China's National Security Review System for Foreign M&As Has Been Unveiled [*]

Prof. Dr. Han LONG [**]
Law School of Zhongnan University

Abstract: In response to the national security concerns caused by the sharp increase of foreign M&As in China, China has formally established its national security review system for foreign M&As in 2011 after its lengthy embryoment and development. The system actually classifies the M&As transactions potentially falling into the scope of national security review into two categories depending on the nature of target of the foreign M&As: the military or military-related enterprises and important enterprises in sectors other than the military or military-related fields, setting up different requirements for them. The system has also listed the factors for consideration in the review, and has set up the mechanism and procedure for the review, similar to American counterpart in structure. The biggest threat to the proper implementation of the system is that it might be misused by the vested interests in China to protect their own interests in the pretext of national security and block foreign investment beneficial for the public interest but harmful for the vested interests.

Key words: M&A national security requirements and procedures

After long time of embryoment and gradual development, the formal national security review system for foreign mergers and acquisitions (hereafter referred to as M&As) in China has emerged with promulgation of Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisition of Domestic Enterprises by Foreign Investors (hereafter referred to as the 2011 Notice) on 3 February 2011 and Ministry of Commerce's Regulation on Implementing of the Secu-

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[*] This note is part of research of the 2008 Key Project of China's National Social Science: Research On the System build-up for Regulation of International Financial Risk and Crisis presided by Professor Han Long, Award Number: 08AJY013.

[**] Law Professor of Law School of Zhongnan University of Economics And Law, PhD of law . E-mail: hanlong168@hotmail.com. Blog: http://blog.sina.com.cn/dragonblock. Mobile: 0086-15927384263.

rity Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (hereafter referred to as the 2011 Regulation) on 25 August 2011. China's national security review system for foreign M&As would certainly have a broad impact on prospective M&A transactions by foreign investors in China, and thus is worthy of attention. This note consists of three parts: Part I traces the embryoment and gradual development of China's national security review system for foreign M&As, focusing on its causes and historical development. Part II examines the structure and main content of the system in China accompanying with necessary analysis. Part III puts forward some observations upon and concerns over the implementation of the system in China.

1. The Embryoment of China's National Security Review System for Foreign M&As

China's national security review system for foreign M&As established in 2011 has undergone long process of embryoment and gradual development. This process can be divided into the following stages:

1.1. Early Stage: 1980s

Within nearly 30 years after the founding of the P.R. of China, China remained hostile to foreign direct investment (FDI) except for the economic assistance from Soviet and East European Block in the 1950s. China's attitude towards FDI changed dramatically from 1978 when it began to adopt reform and open-up policy, a policy that welcomes and attracts FDI. As it had urgent need for foreign capitals in its development, China offered various special benefits and advantages for FDI which were not available to domestic enterprises, that is the super national treatment for FDI. As a result of this, and also as China has developed rapidly and its market has become more and more attractive for foreign investors, China has witnessed sharp increase of FDI in China.

At this early stage, FDI usually made greenfield **investment, i.e.** FDI set up wholly owned foreign invested enterprises or joint ventures with Chinese enterprises. In this case, the national security concerns for foreign M&As of China's domestic enterprises were not prominent and protruding at that time. Nevertheless space for national security were preserved in the 1980s in the implementation rules respectively for the three basic laws governing FDI, i.e. The Law on Chinese-Foreign Equity Joint Ventures, The Law on Chinese-Foreign Contractual Joint Ventures, The Law on Foreign-

Capital Enterprises. For example, Art. 5 of The Implementation Rules for The Law on Chinese-Foreign Contractual Joint Ventures provides: "The applications for the establishment of Chinese-Foreign contractual joint ventures shall not be approved in one of the following cases: (1) impair sovereignty and social benefit; (2)endanger China's national security……(4) not in conformity with the development of China's national economy". The other two implementation rules have the similar rules.[1] Thus in the 1980s although the national security concerns raised by foreign M&As in China were not imminent, the laws contains the general principles of safeguarding of China's national security in its attraction of FDI.

