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China alert

Issue 9 – March 2011

Foreign acquisition of Chinese Enterprises to be vetted for national security risks

Regulations discussed in this issue:

- Notice of the General Office of the State Council on initiating security review system for foreign investors seeking to acquire Chinese enterprises, Guo Ban Fa [2011] No.6, issued by the General Office of the State Council on 3 February 2011, effective from 5 March 2011
- MOFCOM Announcement [2011] No.8, issued by MOFCOM on 4 March 2011, effective from 5 March to 31 August 2011
- Notice of MOFCOM on relevant issues in relation to administration on foreign investment, Shang Zi Han [2011] No.72, issued by the MOFCOM on 25 February 2011

Background

The State Council issued a circular, Guo Ban Fa [2011] No. 6 ("Circular 6"), on 3 February 2011, setting out the security review system for foreign investors seeking to acquire Chinese enterprises. The objectives of Circular 6 are to provide guidance on the orderly development of acquisition activities of foreign investors in China and to safeguard the national security of China. Circular 6 will be effective 30 days after the date of its issuance on 3 February 2011 i.e. 5 March 2011. Subsequently, the Ministry of Commerce (MOFCOM) issued an announcement that provides rules on the implementation of Circular 6 ("Announcement 8") on 4 March 2011. Announcement 8 is valid for the period from 5 March 2011 to 31 August 2011. According to Announcement 8, the public can provide feedback to MOFCOM on the application of Announcement 8 within the period from 5 March 2011 to 10 April 2011. According to the speech of Mr. Chen Deming, China's Minister of Commerce in the press conference of the Fourth Session of the Eleventh National People's Congress on 7 March 2011, Announcement 8 may be subject to revision, depending on such feedback.

The key points of Circular 6 and Announcement 8 are set out below:

1. Under what circumstances will national security review be required?

According to Article 1(1) of Circular 6, national security reviews are required where foreign investors are considering acquiring the following businesses and the effective control over those businesses may be obtained by the foreign investors:

The national security review regulations have come as no surprise, given that a similar line was adopted in the earlier Xugong precedent case in 2006 and in the regulations on foreign acquisition of domestic enterprises that came out the same year. Many other countries have similar regimes to safeguard their national security. There is a valid reason for China to institute its own security review system. However, it appears that some foreign investors hold rather cynical view towards Circular 6, fearing that M&A deals may get blocked easily under the mantle of national security due to economic or other factors. Indeed, in this era of resource scarcities and food shortages, the line between economic concerns and national security can occasionally blur. But one thing is for sure, businesses are awaiting real life security review cases with great interest.

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- Military related enterprises such as:
  - Enterprises in the military industry and military accessory industry
  - Enterprises in the vicinity of strategic and sensitive military facilities
  - Other unites that are related to national defence and security.
- Enterprises involved in operations that are concerned with national security such as:
  - Important agricultural products
  - Important energy and resources
  - Important infrastructure facilities
  - Important transportation services
  - Critical technologies
  - Manufacture of heavy equipment.

None of the abovementioned businesses are defined as Circular 6. Presumably none of these businesses fall within the Prohibited category in the Catalogue for Foreign Investment Industry Guidance, otherwise there should not be any need for review. However, more detailed guidance should be provided on the scope of each of these businesses shortly in order that the reviewing authorities can carry out the review objectively and effectively.

The acquisition of Chinese Enterprises by investors in Hong Kong SAR, Macao SAR and Taiwan Region will also be subject to the rules in Circular 6. Where a proposed acquisition involves the investment in newly added fixed assets or state-owned assets, the regulations in connection with state fixed assets or state-owned assets shall apply. The foreign acquisition of Chinese financial institutions shall be subject to different rules which will be issued separately.

