

## E-ALERT | China Practice

March 10, 2011

CHINA ISSUES IMPLEMENTATION PROVISIONS FOR  
NATIONAL SECURITY REVIEW RULES

Following quickly on the heels of the PRC State Council's February 12, 2011 issuance of a notice concerning the establishment of a security review system for mergers and acquisitions undertaken in China by foreign investors (the "Security Review Notice"),<sup>1</sup> on March 4, 2011, China's Ministry of Commerce ("MOFCOM") published the "Interim Provisions of the Ministry of Commerce on Matters Relating to the Implementation of the System of Security Review of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" (the "Interim Provisions"; click [here](#) to link to the translation).

Although they do not shed light on the most pressing question in the minds of the foreign investment community – i.e., the standards of review that will be applied to determine whether transactions will be deemed to have an impact on national security – the Interim Provisions provide useful detail with regard to the initial process of filing for the security review of contemplated transactions, as well as some indications as to how the process will work. Interestingly, the Interim Provisions are stated to be effective for a period of less than six months – from March 5, 2011 through August 31, 2011 – and to be open for public comment for the period from March 5 through April 10, 2011. MOFCOM's cover notice to the Interim Provisions states that MOFCOM "will keep track of and appraise the status of implementation of these Provisions and will refine these Provisions with reference to the public's opinions and suggestions." A door has thus clearly been opened for interested parties to ask questions and propose revisions.

## DECISION TO SUBMIT A TRANSACTION FOR SECURITY REVIEW

The Interim Provisions outline the procedures by which a foreign investor (referred to as an "Applicant") may apply for security review of a proposed merger or acquisition transaction that may arguably fall within the purview of the national security review regime. The Interim Provisions deal with the threshold question – whether an application for national security review should or should not be lodged with respect to a given transaction – in two ways. On the one hand, the Interim Provisions indicate that it is the responsibility of the foreign investor to make the initial judgment as to whether to file an application for review, although they do afford potential Applicants an opportunity to "file a consultation request with the Ministry of Commerce regarding procedural issues" (*Interim Provisions*, Article III) prior to making an initial filing. Making such a judgment in the absence of any case precedent may not be a simple task, and it is likely that foreign investors will seek to use the "consultation" opportunity as a means of obtaining some guidance on the substance of their application; whether MOFCOM will be accommodating in this regard remains to be seen. On the other hand, the Interim Provisions create a safeguard procedure for the government by providing

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<sup>1</sup> The announcement was made by way of promulgation of the "Notice of the General Office of the State Council on Establishment of a Security Review System for the Merger and Acquisition of Domestic Enterprises by Foreign Investors." Please refer to the Covington & Burling E-Alert on this Notice, which can be accessed [here](#).

that in cases where a conventional merger or acquisition application has been filed by a foreign party without a request for security review, but the local government authorities processing the application deem the transaction to require security review, the local authorities have the right to temporarily suspend the processing of the merger and acquisition application and require the Applicant to file an application for security review with MOFCOM (*Interim Provisions*, Article II). These provisions may help streamline the process and avoid a situation in which a transaction moves some distance through the approval process and then must return to the starting line. However, the power given local authorities to, essentially, give a transaction a “yellow light” may be overused by local authorities out of an abundance of caution and may, therefore, result in processing delays.

Fortunately, such delays will likely not be open-ended: once MOFCOM has received an application for an initial determination as to whether a transaction merits national security review and determined that the materials submitted are “complete and comply with statutory requirements” (*Interim Provisions*, Article V), MOFCOM has fifteen (15) days within which to determine whether to submit the transaction for review by the Ministerial Panel that has been created to carry out the national security review process. During that 15-day period, the Applicant must refrain from moving forward with its transaction, and the local authorities must refrain from processing it. If by the end of the 15-day period MOFCOM has not notified the Applicant to the effect that a security review will be conducted, the Applicant may proceed with its transaction (*Interim Provisions*, Article V). Should MOFCOM determine that security review is warranted, it must notify the Applicant accordingly, and file the case with the Ministerial Panel within five (5) days thereafter. Under the previously published Security Review Notice, the initial consultation and general review process among the Ministerial Panel and various ministries and agencies concerned takes place over a period of twenty-five (25) days after the Ministerial Panel has received a case file from MOFCOM; if all reviewing agencies are of the view that the contemplated transaction will not affect national security, a “special review” will not be conducted, and the Ministerial Panel will notify MOFCOM accordingly within five (5) business days of the determination; if certain reviewing agencies are of the view that the contemplated transaction may affect national security, a “special review” will be carried out. The time allotted for the Ministerial Panel to conduct a special review is sixty-five (65) days; note, however, that if the Ministerial Panel is unable to reconcile all the review opinions and reach a final decision, it may “submit...to the State Council for final decision,” the timeframe for which is not stipulated.