1.2. The Middle Stage: 1990s

As time passed, more and more FDI made its investment by mergers and acquisitions (M&As) of Chinese domestic enterprises and then change them into Foreign Investment Enterprises (FIEs). One of important reasons for the increase of foreign M&As in China in the 1990s is that a vast number of stated-owned enterprises (SOEs) managing a huge amount of state-owned properties ware in a difficult situation in China's transition from the traditional planned economy to the market economy in the 1990s, and policies of China at that time allow small and medium-sized SOEs to be sold out. Against this background, M&As by China Stegy Investment Co of domestic enterprises in 1992 and 1993 became a symbolic case and raised wide concern for national security for foreign M&As. China Stegy Investment Co. is a Hongkong-based corporation listed in Hongkong Stock Exchange. [2] China Stegy Investment Co. acquired all the SOEs as many as 37 in total in Quanzhou city (Fujian province) in September 1992, and then with collaboration of Light Industry Bureau of Dalian city (Liaoning Province) established 101 joint ventures with local enterprises in which China Stegy Investment Co. controlled 51% of the shares, swallowing up the light industry in this city in September, 1993.[3]

Hand in hand with more and more M&As happened later on as China's policy to utilize FDI and foreign M&As as a means to reform and

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1 See Art. 4 of The Implementation Rules for The Law on Chinese-Foreign Equity Joint Ventures and Art. 5 of The Implementation Rules for The Law on Foreign-Capital Enterprises.

2 In 1992, Hongkong has not returned to China, so FDI from Hongkong were treated as foreign investment. Even today after Hongkong returned to China, FDI from Hongkong are still treated as foreign investment for the purpose of foreign investment law of China.

3 Tang Zongkun, Case analysis of State-owned Property Transaction, in Reform, Vol. 2, 1997, p. 41.

restructure the SOEs and to enhance international competitiveness of the domestic enterprises, rules and regulations aiming to protect national security and for other purposes were promulgated . In 1995, permitted by the State Council, the central government of China, the State Planning Committee etc promulgated Interim Provision on Guiding Foreign Investment, which for the first time at law clarifies the industries in which China encourages, restricts and prohibits FDI. Art. 7 of the Interim Provision takes the seven cases of investment as prohibited, and FDI that endangers the security of the state or damage social and public interests ranks the first. And matched with the Interim Provision, the Catalog of Industries for Guidance for Foreign Investment also has corresponding provision. After China entered the WTO in 2001, the State Council promulgated Provision on Guiding Foreign Investment in 2002 renewing the above Interim Provision, and correspondingly the Catalog of Industries for Guidance for Foreign Investment was revised and renewed. The above renewed Provision and Catalog did not make material amendments to their predecessors. Although the renewed Provision and Catalog and their predecessors contained the element of and consideration for national security, yet they were basically industry development policy in nature and character, so to a large extent the Provision and Catalog did not establish national security review system for foreign M&As.

In addition to the above the Provision and Catalog and their predecessors, in this period, China also promulgated Interim Provisions on Asset Reorganization of SOEs by Using Foreign Investment of 1998, which is mainly targeted at preserving the state-owned assets in enterprises restructuring participated by foreign investment. The preservation of the state-owned assets in the context of China may have the value of national security, but this Interim Provisions did not set up the formal and comprehensive national security review system for foreign M&As either.

1.3. Final Stage: 21 Century

In 21 Century, China became a member of the WTO on December 2001, and carried out wide range of policies to open up to the outside world. In parallel with this trend, FDI kept on increasing in China, and continued and enhanced its access form of M&As prevalent in 1990s, and exhibited two characteristics: First, the buyers of M&As are almost all of the world's famous multinational corporations. Examples include American companies like GM, HP, IBM, Dupont, Motorola; Japanese companies such as Panasonic, Toyota; German companies like Siemens, BAL and the Dutch com-

pany Philips, and so on.[4] Secondly, these multinational corporations usually targeted at the top domestic enterprises of the industries to which the foreign investors wanted to make access, this phenomenon is usually referred to in China as "cutting the head strategy", such as Carlyle Group's attempt to purchase a subsidiary of Xugong Group, China's construction and machinery giant in 2005.