2. What constitutes "acquisition of Chinese Enterprises by foreign investors" for national security review purposes?

Foreign investors will be treated as acquiring Chinese Enterprises[1] under the following circumstances:

- Foreign investors acquire the equity interests in non-Foreign Investment Enterprises (non-FIEs) or subscribe to additional capital of non-FIEs in China
- Foreign investors acquire the equity interests in FIEs from a Chinese partner or subscribe to the additional capital of FIEs in China
- Foreign investors set up FIEs through which to acquire and operate the assets of Chinese Enterprises or through which to acquire the equity interests in Chinese Enterprises
- Foreign investors directly acquire the assets of Chinese Enterprises and use those assets to establish and invest in FIEs that will operate those assets.

In the first situation, it is not clear if on-FIEs include enterprises in China that are owned and controlled by other FIEs. Such enterprises do not qualify as FIEs unless they are located in the Central and Western Region of China or they are owned by FIEs that have the status of a Chinese Holding Company. It is important to note that in the second situation, even the transfer of equity interests in FIEs can be subject to national security review. However, it seems that where a foreign investor acquires equity interests in a FIE from another foreign investor, there is no need for national security review even if the FIE carries out the operations that fall within the national security review scope. It is not clear if "FIEs" in this context include FIEs whose approval certificates bear the additional remark, "foreign interest is less than 25 percent". However, in that case, most probably the criteria for "effective control" as discussed in Point 3 of this article below, will not be met.

[1] Circular 6 uses the term, "Enterprises within the territory of China" (境内企业) rather than "Chinese Invested Enterprises" (内资企业). There is also the use of the term, non-FIEs (非外商投资企业). To distinguish these types of enterprises from FIEs in the English version of this article, the term, "Chinese Enterprises", is used to denote enterprises within the territory of China.

In the third situation, it is not clear if the national security review is required when the foreign investor first sets up the FIE or only when the FIE proceeds to acquire the assets of the Chinese Enterprise. Generally the act of acquiring assets itself does not require approval of the Ministry of Commerce or its local offices.

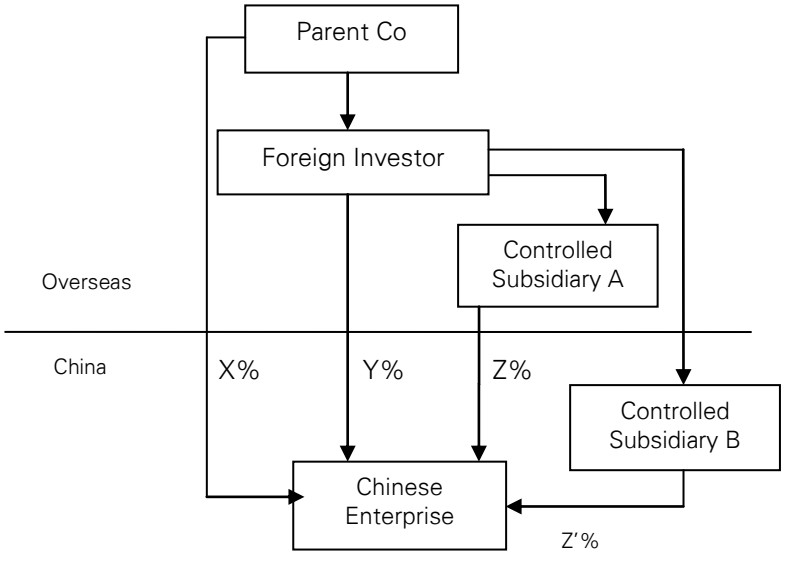
Circular 6 also does not deal with situations where the acquisition of equity interests in Chinese Enterprises is effected via the purchase of the shares in the offshore holding companies of the Chinese Enterprise. Such offshore holding company structure could have been put in place under a "round-trip" investment arrangement. Circular 6 also does not cover situations where equity interests in Chinese Enterprises are held on trusts or as nominees by other Chinese Enterprises for foreign investors. However, according to Article 15 of the Regulations on Acquisition of Chinese Enterprises by Foreign Investors issued by the MOFCOM on 2006 and revised in 2009, Decree No 6, parties involved in a foreign acquisition shall not conceal the relationship between two parties via trusts, nomination or other methods.

