China Establishes Mechanism for National Security Reviews of Foreign Investments

February 16, 2011

On February 3, 2011, the General Office of the State Council released long-anticipated rules for reviewing foreign direct investments in China for national security concerns. The new procedures, effective March 5, 2011, are set forth in the Notice of the General Office of the State Council on Establishing the Security Review Mechanism for Merger with and Acquisition of Domestic Enterprise by Foreign Investors (the Notice) [1]. On February 16, 2011, the National Development and Reform Commission (NDRC) posted informal guidance indicating that foreign investors will not be required to make a separate filing to initiate a security review; rather, the parties may be asked to provide information necessary for the security review in the course of other regulatory reviews[2].

While foreign direct investment projects in China have long faced a gauntlet of review and approval procedures by various government authorities, the Notice establishes the first detailed review mechanism devoted to national security issues. Several procedural and substantive facets of the new process resemble analogous procedures in the United States and elsewhere for screening foreign investment on national security grounds. Nevertheless, the Notice incorporates distinctive and broad standards, leaving unanswered many questions about the scope and impact of the new national security reviews.

Key Points
Here are five key points about the new review mechanism:

- The Notice covers two basic categories of transactions: (1) Investments involving Chinese enterprises directly involved in the national defense industry, and businesses located “adjacent” to such enterprises; and (2) investments involving any other Chinese enterprise that more indirectly invokes national security concerns, such as critical infrastructure, “key” technologies, and “important” agricultural or energy products. Notably, the rules do not apply to transactions involving financial institutions or certain transactions involving “state-owned assets.”
- Although the text of the Notice is not clear, the NRDC guidance clarified that with respect to either category of covered transaction, a “merger or acquisition” is reviewable only if the foreign investor will gain “actual control” of the enterprise. The Notice describes various scenarios by which such control may be acquired. The overall structure reflects an analytical approach quite similar to that followed by the Committee on Foreign Investment in the United States (CFIUS), but a number of questions concerning treatment of minority investments, for example, remain unanswered.
- Reviews will be conducted by an interagency committee co-chaired by the NDRC and the Ministry of Commerce (MOFCOM). The committee will follow a two-stage review process that also mimics the CFIUS process, including following a timeline that aims to complete reviews in about 90 days.
- Importantly, covered transactions will be reviewed not only for their potential impact on national security, but also with respect to potential impacts on China’s “economic stability” and “social order.”
- The interaction between the general foreign direct investment approval procedures and the national security review process remains uncertain. In recent years, provincial and local authorities have received greater authority to approve larger projects in more industries without central government involvement. The new national security review system channels certain transactions to the central government for review.

**Legislative Background**

National security concerns have long colored the Chinese government’s view of foreign investments, but the first measures providing for separate review of foreign direct investment on national security grounds appeared in the 2006 *Rules for M&A of Domestic Enterprise by Foreign Investors* (2006 M&A Rules)[3]. These rules introduced requirements for foreign acquisitions of Chinese firms that “result in actual control by the foreign investor” and “involve key industries, have factors imposing or possibly imposing material impact on the economic security of the State, or would result in transfer of actual control in a domestic enterprise which owns any well-known trademarks or Chinese historical brands”[4]. MOFCOM, “together with other relevant departments,” may act to block, modify or unwind unreported transactions with actual or potential “material impact” on...
The Notice establishes the first detailed review mechanism devoted to national security reviews of foreign investments. While foreign direct investment projects in China have long faced a gauntlet of review and approval procedures by various government authorities, the Notice provides a more granular approach. "The Security Review System for Merger & Acquisition of Domestic Enterprises by Foreign Investors" will follow a two-step review process that also mimics the CFISUS process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days. The interaction between the general foreign direct investment approval process, including following a timeline that aims to complete reviews in about 90 days.
As noted above, NRDC officials have clarified that the proviso in category (ii) - “provided that the actual control of the domestic enterprise is acquired by foreign investors after the transaction” - also applies to transactions described in category (i).

Both categories involve “mergers and acquisitions of domestic enterprises by foreign investors.” Such transactions are defined by reference to the concept of a Foreign Invested Enterprise (FIE), and encompasses the following four scenarios involving the formation or change in ownership of an FIE:

(i) “Foreign investors purchase shares from a domestic non-FIE, or subscribe for any capital increase of a domestic non-FIE, and after the transaction the status of the domestic enterprise is changed into an FIE.