Of course, "cutting the head strategy" certainly put intense pressure on Chinese government to take measures. Thus Chinese government has issued new rules and provisions to regulate international M&As in China. Among them is the Provisional Rules on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (hereafter referred to as the 2003 Provisional Rules) promulgated on March 7, 2003 jointly by the Ministry of Foreign Trade and Economic Cooperation (now the Ministry of Commerce, MOFCOM), the State Administration for Industry and Commerce, the State Administration of Taxation and the State Administration of Foreign Exchange, enhancing the regulation of foreign M&As in China. Despite the 2003 Provisional Rules, M&As of domestic enterprises by foreign investors continued to rise. Thus in August 2006, six Chinese government authorities, i.e. the Ministry of Commerce, the State-owned Assets Supervision and Administration Commission of the State Council, the State Administration for Industry and Commerce, the State Administration of Taxation, the China Securities Regulatory Commission and the State Administration of Foreign Exchange jointly promulgated Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (hereafter referred to as the 2006 Provisions). [5] Art. 12 of the 2006 Provisions provides if the foreign M&As "involves any critical industry, affects or may affect the security of national economy, or causes transfer of actual control over the domestic enterprise who possesses a resound trademark or China's time-honored brand," then foreign investors must make applications to MOFCOM.

But 2006 Provisions dose not clarify how MOFCOM shall handle these applications to solve the national security concerns. This provision also reflects the awkward MOFCOM faces: according to China's Administrative Permission Law, ministerial rules may not create administrative permission.

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[4] Guilian Yang, International Mergers and Acquisitions in China, July 2005, at http://www.unige.ch/droit/mbl/memoires, p.10.

[5] Hui, Kenneth Y., National Security Review of Foreign Mergers and Acquisitions of Domestic Companies in China and the United States, 2009, *Cornell Law School Inter-University Graduate Student Conference Papers,* Paper 34, at http://scholarship.law.cornell.edu/lps_clacp/34.

So the 2006 Provisions may only require foreign investors make applications, or shall be punished. But if applications are really filed with MOFCOM by foreign investors, strictly speaking, MOFCOM does not have the power to permit or cancel the M&A transactions in question due to the above prohibition in China's Administrative Permission Law. Thus the 2006 Provisions has not established China's national security review system for foreign M&As. [6]

In this period, and before the formal national security review system for foreign M&As are established, another important development is the adoption of Anti-Monopoly Law by the Standing Committee of the 10th National People's Congress in August 30, 2007(the Law came into force on August 1, 2008). Art. 31 of Anti-Monopoly Law is about national security, it states that "where a foreign investor mergers and acquires a domestic enterprise …, if state security is involved, besides the examination on the concentration in accordance with this Law, the examination on national security shall also be conducted in accordance with the relevant State provisions." Art. 31 does not add anything new besides reiterating the applicability of existing national security laws which was not established at that time.

The need for national security review system for foreign M&As in combination with the above regulatory drawbacks leads to the promulgation of the 2011 Notice and the 2011 Regulation mentioned in the beginning of the essay, which represents the formal establishment of China's national security review system for foreign M&As.

2. China's National Security Review System Established in 2011

The 2011 Notice and the 2011 Regulation have the main following important content:

2.1. Scope of National Security Review

2.1.1. M&As Potentially Falling into the Scope of National Security Review

According to the 2011 Notice, M&As of Chinese enterprises by foreign investors in China shall go through security review if the Chinese enterprises are:

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[6] Peng Yue, The Evolution of China's National Security Review System for Foreign M&As, China Social Science Newspaper, August 1, 2011.

- Military industry enterprises, supporting enterprises for military industry enterprises or enterprises located close to key or sensitive military facilities or units otherwise related to the military;
- National security-related enterprises regarding important agricultural products, important energies and resources, important infrastructure, important transportation services, key technologies or major equipment manufacturing, and the foreign investors acquire the de facto control of the enterprise.