Except for the second situation, all the above situations are envisaged in Article 2 of Decree No 6 issued in 2009.

3. What constitutes "effective control" for national security purposes?

A foreign investor is regarded as having effective control over a Chinese Enterprise where the foreign investor becomes the controlling shareholder or effective controlling party of the Chinese Enterprise via acquisition, including the following circumstances:

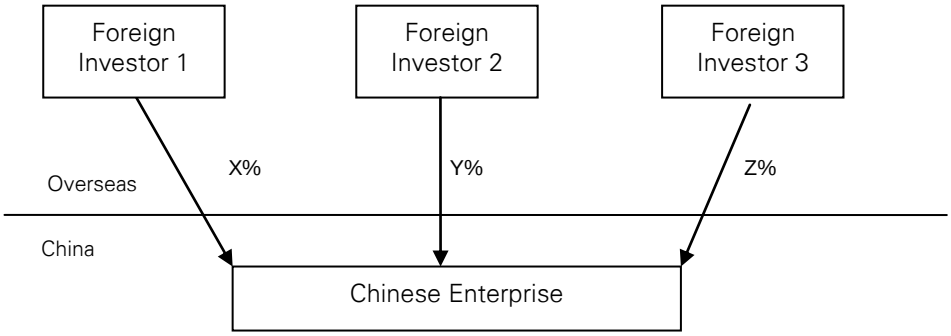
- The foreign investor and its controlling parent company and controlled subsidiary or subsidiaries would hold 50% or more of the shares in the Chinese Enterprise after the acquisition, as illustrated in the following diagram.



X% + Y% + Z% + Z'% > 50%

It is not clear in the first situation as to how to identify the controlling parent company and the controlled subsidiaries of the foreign investors. It is reasonable to assume that the same test of "effective control" as applied to the Chinese Enterprises will apply. It is also not clear if "controlled subsidiaries" cover both subsidiaries outside China and subsidiaries in China or subsidiaries outside China only. In the above example, it is assumed that controlled subsidiaries in China will also be taken into account in ascertaining effective control of the Chinese Enterprise.

- A number of foreign investors would together hold 50% or more of the shares in the Chinese Enterprise after the acquisition, as illustrated in the following diagram.



X% + Y% + Z% > 50%

- The foreign investor would hold less than 50% of the shares in the Chinese Enterprise after the acquisition but would have sufficient voting rights to exert significant influence over the resolutions of shareholders' meetings, general meetings or board meetings.

- Other circumstances that would cause the effective control in respect of operational decisions, finance, personnel, technologies, etc to be transferred to the foreign investor.

The fourth situation contains a catch-all provision. This may cover where foreign investors control the operation of Chinese Enterprises through trustees or nominees.

4. What factors will the authorities look at in a national security review?

The reviewing authorities will consider the following factors:

- National defence and security, including the impact on the capability of the State in producing domestic products and providing domestic services and related equipment and facilities required for national defence and security

- Stable operation of national economy

- Maintenance of basic social order

- Capability of conducting research and development on the critical technologies relating to national security.

5. Who will carry out such review?

The national security review will be conducted by an inter-ministry joint committee (Joint Committee). A Joint Committee will be initiated by the National Development and Reform Commission (NDRC) and MOFCOM under the leadership of the State Council and joined by the departments in charge of the industries and sectors related to the proposed foreign acquisition.

