

China's National Security Review for Inbound Acquisitions

PENpoints

China's recently enacted Circular 6 adds to the barriers facing non-Chinese investors in the China market by empowering Chinese authorities to review transactions for which investors have not traditionally sought PRC approval.

On February 3, 2011, China's State Council issued Circular 6,¹ establishing a national security review scheme for the acquisition of a Chinese company by one or more non-Chinese² investors. Effective March 5, 2011, Circular 6 adds to the barriers facing non-Chinese investors in the China market and empowers Chinese authorities to review certain types of transactions for which investors have not traditionally sought PRC governmental approval.

On March 4, 2011, China's Ministry of Commerce (MOFCOM) issued interim rules (the Implementing Rules) for Circular 6's implementation, which are expected to be replaced by revised (or new) implementing rules by August 31, 2011.

Scope

Two broad transaction types are subject to Circular 6 security review: (1) a non-Chinese investor's "acquisition" (as described below) of any stake (even a small one) in a military enterprise, a supplier to a military enterprise, a company located near sensitive military facilities, or any other company relating to national defense; and (2) a non-Chinese investor's "acquisition" involving "control" (as described below) of a Chinese company whose business involves "key" agricultural products, energy and resources, infrastructure, transportation services or technologies or manufacturing of equipment and machinery "affecting national security,"³ although Circular 6 does not provide guidance as to the meaning of "key" or "affecting national security."

Meaning of "acquisition." An "acquisition" under Circular 6 includes any of the following: (1) purchasing equity of a Chinese company (other than a foreign invested enterprise (FIE)⁴) from its shareholders or directly from the company (in which case such company would become an FIE); (2) purchasing equity of an FIE from a Chinese shareholder or directly from an FIE;⁵ (3) establishing an FIE to indirectly acquire the equity or assets of a Chinese company;⁶ and (4)

purchasing directly the assets of a Chinese company and operating them through an FIE.⁷ Unlike China's Anti-Monopoly Law, Circular 6 does not cover the purchase of a non-Chinese company with assets in China (e.g., acquiring the non-Chinese parent of a Chinese operating company).

Meaning of "control." "Control" under Circular 6 is defined broadly as follows: (1) owning 50% or more of the equity of a company (including where multiple non-Chinese investors together own 50% or more of the company's equity); (2) having voting rights sufficient to exercise a major impact on resolutions of a shareholders' meeting or board meeting; or (3) having decision-making authority over a company's business, financial affairs, personnel or technology. Because Circular 6 does not specify when "voting rights," "major impact" or "authority" constitutes control, it remains unclear whether a minority investment with customary protections (e.g., veto rights, supermajority voting requirements, negative covenants) constitutes "control."

Impact for VIE structures. In the past, many non-Chinese investors have used a "variable interest entity" (VIE) to invest (indirectly) in China without Chinese regulatory approval. Under a VIE structure, a non-Chinese investor forms a Chinese subsidiary (known as a WFOE or wholly foreign owned entity), and the WFOE enters into contractual arrangements (which may include exclusive service or license agreements, loan agreements, share pledge agreements and voting rights proxy agreements) to control and obtain an economic interest in (without legally owning) a Chinese operating company. Because a WFOE under a VIE structure typically acquires intellectual property (and

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sometimes other assets) of a Chinese company, the broad definitions of “acquisition” and “control” in Circular 6 can be read to cover VIE structures (under “acquisition” prong (3) and “control” prong (3) above).

Review Process and Timeline

Reviewing authority. A joint review committee (JRC) led by the National Development and Reform Commission and MOFCOM, with participation from representatives of governmental agencies with jurisdiction over the industry implicated in the transaction, will review each Circular 6 transaction. Under the long-standing regulatory regime, a local counterpart to MOFCOM (rather than central MOFCOM) reviews each acquisition by a non-Chinese investor falling below certain size thresholds (which typically makes the approval process faster and less burdensome). However, Circular 6 now requires an additional review—this one by the central government—for transactions falling below such size threshold.

Content of review. As part of its review, the JRC will consider the effect of a transaction on national defense and security, the stability of the national economy and the social order, and the research and development of key technologies relevant to national security. Circular 6 does not specify how the JRC will weigh such factors and reach a decision.