From the wording of the above provision, the 2011 Notice actually classifies the M&As transactions potentially falling into the scope of national security review into two categories depending on the nature of target of the foreign M&As: the first category is the military or military-related enterprises, the second is important enterprises in industries other than the military or military-related fields. For the M&As potentially falling within the scope of the first category, the mere M&As by foreign investors would trigger the potential national security review mechanism for the them, while for the M&As potentially falling within the scope of the second category, national security review is triggered not only by foreign investors' M&As, but also by the de facto control of the target enterprises by foreign investors resulting from the M&As in question.

2.1.2. Issues Related with Demarcation of Scope of National Security Review

The determination of whether certain M&A transactions potentially fall within the scope of national security review depends further on the definition of the M&As in question and the de facto control of the target enterprises as the result of M&As in the case that the targets of foreign M&As are important enterprises in industries other than the military or military-related fields .

2.1.2.1. M&As of Domestic Enterprises by Foreign Investors

According to the 2011 Notice, M&As of domestic enterprises by foreign investors consist of four categories: (1) Foreign investors purchase the equity of non-foreign investment enterprises or subscribes to the increased capital of such enterprises, resulting in changing the such enterprises into foreign-invested enterprises(FIEs). According to the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, a FIE is an enterprise in which the investment of foreign investor(s) shall amount to at

least 25% or more in the share of the enterprise, although this is not made clear in the 2011 Notice. (2) Foreign investors purchase the equity of a Chinese shareholder of FIEs or subscribes to the increased capital of FIEs. (3) Foreign investors set up an FIEs and uses it to purchase and operate the assets of domestic enterprises, or use the FIEs to purchase the equity of domestic enterprises. (4)Foreign investors directly purchase the assets of domestic enterprises, and set up FIEs with the assets which then operate the assets.[7] All the above transactions constitute the M&As of domestic enterprises by foreign investors in the sense of 2011 Notice.

2.1.2.2. De Facto Control

According to the 2011 Notice, de facto control of target enterprises by foreign enterprises refers to the foreign investors becoming controlling shareholders or de facto controllers of domestic enterprises via the M&As in question, which includes: (1) A foreign investor, its controlling parent company and/or controlled subsidiary taking more than 50 per cent of the equity of the merged or acquired target enterprise. (2)Several foreign investors cumulatively taking more than 50 per cent of the equity of the merged or acquired target enterprises.(3) A foreign investor having a material influence over the decision of the meeting of the shareholders or the board of directors of the merged or acquired enterprise although the foreign investor acquires less than 50 percent of the equity of the merged or acquired target enterprise. (4) other cases which result in the transfer of de facto control over business decision-making, finance, human resource or technology of the merged or acquired domestic enterprises to foreign investors.[8] As mentioned above, de facto control requirement shall be satisfied when M&As of domestic enterprises by foreign investors happen in the fields other than military or military-related fields.

2.2. Factors for Consideration in National Security Review

The 2011 Notice lists the following factors for consideration in the national security review: (1)Influence of the M&As over national defense including the capacity of manufacturing domestic products, providing do-

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[7] See Article 1.2 of Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisition of Domestic Enterprises by Foreign Investors.

[8] See Article 1.3 of Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisition of Domestic Enterprises by Foreign Investors.

mestic services or providing the equipments and facilities to meet the needs of national defense. (2)Influence of the M&As over the stable running of China's economy. (3)Influence of the M&As over basic order of society. (4)Influence of the M&As over research and development capacity of key technologies regarding national security.[9]

Thus if the M&As of domestic enterprises by foreign investors have such influences or impacts, they may be deemed to have the negative impacts on China's national security, and M&As transactions may be blocked or cancelled depending on the M&A transactions have been finished or not.

2.3. National Security Review Mechanism and Procedure

2.3.1. National Security Review Organization and its Duties

The 2011 Notice as well as the 2011 Regulation established an inter-ministry Joint Conference (hereafter referred to as Joint Conference) to conduct the national security review. The Joint Conference, under the leadership of the State Council, is jointly headed by the National Development and Reform Committee and MOFCOM, and is participated by relevant ministries depending on the industries that the M&As involve.