The principal duties of a Joint Committee are to:

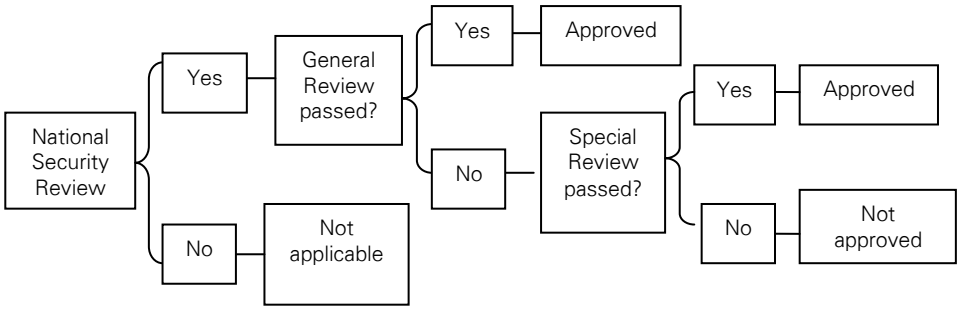
- Analyse the impact foreign acquisition will have on national security

- Carry out research and coordination in respect of major problems encountered in the national security review

- Reach a decision on the outcome of the national security review.

6. What will be the decision-making process of a Joint Committee?

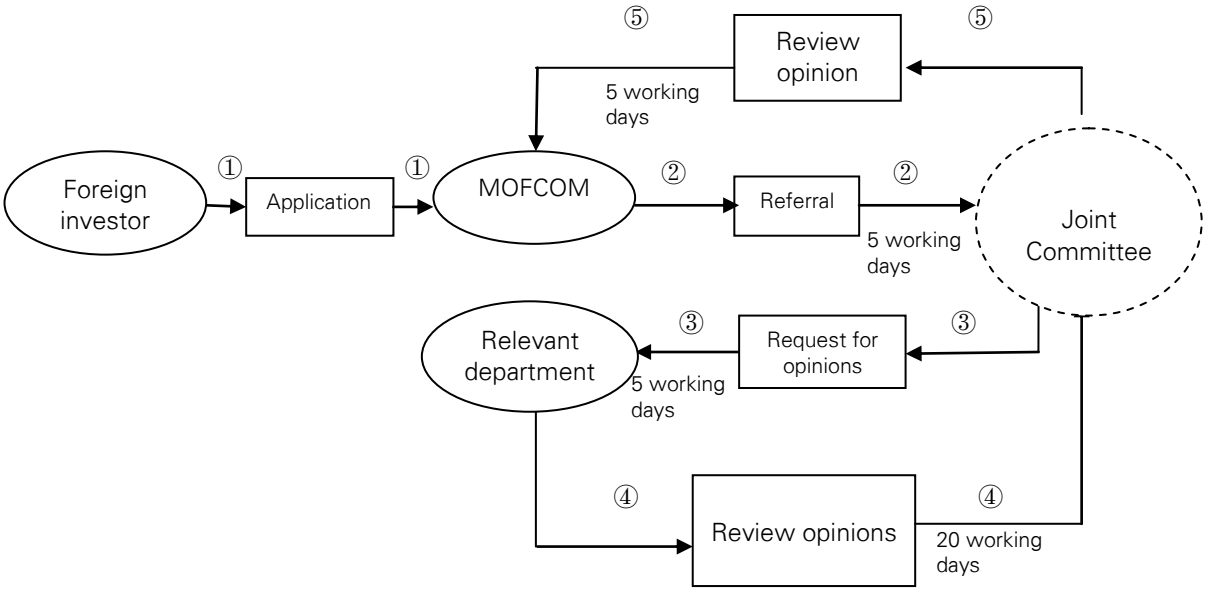
When a Joint Committee receives an application for national security review, it should first decide whether it is necessary to conduct such review. If so, the Joint Committee will conduct a General Review. If the General Review is passed, then the foreign investor may proceed with the acquisition; otherwise, the Joint Committee will conduct a Special Review. If the Special Review is passed, then the foreign investor may proceed with the acquisition. Otherwise the foreign investor will have to abandon the acquisition. The decision of the Joint Committee seems to be final, and Circular 6 does not provide for any further review or appeal procedures. The decision-making process may be illustrated as follows:



7. What will be the procedure of a General Review?

A General Review takes the form of a written request for opinions. When the Joint Committee receives an application for national security review from MOFCOM, the Joint Committee will have to seek opinions from the relevant departments in charge of the industry and sector related to the proposed acquisition in writing within five working days of receipt of the application. When the relevant departments receive the written request for opinions, they should issue written opinions within twenty working days. If the relevant departments are of the view that the acquisition will not affect national security, there shall be no special review. In that case, the Joint Committee will be required to express its review opinion and notify MOFCOM of such opinion within five working days of receipt of the written opinions from all the relevant departments.

