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MOFCOM Releases Measures to Implement the New Foreign Investment National Security Review Mechanism - Renewed Scrutiny of Captive Structure

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On August 25, 2011, the PRC Ministry of Commerce (“MOFCOM”) issued the *Measures on Security Review Mechanism for Merger & Acquisition of Domestic Enterprises by Foreign Investors* (the “Measures”). The measures further refine China’s procedures for reviewing certain foreign acquisitions of control over domestic PRC entities on national security grounds. The State Council set the basic framework for national security reviews through the February 2011 *Notice on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (see our alert here), and MOFCOM fleshed out this framework with the release of the “Interim Measures of the Ministry of Commerce on Security Review Mechanism for Merger & Acquisition of Domestic Enterprises by Foreign Investors” (the “Interim Measures”) on March 4, 2011 (see our alert here).

Although the new Measures supersede the earlier Interim Measures, most provisions of the earlier procedures remain unchanged.

The new Measures refine existing procedures with respect to preliminary consultations, re-submission of amended applications, and the reviewing authorities’ confidentiality obligations. The most controversial element extends national security review to “contractual control arrangements” for

gaining control over PRC-owned entities. Some commentators have raised questions about whether MOFCOM and other regulators are clamping down on the use of captive structures (also commonly referred to as “Sina-Sohu” or “variable interest entity (VIE)” structures), which are widely used by China-based companies in restricted sectors (such as the Internet or education sectors) seeking to pursue offshore listings.

“Anti-circumvention” & implications for captive structures

Article 9 of the Measures provides that the applicability of the national security review process to a specific transaction shall be “judged on the substance and actual impact of the transaction.” Article 9 further states that foreign investors may not “circumvent” the national review process “in any way,” and lists possible circumvention strategies such as “nominee holding, trusts, multi-level reinvestments, leasing, loans, contractual control arrangements or off-shore transactions.”

This provision targets investment structures that enable foreign investors to exercise effective control over a PRC company without directly acquiring a controlling equity stake, such as the captive structure. Typically, such structures utilize contractual control arrangements, whereby a PRC domestic company held by PRC shareholders enters into a series of contractual arrangements with a separate foreign or foreign-invested entity that gives the foreign entity effective control over the PRC domestic company, and the ability to consolidate the PRC domestic company's financial statements as a variable interest entity of the foreign holding company. The captive structure was pioneered by the early PRC Internet portal operators such as Sina.com and Sohu.com in the late 1990s. Such structure operated to give foreign investors exposure to China's value-added telecom services sector in spite of PRC regulatory restrictions on foreign investment in that sector. Although the structure has never been officially or publicly blessed by the PRC government, the captive structure has become widely used in certain sectors where foreign investment is restricted (e.g., the Internet, education and media sectors), with dozens of China-based companies that have adopted the structure currently trading on foreign stock exchanges.

As a practical matter, many transactions utilizing captive structures are unlikely to implicate core national security concerns and therefore would likely not be subject to the national security review. Nevertheless, the inclusion of Article 9 raises questions as to whether MOFCOM and other regulators are moving to block the use of captive structures. On one hand, Article 9 may signal a future shift by MOFCOM to place captive structures under scrutiny as a special kind of “M&A” activity of international investors, even though this structure was not explicitly addressed under the Provisions on Foreign Investors' Merger with and Acquisition of Domestic Enterprises

(commonly referred to as the “M&A Rules” or “Circular 10”). On the other hand, given that Article 9 aims more narrowly to reserve the option for MOFCOM to block transactions involving captive structures that actually impact Chinese national security interests, we do not believe this necessarily portends a move towards general prohibition of such investment structures where national security concerns do not arise. However, market participants will be closely watching indications from MOFCOM in this regard following the issuance of the Measures.

Initiation of National Security Reviews

The new Measures enable MOFCOM to review a transaction on national security grounds at its own initiative, even if the transaction parties themselves do not submit the transaction for review. Article 3 permits other government departments under the State Council, national trade associations, competitors, and upstream or downstream enterprises to request that MOFCOM conduct a national security review of a specific transaction. MOFCOM may then solicit additional information directly from the parties to the transaction. If MOFCOM concludes that the transaction may merit national security review, it shall refer the transaction to the Joint Ministry Conference for further examination pursuant to the normal review procedures.

Prohibition of Unimplemented Transactions

Article 7(2) of the new Measures provides that, if the Joint Ministry Conference finds national security concerns with a transaction which has not yet been addressed, the parties must terminate the transaction, and they may not reapply for approval of the same transaction without revising the transaction to address the national security concerns. Although this principle was arguably implicit in the previous rules, it is now expressly confirmed.

Confidentiality

Article 11 of the new Measures stipulates that personnel from MOFCOM and other government authorities involved in national security reviews are obliged to “treat as confidential any national and trade secrets and other information that needs to be kept confidential which are involved in the security review.” The Measures do not, however, clarify the standards and procedures for determining whether specific information is entitled to

confidential treatment, or the ramifications of a denial of confidential treatment to submitted information.

Chinese regulators have numerous channels to block or modify foreign investments based on national security grounds or even broader industrial policy or public interest concerns. The extent to which the national security review process will actually compound the regulatory burdens on Chinese deals remains to be seen.

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