(ii) Foreign investors purchase shares from a Chinese shareholder of an existing FIE, or subscribe for any capital increase of an existing FIE.

(iii) Foreign investors establish an FIE, and use that FIE to (a) purchase assets of a domestic enterprise and operate such assets after the purchase or (b) purchase shares of a domestic enterprise[11].

(iv) Foreign investors purchase assets directly from a domestic enterprise, and then establish an FIE to hold and operate such assets”[12].

The Notice defines the acquisition of “actual control” as “a merger or acquisition after which a foreign investor becomes the controlling shareholder or the actual controller of a domestic enterprise.” Such control may result from the following circumstances:

(i) “A foreign investor, its share-controlling parent companies, and share-controlling subsidiaries, collectively hold more than 50% of the total outstanding shares of the target enterprise after the transaction.

(ii) Several foreign investors collectively hold more than 50% of the total outstanding shares of the target enterprise after the transaction.

(iii) Although a foreign investor holds less than 50% of the total outstanding shares after the transaction, the foreign investor, through the voting power of such shares, may nevertheless materially influence the outcomes of shareholder meetings, general meetings or board meetings of the target enterprise.

(iv) Any other circumstances in which the actual control of business operations, finance, personnel and technology decisions of a domestic enterprise is transferred to a foreign investor”[13].
Importantly, the Notice specifies that mergers and acquisitions of domestic enterprises by investors from Hong Kong, Macao and Taiwan are subject to its provisions[14].

**Joint Committee**

According to the Notice, a joint committee (the “Committee”) shall be established at the inter-ministry level under the State Council[15] The Committee will be led by the NDRC and MOFCOM, and will be overseen by the State Council. The Committee shall involve other relevant ministries and governmental agencies in its activities, depending on “the industries and areas involved”[16]. The major responsibilities of the Committee include: (i) analyzing the impact of transactions on China’s national security, (ii) analyzing and coordinating major issues during the security review process, and (iii) conducting security reviews of applicable transactions and making decisions accordingly[17].

**Substantive Standards**

Without further elaboration, the Notice lays down four criteria for evaluating transactions:

(i) "The impact of the transaction on national security, including the domestic production capacity, the domestic service capacity and related equipment and facilities needed for national security purposes.

(ii) The impact of the transaction on China’s economic stability.

(iii) The impact of the transaction on China’s social order.

(iv) The impact of the transaction on China’s R&D capacity of critical technology related to national security”[18].

**Initiation of Reviews by Application and Referral**

The Notice establishes two channels for initiating reviews. First, the Notice explicitly requires foreign investors to submit applications to MOFCOM regarding covered transactions - they “shall” do so. The Notice does not, however, specify when the investors must file such a notice. Within five working days of such submission, MOFCOM “shall” submit any transaction falling under the scope of the security review to the Committee[19].

Second, if any department or agency of the State Council, any national industry association, any enterprise in the same industry, or any upstream or downstream enterprise believes that a transaction should be subject to the security review process, it may suggest to MOFCOM that a review be conducted. If the Committee determines that a review is indeed necessary, it may initiate the security review process[20].

The NRDC guidance published on February 16 indicates that no separate
Two-Stage Review Process

The Notice outlines a two-stage review process entailing a general review and special review (or an extended review). According to the Notice, the Committee shall first conduct a general review of a transaction submitted by MOFCOM. If the Committee does not clear the transaction after the general review, then a special review shall be conducted.

General reviews will be conducted through written inquiries. The Committee shall solicit opinions from relevant agencies within five working days after the submission by MOFCOM. Relevant agencies shall provide their opinions in writing within 20 working days after the opinion solicitation notice. If all the relevant agencies find that the transaction has no impact on national security, then no special review is required. The Committee shall issue the decision within five working days after receipt of all opinions and inform MOFCOM in writing.

If any agency finds that the transaction may potentially have any impact on national security, the Committee shall start the special review process within five working days after receipt of such opinion in writing. The Committee shall organize a security assessment of the transaction and...