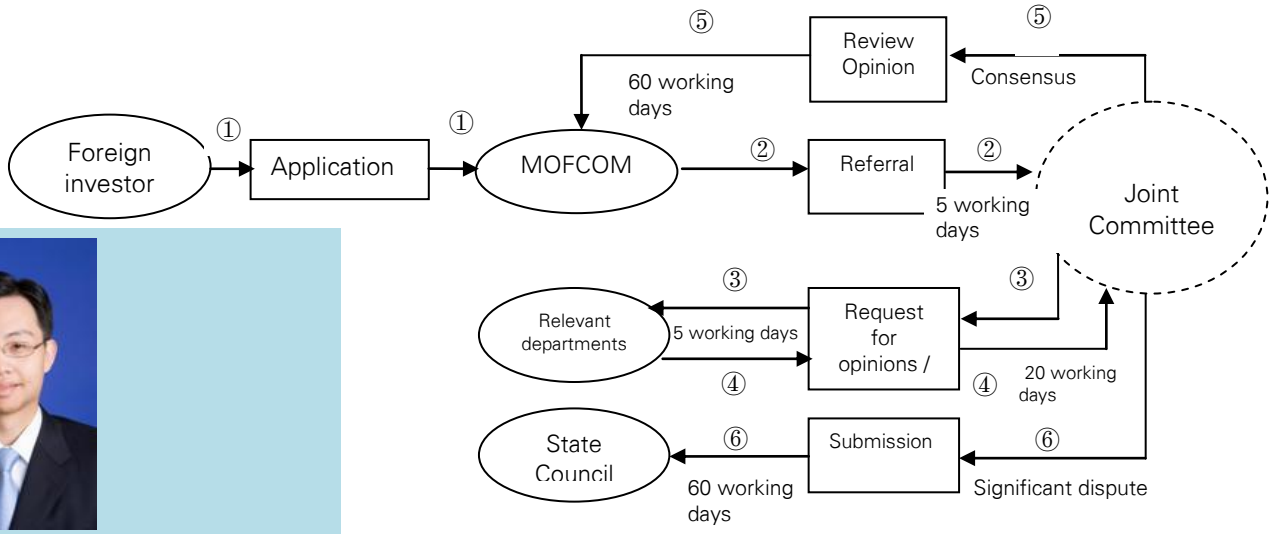
The procedure of a General Review is summarised as follows:



8. What will be the procedure of a Special Review?

If the relevant departments are of the view that the acquisition may affect national security, the Joint Committee should initiate the procedure of a Special Review within five working days of receipt of the written opinions of the relevant departments. After the Joint Committee has initiated such procedure, it should organise the assessment of the security implications of the acquisition and take into account the views from the assessment in reviewing the acquisition. Where there is a general consensus, then the Joint Committee will express its review opinion accordingly; where there is significant dispute, then the Joint Committee shall submit the case to the State Council for the latter's decision. The Joint Committee should complete a Special Review or submit the case to the State Council for the latter's decision within sixty working days from the day on which it initiates the Special Review procedure. The Joint Committee shall notify MOFCOM of its review opinion in writing.

The procedure of a Special Review is summarised as follows:



**Steps 5 and 6 are mutually exclusive.*

9. Should a proposed acquisition that is for USD 300 million or below be subject to national security review?

According to Announcement 8, an acquisition that is for USD 300 million or below should still be subject to national security review if the acquisition constitutes an effective control over a company that falls with the scope of operations set out in Article 1(1) of Circular 6.