The duty of the Joint Conference is: to analyze the influence of the M&As by foreign investors of domestic enterprises over the national security of China, to conduct research on and coordinate the major issues in the process of national security review of such M&As, and review the M&As and make its decision. [10]

2.3.2. Initiation of Security Review

The national security review mechanism may be initiated by the following subjects: (1) Foreign investors involved in M&As that fall within the scope of review under the 2011 Notice. The investors shall file applications for review with MOFCOM. In the case of several foreign investors involved in one M&A, the application may be filed by them jointly or just through one representative. [11] (2) Competent local MOFCOM authorities. If compe-

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[9] See Article 2 of Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisition of Domestic Enterprises by Foreign Investors.

[10] See Article 2.3 of Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisition of Domestic Enterprises by Foreign Investors.

[11] See Article 1 of Ministry of Commerce's Regulation on Implementing of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.

tent local MOFCOM authorities, during examination of M&As applications in accordance with the 2006 Provisions etc, consider the M&As shall subject to national security review, such authorities shall suspend the examination, report the cases to MOFCOM and issue written notices requiring the foreign investors to file applications with MOFCOM.[12] (3) Ministries of the State Council, national industrial association, competitors and upstream and downstream enterprises. If they consider it necessary for M&As to be subject to security review, they may also suggest a security review with MOFCOM. [13]

2.3.3. Pre-Review Consultation Mechanism

Before formally submitting security review applications, foreign investors may apply with MOFCOM for consultation on procedural issues regarding the intended M&As and for communication. However, such pre-review consultation and communication are not legally binding, and do not constitute formal applications.

2.3.4. Review Process

After foreign investors present MOFCOM with full set of application documents satisfying the requirements of law,[14] MOFCOM shall give written notice to the applicants that their applications have been received or accepted.

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[12] See Article 2 of Ministry of Commerce's Regulation on Implementing of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.

[13] See Article 3 of Ministry of Commerce's Regulation on Implementing of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.

[14] Documents that shall be filed with MOFCOM for a security review application: (1)Duly signed application letter and transaction statement;(2)Notarized and legalized ID documents or certificate of incorporation of the foreign investors and letter of creditworthiness;(3)Fact Statement, Articles of Association, Business License, audited financial reports of the previous year, diagram of organizational structure before and after M&A of the merged or acquired Chinese company and conditions of its investing companies;(4)Joint Venture Contract, Articles of Association, appointment letters of directors, list of management and officials of the intended newly established company upon completion of the M&As;(5)For M&As by share transfer, share transfer agreement (or subscription agreement for capital increase), approval resolution of shareholders of the merged or acquired company and assets evaluation report;(6)For M&As by assets transfer, assets purchase agreement (including list and status of assets to be purchased), approval resolution and assets evaluation report;(7)Foreign investors' voting power's impact on resolution of shareholders' meeting and board of directors upon completion of the M&As, statements about other conditions to cause change of de facto control over business decision-making, finance, human resource or technology to foreign investors, and related agreements or documents;(8) Other documents that MOFCOM may require.

If the MOFCOM deems that the M&As under consideration fall into the review scope, the MOFCOM shall notify the applicants that information in written form within 15 business days, the applicants may not carry out the M&A transactions in question in this time period, and competent local MOFCOM authorities may not allow the transactions proceed either. And at the same time, the MOFCOM shall forward the applications to the Joint Conference for review within the following five business days. If the applicants have not received the written notice that their M&As fall into the review scope from the MOFCOM after the above 15 business days, they may continue to carry on or clear the formalities related with the M&As in accordance with relevant laws and regulations.

If the M&As are deemed to fall into the review scope and the above applications are extended to the Joint Conference, the Joint Conference will conduct general review first for M&As solicited by MOFCOM. At this phase, the Joint Conference will, within five business days of MOFCOM making a submission, seek written opinions from the relevant government departments related with the transaction in question, and the relevant departments are required to give their feedback within 20 business days of receipt of the Joint Conference's request for comments. If none of the departments concerned believes that the transaction under review would endanger national security, the special review phase will not be initiated. In this case, i.e. no national security impact is found, the Joint Conference will notify MOFCOM of the result. MOFCOM will then notify the applicant the information within five business days receiving feedback from all the departments concerned, and the suspended examination and approval formalities can be resumed. However, if any relevant authority or authorities find the M&As may impact national security, the Joint Conference will take further steps to initiate a special review within five business days upon its receipt of the opinion.