## CONTENTS OF SUBMISSIONS

The Interim Provisions provide a detailed list of the information and documentation an Applicant must compile and submit in applying for a security review (see *Interim Provisions*, Article IV). In addition to basic corporate identity, governance and structural information relating to the foreign investor and the domestic target entity, information about the foreign investor’s “relationship with the relevant national government(s),” and details of the post-merger or acquisition domestic entity, such as its governance structure and the identities of its board members and executives, must be submitted. Of particular note is the list of information that will be used to determine whether the foreign investor will be gaining “actual control” over the merged or acquired domestic entity. The list includes information on the impact that the foreign investor’s post-merger or acquisition voting rights will have on matters such as corporate governance and decision-making, and the impact that the merger or acquisition may have on control (i.e., a shift of control to the foreign investor) of matters such as finance, personnel and technology of the merged or acquired entity. It is clear from these provisions that the practical aspects of target companies’ business operations and the degree to which they will be controlled by foreign investors following consummation of a merger or acquisition will be subject to close scrutiny.

The enumeration of documents and materials to be submitted also includes a general reference to “[o]ther documents as required by the Ministry of Commerce.” The open-ended nature of this reference would seem to indicate that the process of compiling an application that MOFCOM will deem “complete” may prove in practice to be quite challenging.

## PROCEDURAL FACTORS THAT MAY DELAY MERGER AND ACQUISITION TRANSACTIONS

As the details of the security review process begin to emerge, it is now possible to pinpoint various points at which delays may occur. Foreign investors contemplating merger or acquisition transactions in China would be well advised to take the possibility of such delays into account when determining the schedules and deadlines for their transactions:

- It may take some time for a foreign investor to make the initial judgment as to whether a transaction is reviewable and, therefore, whether a security review application needs to be filed ;
- Even in a case in which a foreign investor has determined that its transaction is not reviewable, the local governmental authorities have the power to determine that it is, and to have the transaction put on hold while a review process is conducted;
- Once a security review application has been submitted to MOFCOM, MOFCOM must determine whether the application is “complete and complies with requirements” before the time clock starts to run on the review schedule for which the Security Review Notice and Interim Provisions provide;
- Although the time frames for Ministerial Panel review of a proposed transaction are clear, in the event that a consensus has not been reached following the maximum allotted review period of 90 days, the matter will be referred to the State Council for final decision (Security Review Notice, Clause IV(3)) – a process for which, as noted above, no time limit is specified.
- If following a security review, an Applicant is required by MOFCOM to restructure its proposed transaction or make changes to the transactional documents, these changes will have to be negotiated and made, and the application process repeated; whether or not a resubmission can be completed more quickly than an initial submission is unclear;
- The regime established by the Security Review Notice and Interim Provisions allows interested third parties, such as national industry associations or domestic enterprises operating in the same sector as a proposed domestic target company, to submit comments and objections in connection with proposed transactions; but the timeframes for such submissions is unclear. In addition, the possibility mooted in the Security Review Notice and confirmed in the Interim Provisions that comments and objections can be raised by any party retroactively with respect to a transaction that has already been consummated (Interim Provisions, Clause VI(3)) introduces an additional degree of open-endedness and unpredictability to the process.
- Finally, the Interim Provisions have introduced a submission requirement with respect to projects that originally were not submitted for security review, or were submitted and cleared, in cases where certain elements of such projects have changed over time in a way that arguably has brought them within the purview of the national security review regime. This is a clear indication that national security considerations have now been woven into the general fabric of “doing business in China,” and will have to be factored into business decision-making on an ongoing basis.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our firm:

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