investor "may" become the controlling shareholder or actual controller of the domestic enterprise, including transactions in which:

a) Over 50% of the equity is held by the foreign investor, its parent company or controlled subsidiaries after the Acquisition;

b) Over 50% of the equity is held by several foreign investors after the Acquisition;

c) The foreign investor holds less than 50% of the target's equity after the Acquisition, but its voting rights will have a material influence over shareholder or board resolutions; or

d) Other situations resulting in change of the actual control right over business operations, finance, human resources, technology, etc. of the domestic enterprise in favor of the foreign investor.

Issues and Observations

- This generally mirrors the US CFIUS approach, but only becomes relevant in China if an "Acquisition" occurs.

- While exerting control through a VIE structure in and of itself does not appear to bring a transaction under the scope the Security Examination Circular, as soon as an Acquisition occurs, no matter how small, the actual control factors would then apply.

Substantive Contents of Security Examination

The review process will focus on the impacts of the proposed Acquisition in the following areas:

a) National defense, safety and security, including the production capacity of domestic products, the ability to offer domestic services, as well as related equipment and facilities, necessary for national defense;

b) National economic stability;

c) The fundamental order of the life society; and

d) R&D capability in respect of key technologies relating to national security.

Issues and Observations

- The lack of definition and detail in these categories as well as the potential role of Chinese industry associations, competitors, suppliers and customers presents a significant test to the PRC security review process: will it be applied in a reasonably narrow and objective manner, or serve as means to channel protectionist and retaliatory influences?

Governing Authorities

Pursuant to the Circular, the Joint Conference shall be established under leadership of the State Council, and headed by the National Development and Reform Commission (NDRC) and MOFCOM. The Joint Conference, consisting of the NDRC, MOFCOM and other relevant authorities over concerned industries, conduct security reviews.

Security Review Procedures

a) Application Submission

- Foreign investors are required to file applications with MOFCOM when making Acquisitions subject to the Security Review Circular. MOFCOM will make an initial determination and within 5 working days submit to the Joint Conference for review transactions falling within the scope of security examination. Based on informal discussions with MOFCOM, applications should first be submitted to local counterparts of MOFCOM for preliminary feedback on whether the deal falls within the scope of the Circular.

- Relevant authorities under the State Council, national industry associations, enterprises in the same industry and upstream and downstream enterprises may also submit requests through MOFCOM to the Joint Conference, if they believe it is necessary to conduct security examination over certain transactions.

b) Ordinary Review

The Joint Conference shall conduct an ordinary review in the first instance. The parties to an Acquisition should cooperate with the review, provide necessary materials and information, as well as respond to inquiries.

Within 5 working days after receiving the application submitted by MOFCOM, the Joint Conference solicits opinions in writing from relevant authorities, which are to give their comments within 20 working days following receipt of the written solicitation. If none of the authorities deems that such transaction would impact national security, the Joint Conference shall, after receiving all written comments, provide its review opinion in 5 working days and notify MOFCOM in writing.

c) Special Review

If an agency believes the transaction would potentially impact national security, the Joint Conference shall within 5 working days after receipt of such written comment, initiate the special examination by organizing a security assessment of the transaction. Within 60 working days, the Joint Conference shall either issue its opinion and thus complete the special examination, or submit the matter to the State Council for final decision.

d) Amendment and Revocation

During the security examination, the applicant may file an application to MOFCOM to amend its transaction plan or terminate the transaction.

e) Notifications

MOFCOM is responsible for communicating review opinions to the applicant in writing.

Issues and Observations:

- While foreign investors are required to submit filings in respect of subject Acquisitions, unlike Article 31 of the Anti-Monopoly Law, the Circular does not pose a flat ban on closing in the case of failure to request review of a subject transaction. Nonetheless, MOFCOM's power to abort or unwind Acquisitions raising security concerns should provide sufficient motivation to request review in borderline cases.

Measures Imposed on M&A Transactions Failing to Clear Security Review

Upon a decision that the Acquisition has exerted or may have a material impact on national security, the Joint Conference shall request MOFCOM as well as relevant authorities to terminate the transaction, or take effective measures, such as equity transfer or asset transfer, in order to eliminate the adverse influence on national security.

Issues and Observations:

- It is encouraging to note that, as of the date of this GT Alert, a working-level official at MOFCOM has informally confirmed that they will **not** retroactively apply the Circular to transactions closed prior to the effective date of the Circular which would otherwise be subject to security review. That being said, subsequent capital increases or acquisitions of a Chinese partner's equity in the same FIE could nonetheless be subject to security review.

- Nonetheless, this provision on its face does empower MOFCOM to review legacy non-reviewed transactions pre-dating the Circular, and this currently benign position could change given a sufficiently compelling policy reason to conduct retroactive reviews.

Comparison to Current U.S. Foreign Investment Notifications and CFIUS Review

Similar in principle to the requirements of the Security Review Circular, the U.S. president has authority to review and ultimately prevent any foreign investment transaction that could result in control of a U.S. business by a foreign person if it threatens U.S. national security.