During the phase of special review, the Joint Conference will organize the members of the Joint Conference to carry out a security evaluation in relation to the M&As transactions. If the members of the Joint Conference can reach consensus on the transactions, the Joint Conference will issue its decisions and then MOFCOM will notify the applicants of such decisions in writing. In the event that there is a "material difference of opinion" amongst the members of the Joint Conference following the conclusion of the special review, the matter will be submitted to the State Council for final decisions. The Joint Conference is required to complete the special review within 60 business days. In this time period, the Joint Conference has to either come to

a decision on its own or submit the case to the State Council for a final decision. For cases submitted to the State Council for a final decision, there is no specific timeline for the State Council to make the final decision.

If an M&A transaction under review is found to have caused or is likely to have a significant negative impact on national security, the Joint Conference may instruct MOFCOM to work with other relevant departments in charge to either terminate the transaction, order transfer of shares or assets, or take other actions to eliminate the negative impact on state security.

Additionally, during the national security review process, the applicants are allowed to apply to MOFCOM to amend or cancel the proposed M&As transactions.

3. Some Observations upon and Concerns over the Implementation of the System

The development of China's national security review system for foreign M&As is by large similar to the historical development of the American counterpart in that both are also triggered by increasing foreign direct investment and acquisition of domestic companies. In the late 1970s, the U.S. Congress became concerned with the rapid increase of investments in America by OPEC countries. As a result, President Gerald Ford created the Committee of Foreign Investment in the United States ("CFIUS") in 1975. CFIUS, at the time, was tasked with monitoring the impact of foreign investments in the United States. Subsequently in the late 1980's, increasing acquisition of United States firms by Japanese firms led to the passage of the Exon-Florio provision by Congress granting the President authority to block foreign acquisitions of persons engaged in United States interstate commerce. Through Executive Order 12,661, President Ronald Reagan then delegated power to CFIUS, transforming it from an administrative body to a Committee that could investigate, review and make recommendations.[15] In 2007, the American Congress passed Foreign Investment and National Security Act, FINSA to replace the Exon-Florio provision to enhance the U.S. national security review system for foreign M&As.[16] The similar factors that trigger the establishment of the system make it similar in certain aspects between China and America, but different conditions and situations in these two countries cause the difference between them.

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[15] Han Long, National Security Review of Foreign Mergers & Acquisitions in the United States:Implications for China, Jianghai Academic Journal,Vol.4,2007.

[16] Han Long & Shen Gexin, The Latest Development of U.S. National Security Review System on Foreign Mergers and Acquisitions, Presentday Law Science,Vol.5,2010.

Although there is the objective need for national security review system for foreign M&As in China, the misuse of the newly established system by vested interests for their own interest and as market barriers is not baseless. In the reform of the past 30 years, various vested interests have been formed. These vested interests mostly resulted from the reform and open-up policy practiced by China, but after their formation they use various pretext and their power to resist the further reform and open-up in China. China's national security review system for foreign M&As has the quality of vagueness and ambiguity as its American counterpart shares due to the fact that national security can not exhausted by definitions and listing within the system. But the vagueness and ambiguity maybe provide the vested interests with opportunities to resist the opening of China's market to foreigners for public interest but harmful for the vested interests, turning the system into the vested interests' tool for exclusion of the foreigners. For example, Art. 3 of the 2011 Regulation provides that Ministries of the State Council, national industrial association, competitors and upstream and downstream enterprises may also suggest a security review with MOFCOM if they consider it necessary for M&As to be subject to security review, but there is no requirement that the M&As meet any specific criteria in order to be reported by such interested parties, or that the latter have to satisfy certain requirements to have standing. [17] The prevention of the system from changing into its contrary is worthy of high attention and caution.

[17] Hoganlovells, China's New National Security Review Procedures for Mergers and Acquisitions Involving Foreign Investors: A New Hurdle for Foreign Investors or China Just Putting Existing Practice To Paper? at http// **www.hoganlovells.com**, April 9, 2012.