Initiation of review. If a proposed transaction falls within the scope of Circular 6, the non-Chinese investor is required to apply to MOFCOM for security review, and if it fails to do so, a third party (including a relevant department under the State Council, a national industry association or a competitor, customer or supplier of the target) may request MOFCOM to initiate a security review. Until more detailed rules are promulgated with respect to, e.g., the precise scope of review and meaning of “control,” a non-Chinese investor should typically notify MOFCOM of any transaction involving the relevant industries (even if it is unclear whether the business is “key” or “affects national security”) as soon as possible after executing transaction documents (to avoid any complications should a third party later request review).

General and special review. According to the Implementation Rules, MOFCOM has 15 business days after receiving an application for review to

determine whether a transaction falls within the scope of Circular 6. If it so determines, MOFCOM will forward the application to the JRC within five business days after making such determination. The transaction will then be subject to a two-stage review.

In the first stage (a general review, lasting up to 30 business days), the JRC will consult with and solicit written opinions from relevant governmental authorities. If any of them opines that the transaction is likely to impact national security, the review will proceed to a second stage (a special review), during which the JRC will carry out a security assessment. If JRC members do not reach a consensus within 60 business days of submission to this second stage, the JRC will seek a final decision from the State Council.

Impact on other reviews. The Implementing Rules preclude MOFCOM’s local counterpart from accepting an application for review of a transaction falling within Circular 6’s scope unless the non-Chinese investor has submitted an application for national security review with central MOFCOM. Further, if a transaction falls within Circular 6’s scope, the Implementing Rules suggest that local MOFCOM will not review and approve an application until national security review has been cleared, which could significantly lengthen the approval process for acquisitions in China. It remains to be seen whether local MOFCOM will, in practice, conduct its own review sequentially or (notwithstanding the Implementing Rules) in parallel with a national security review and whether the PRC authorities will revisit this issue when they issue new rules.⁸

While national security review and antitrust review are expected to proceed in parallel, it is not known whether MOFCOM will wait to grant antitrust approval until national security review is cleared, which could further delay the approval process.

Pre-filing consultation. The Implementing Rules permit a non-Chinese investor to request a consultation with MOFCOM on procedural issues before making a filing. It remains to be seen whether investors will also be able to address substantive issues in such consultations.

Authority to Reverse Transaction

In addition to authority to block a transaction, Circular 6 allows the JRC to order MOFCOM (together with

other governmental agencies) to rescind an already-completed transaction (i.e., cause the buyer to return the equity or assets to the relevant seller) or to take other actions (such as causing the equity or assets to be transferred to a third party) if it determines that the transaction has caused or is likely to cause an adverse impact on national security. Although it is not expected that this authority will be applied retroactively for transactions closed prior to March 5, 2011, it remains to be seen whether it will be applied to transactions currently seeking regulatory approval.

Conclusion

Circular 6 and the Implementing Rules leave several questions unanswered, including what businesses are “key” or “affect national security,” what types of minority investor rights constitute control, how the JRC will weigh different factors in its review, the extent to which security review will lengthen the approval process in practice and the likelihood that transactions will be blocked or reversed. It is expected that the Chinese authorities will issue additional rules to clarify at least some of these questions.

- 1 Circular 6 is titled *Circular on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.
- 2 “Non-Chinese” investors include investors from Hong Kong, Macau and Taiwan for purposes of the security review process.
- 3 Acquisitions of financial institutions are expected to be covered by future rulemaking.
- 4 An FIE is a company incorporated in the PRC that is either wholly or partly-owned by a non-Chinese investor.
- 5 A plain reading of Circular 6 suggests that an additional investment by a non-Chinese investor in a Chinese subsidiary wholly-owned by such investor (a common way to move money onshore) could trigger national security review, but it is not expected that such investments will be reviewed in practice, at least when made to invest in an existing business.
- 6 The purchase of a Chinese company through an existing FIE (as opposed to a newly formed FIE) does not appear to be covered by Circular 6 (unless it involves an additional investment in the FIE by a non-Chinese shareholder).
- 7 It remains to be seen whether, and under what circumstances, an acquisition of equity or assets of an FIE under acquisition prong (3) or (4) will be reviewed in practice.
- 8 It also remains to be seen whether central MOFCOM will conduct a regular, non-Circular 6 review (to the extent required) sequentially or in parallel with a Circular 6 review of the same transaction.

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

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