This questions has been raised because, according to a circular issued by MOFCOM on 25 February 2011, Shang Zi Han [2011] No. 72 ("Circular 72"), under normal circumstances a foreign acquisition project that is for an amount of USD 300 million or below needs only approved by the commerce department at the provincial level. However, if such project falls within the scope of Decree 6, it will have to be approved by MOFCOM at the national level. Decree 6 basically requires MOFCOM approval for projects in key sectors, projects containing factors that affects or may affect national economic security or projects that would result in the change of effective control over well-known trademarks or old China brands. By the same token, projects that would potentially affect national security in accordance with Circular 6 should still go through the national review process as prescribed by Circular 6 even if the proposed acquisition is for an amount of USD 300 million or less. Basically, Announcement 8 confirms this position.

Interestingly, while the rules for foreign acquisition of Chinese enterprises have been tightened, those for the approval of setting up foreign investment enterprises have generally been relaxed. In many cases, the power of approval has been delegated to the department of commerce at the provincial level. However, despite the empowerment of the provincial commerce departments, MOFCOM is still very vigilant about the service industry. According to MOFCOM's recent Circular 72, three service sectors will require special attention, namely (1) special regulated sectors (e.g. finance lease, advertising (2) sensitive sectors (e.g. micro-finance, credit rating) and (3) sectors with large cash influx (e.g. venture capital, equity investment).

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It is interesting to see how the anti-monopoly review process will interact with the national security review process. Presumably the national security review process should take precedence over the anti-monopoly one. Once an acquisition proposal has failed the national security review, there should be no point for it to proceed to any other review. Conversely, a proposal that has passed the national security review can still fall foul of the operator concentration rules. This potentially means that foreign investors will have one more hurdle to clear. As such, foreign investors should allow more time, do more research and enlist more professional advice and assistance in planning acquisitions in China.

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KPMG observation

Circular 6 can trace its inception back to a MOFCOM panel review in 2006 when Carlyle, an international private equity firm, proposed the acquisition of an 85 percent interest in Xugong Group Construction Machinery Co., Ltd, a domestic manufacturer of heavy equipment. In that case, MOFCOM refused to grant the approval to the private equity firm's proposed acquisition of Xugong. National security was cited as the grounds in that decision. The State Council issued Decree 6, as mentioned in Point 2 of this article, in the same year, which endorses the principle of "economic security" as a key criterion to consider in reviewing and approving a foreign acquisition application in China.

In August 2007, China's Anti-Monopoly Law was promulgated, taking effect from 1 August 2008.The Anti-Monopoly Law more clearly sowed the seeds for Circular 6. In Article 31 of the Anti-Monopoly Law, it is stated that where foreign investors acquire Chinese Enterprises or use other methods to participate in operator concentration, affecting "national security", the approval authorities are required to not only scrutinise the risk of operator concentration in accordance with the Anti-Monopoly Law, but also to review national security risks in accordance with the "relevant regulations of the State". Such regulations are now set out in Circular 6.

While Circular 6 should provide more clarity, certainty and objectivity to the approval process of foreign acquisition, it is clear that foreign M&A transactions in certain sectors will be subject to greater scrutiny and additional approval process. Further, as mentioned above, there are still a number of unanswered questions created by the new rules. For example, the exact scope of projects that will call for national security review, and the criteria used in the review, all require further clarification. No doubt, the combination of the Anti-Monopoly Law and national security review requirements can make the approval process even more complicated and time-consuming. Foreign investors contemplating acquisitions in China should expect more challenges ahead.

In addition, it would be interesting to see whether the national security review will be extended to M&A transactions undertaken by RMB funds managed and controlled by foreign private equity managers, particularly when they co-invest with offshore funds managed by the same manager, a growing phenomenon in China.

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