WILMERHALE

China Adopts Its Own 'CFIUS' Regulations

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Having seen several of its proposed investments in other countries blocked on national security grounds, the Chinese government determined to adopt such regulations of its own. The decision process was driven not only by the fact that China led the world in the absorption of foreign investment last year, totaling approximately US $100 billion, but in the expectation of an increase in acquisitions of Chinese domestic companies by foreign investors. Such regulations were anticipated under the Regulations on Mergers and Acquisitions by Foreign Investors (2006) and authorized under Article 31 of the Anti-Monopoly Law (the "AML," 2007 and effective 2008). Article 31 authorized a separate national security review in addition to the anti-monopoly review for mergers and acquisitions of domestic Chinese enterprises, or participation by other means in concentrations of undertakings, by foreign capital which have implications for China's national security.

The State Council General Office, the secretariat of China's central government, on February 3 issued the Notice Concerning Establishment of the Security Review System on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "Security Regulations"). The timing of the issuance appears to have been a matter of some urgency given that it occurred during China's week-long Spring Festival or Lunar New Year

holiday. The Security Regulations take effect in 30 days, on March 5.

The scope of the Security Regulations, as signified by their title, extend beyond national security which as narrowly defined might include only national defense. Under par. 1(1) they apply not just to military and national defense-related transactions but also to transactions involving important agricultural products, energy and resources, infrastructure facilities, and transportation services; core technologies; and important equipment manufacturing enterprises. Thus, a security review may be initiated with respect to many transactions that do not have a direct nexus to national defense. In this sense the Security Regulations reveal a concern about foreign acquisitions in many areas of the economy–even though the preamble identifies as their first purpose guiding the smooth development of mergers and acquisitions by foreign investors.

Par. 1(2) of the Security Regulations applies to a foreign investor's equity or asset acquisition of a domestic enterprise taking any of the following forms: (1) acquisition of the equity interest of a non-foreign invested enterprise[1] or subscription for an increase in the capital of such enterprise with the result that such domestic enterprise becomes a foreign-invested enterprise ("FIE");[2] (2) acquisition of the Chinese-owned equity in a domestic FIE (here, a joint venture) or subscription for an increase in the capital of a domestic FIE; (3) establishment of an FIE which acquires and operates the assets of a domestic enterprise or acquires the equity of such domestic enterprise; or (4) direct acquisition of the assets of a domestic enterprise to establish an FIE to operate such assets.

Under par. 1(3), the acquisition of a controlling equity interest or of actual control in any of the following forms is also covered: (1) direct or indirect acquisition by a foreign investor of 50% or more of the shares in a domestic

enterprise; (2) acquisition by a group of foreign investors of 50% or more of the shares in a domestic enterprise; (3) acquisition of material influence over decisions of the shareholders meeting or board of directors even with less than 50% of the shares; or (4) acquisition of actual control over a domestic enterprise's policies, finances, personnel or technology. The application to acquisition of actual control signifies that the Security Regulations, like the AML, can reach offshore transactions.

The security review will have a broad focus under par. 2, including the impact on national defense, economic stability, basic social livelihood order, and technology R&D capability relating to national security.

Under par. 3 the review process will be led by the new Joint Inter-Ministerial Security Review Committee (the "Security Review Committee"), which will be led by the National Development and Reform Commission ("NDRC," the former State Planning Commission) and the Ministry of Commerce ("MOFCOM"), with participation by other affected ministries. MOFCOM is already in charge of anti-monopoly review. Although NDRC has no statutory role in anti-monopoly review of business concentrations, in practice MOFCOM consults first with NDRC after an anti-monopoly review is initiated. In this sense the joint leadership of NDRC and MOFCOM merely gives NDRC a direct role and one that is likely to be greater than that of MOFCOM. The Security Review Committee has substantive authority under the Security Regulations, including analysis of the impact of foreign M&A on national defense, study and coordination of key issues identified during the security review, examination of foreign M&A and in some instances ultimate decision-making power.

The review provision under par. 4 is triggered by a notification by the

foreign investor(s), although it is unclear whether a separate national security notification is required if an anti-monopoly notification is also submitted. Moreover, other government ministries, national trade associations, other companies in the industry and domestic enterprises can also ask MOFCOM to initiate an investigation. In addition, the Security Review Committee can initiate an investigation on its own if it deems doing so appropriate. Although the Security Regulations are not explicit as to whether the foreign investor is obligated to file a national security review application with respect to covered transactions, it would appear that the obligation is intended to be mandatory, as the legislative authority is the AML. Article 48 of the AML provides that implementation of a transaction in violation of the AML may result in an order by the anti-monopoly enforcement authority (i.e., MOFCOM) to suspend the transaction, dispose of the relevant equity or assets, transfer the business or take other actions to restore the status quo ante. The Security Review Committee has five business days to determine whether to initiate a review. It is unclear whether that clock begins to run on the submission of a notification or, as is the case with anti-monopoly reviews and many other regulatory and judicial processes in China, the running of the clock can be delayed until the notification is accepted for processing by the agency, MOFCOM in this instance. Transactions involving state-owned assets and financial institutions are to be addressed under separate regulations.

A review, once initiated, is to be completed by the Security Review Committee within 20 business days. If the Security Review Committee determines that there is no impact on national security, it then informs MOFCOM within an additional five business days. If the Security Review Committee by contrast determines that there is a possible impact on national security, it initiates a special review within five business days. If such impact is deemed to be major, the special review will take up to 60

business days or the matter will be referred to the State Council for decision. The party may at any time withdraw or modify its notification and/or the underlying M&A transaction. The eventual decision is notified by MOFCOM to the party. A transaction that has already cleared without being subject to national security review can be investigated and unwinding or divestiture can be required in some circumstances.

Implications

The Security Regulations will potentially subject a large number of M&A transactions by foreign investors in China to an additional layer of review. The covered transactions can go well beyond national security, narrowly defined, to include agriculture, infrastructure and other industries. They include acquisitions of domestic non-FIEs within the broad subject matter reach of the Security Regulations, and also apply to increases of control and to acquisitions of actual control along one or more dimensions even if ownership is less than 50%. If widely enforced to block foreign M&A transactions, the Security Regulations risk engendering an adverse reaction by foreign governments to acquisitions by Chinese companies in resources and other industries within their jurisdictions.

The security review process is not in sync with the foreign investment and anti-monopoly review. Unlike an anti-monopoly review, there is as yet no monetary threshold for initiating a national security review. Thus, foreign M&A transactions of any size within the broad subject matter reach of the Security Review Regulations may trigger a national security review. Moreover, many transactions which for purposes of foreign investment review are generally subject only to local government approval, even though total investment may be as much as US $300 million, may be subject to national security review by the NDRC and MOFCOM in the central

government. In addition, although a Phase I anti-monopoly review must be completed within 30 calendar days, the timing for a national security review is tied to business days and thus even an initial review can take longer.

[1] An enterprise with less than 25% foreign ownership.

[2] Foreign investment increasing to at least 25%.

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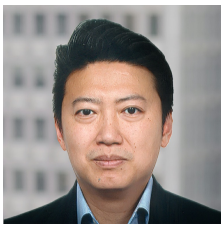

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