Specifically, the Committee on Foreign Investment in the United States, or CFIUS, an inter-agency committee chaired by the Secretary of Treasury, is charged with administering the relevant provisions. The analysis whether CFIUS notification is appropriate in the case of foreign investment in the United States hinges on two fundamental points:

(1) *Will the transaction result in the transfer of control of a U.S. business to a foreign (non-U.S.) person?*

Unlike the Security Examination Circular, which provides a clear 50% threshold for what constitutes "control," under U.S. regulations, "control" is defined functionally as the direct or indirect power, whether or not exercised, to direct or decide important matters, such as the sale of assets; dissolution; the closing or relocation of production or research and development facilities; the termination of contracts; or the amendment of governing instruments. CFIUS will consider the issue of foreign control on a case-by-case basis, focusing on such factors as the level of ownership interest and the nature of the affirmative or negative rights such foreign owner obtains with such ownership, such as the right to nominate board members or veto certain corporate actions. Although there is no bright-line ownership threshold for determining "control," an acquisition of 10% or less of the voting securities of a U.S. company "solely for the purpose of passive investment" will generally not trigger a CFIUS review.

The PRC Security Review Circular on the whole takes a similar approach, but also provides unequivocally that acquisition of 50% or more of the target's equity definitively constitutes actual control.

(2) *Does the transaction raise U.S. national security concerns?*

The relevant U.S. laws and regulations do not define the term "national security." Instead, the interpretation of that term is left to the discretion of the President. "National security" has been interpreted quite broadly, to include businesses involved not only in defense, security, and law enforcement, but also those that involve critical infrastructure such as energy, transportation, telecommunications, or information technology. The Security Review Circular by comparison, is far broader, also including "important" energy, resources,

infrastructure and transportation, but also adding "important" agriculture products and resources, and "key" technologies, and "material" equipment manufacturing."

Although parties are not required to notify CFIUS in advance of a proposed transaction, voluntary filings with CFIUS are often advisable if a transaction is believed to be reviewable by CFIUS. The president is authorized not only to investigate and prohibit proposed transactions with a foreign person that threaten national security, but also to order divestitures in the case of completed transactions. Once a transaction has been cleared by CFIUS or the president, however, it is no longer subject to reinvestigation, which does provide a safe harbor for the particular transaction, provided that no material changes occur to the facts as presented to and reviewed by CFIUS.

By contrast, the Security Review Circular makes advance filing mandatory, although it does not articulate a particular penalty for failing to do so. However, there is no safe harbor categorically exempting from re-examination a subsequent transaction involving a cleared entity, arising, for example, in the case of a subsequent capital increase. It also remains to be seen whether such a safe harbor will be created by subsequent rules.

Open Questions and Clarifications Needed

While at least providing a framework for M&A security reviews, the Circular raises various questions requiring further explanation and assurances. For example, clearer guidance by which to identify specific security-sensitive non-defense industries would be extremely helpful. Where no military or dual-use technology is involved, materiality thresholds relating to market share or transaction price would also go far to ease the burden on routine foreign direct investment. Most importantly, however, is whether reviewing government agencies will exercise their discretion in an informed and reasonable manner to focus on transactions that present genuine security concerns, free from protectionist and competitive influences.

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This *GT Alert* was prepared by shareholder **Peter Neumann** and associate **Wenjing Zhao** of the Shanghai Office, and shareholder **Kara Bombach** of the Washington, D.C. office. Questions about this information can be directed to:

- **Peter Neumann** — +86 21 6391 6633 (neumannp@gtlaw.com)
- **Kara Bombach** — 202.533.2334(bombachk@gtlaw.com)
- **Wenjing Zhao** — +86 21 6391 6633 (zhaow@gtlaw.com)
- Or your Greenberg Traurig attorney

[1] See the *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (《关于外国投资者并购境内企业的规定》), promulgated by the MOFCOM on August 8, 2006 and revised on June 22, 2009.
[2] *See the PRC Anti-Monopoly Law* (《中华人民共和国反垄断法》), *promulgated by the Standing Committee of the National People's Congress, effective on August 1, 2008. See also the Provisions on the Standards for Declaration of Concentration of Business Operators* (《关于经营者集中申报标准的规定》), *promulgated by the State Council, effective on August 3, 2008.*

Albany
518.689.1400

Amsterdam
+31 20 301 7300

Atlanta
678.553.2100

Austin
512.320.7200

Boston
617.310.6000

Chicago
312.456.8400

Dallas
214.665.3600

Delaware
302.661.7000

Denver
303.572.6500

Fort Lauderdale
954.765.0500

Houston
713.374.3500

Las Vegas
702.792.3773

Los Angeles
310.586.7700

London*
+44 (0) 203 349 8700

Miami
305.579.0500

New Jersey
973.360.7900

New York
212.801.9200

Orange County
949.732.6500

Orlando
407.420.1000

Palm Beach County North
561.650.7900

Palm Beach County South
561.955.7600

Philadelphia
215.988.7800

Phoenix
602.445.8000

Sacramento
916.442.1111

San Francisco
415.655.1300

Shanghai
+86 21 6391 6633

Silicon Valley
650.328.8500

Tallahassee
850.222.6891

Tampa
813.318.5700

Tysons Corner
703.749.1300

Washington, D.C.
202.331.3100

White Plains
914.286.2900

Greenberg Traurig, LLP Shanghai Office
Room 3125-141, Central Plaza
381 Huaihai Zhong Road
Shanghai 200020, P R China
Tel (86 21) 63916633
Fax (86 21) 63916232