

## **China's New National Security Review Process for Foreign Investments: U.S. CFIUS Review Moves East**

**March 3, 2011**

On February 3, China's State Council released the "Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" (Notice),<sup>1</sup> which announced the creation of the nation's first system for assessing the national security implications of proposed foreign investments in Chinese companies. The new security review procedures take effect on March 4. According to the Notice, not all of the transactions will be subject to the national security review. The new procedures will apply to four types of target domestic enterprises:

1. Military industrial enterprises or military-related supporting enterprises
2. Enterprises located near key and sensitive military facilities
3. Other entities relating to national defense
4. Key domestic enterprises in areas such as the following:
  - Agriculture
  - Energy and resources
  - Infrastructure
  - Transportation
  - Technology
  - Assembly manufacturing

It is worth noting that for transactions involving national economic security concerns, the review process will be triggered only if a foreign investor intends to obtain "actual control" of the target domestic enterprise. In comparison, the acquisition of the "actual control" is not a prerequisite for triggering the review process against those transactions involving national defense security issues.

The precise elements of the new security review procedures are still being developed and we anticipate that the State Council is likely to issue implementing rules to further work out the details of how the national security review process will be conducted and enforced, notwithstanding the prompt effective date. The Notice will also apply to M&As by investors from Hong Kong, Macau, and Taiwan.

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1. Read the full Notice in English at [http://www.morganlewis.com/pubs/English-GuoBanFa2011No6\\_02march11.pdf](http://www.morganlewis.com/pubs/English-GuoBanFa2011No6_02march11.pdf) and in Chinese and English at [http://www.morganlewis.com/pubs/GuoBanFa2011No6\\_02march11.pdf](http://www.morganlewis.com/pubs/GuoBanFa2011No6_02march11.pdf).

Companies interested in investments in China will note that the security review process described in the Notice both resembles and differs from the national review process administered by the Committee on Foreign Investment in the United States (CFIUS) in several important ways.

For example, “control” is a key concept in defining transactions subject both to the new Chinese security review process and to CFIUS review. CFIUS’s mandate extends to transactions “by or with any foreign person, which could result in control of a U.S. business by a foreign person.” “Control” is defined as the power to determine important matters affecting the U.S. entity. A foreign entity may obtain control of a U.S. business through the ownership of a majority or dominant minority share of the U.S. entity. According to the Notice, a transaction will be subject to the new security review procedures if a foreign investor gains “actual control” over a Chinese domestic entity engaged in businesses having national economic security concerns. A foreign investor attains actual control of a Chinese domestic entity when it becomes “the controlling shareholder or actual controller of the concerned domestic enterprise.” Situations in which a foreign investor may be deemed to have acquired “actual control” include the following:

1. A foreign investor and its controlling parent or subsidiary hold an aggregate of 50% stake or more in the target company after the M&A.
2. More than one foreign investor holds an aggregate of a 50% stake or more in the target company after the M&A.
3. A foreign investor holds less than a 50% stake in the target company after the M&A, but the voting rights actually enjoyed by the foreign investor are sufficient to exert a major impact on the resolution of the shareholders’ meeting, general meeting of shareholders, or the board of directors.
4. Other circumstances that may result in the actual controlling right in business decision-making, financial affairs, human resources, technologies, and similar important issues being transitioned to the foreign investor.

As points three and four make clear, certain transactions in which a foreign investor acquires less than 50% ownership of a Chinese domestic entity may still be subject to a security review. This is similar to the situation under CFIUS, where the key factor is not the percentage of control, but actual control over some key elements of the corporate governance process.

In addition, it is significant that both the new Chinese security review process described in the Notice and CFIUS review extends beyond transactions involving traditional defense and military sales and contractors. The Foreign Investment and National Security Act of 2007 explicitly instructed CFIUS to review transactions involving “critical infrastructure.” CFIUS’s regulations define critical infrastructure as “a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset . . . would have a debilitating impact on national security.” The Notice similarly establishes that the new Chinese security review procedures will apply not only to military and defense enterprises, but also to “key domestic enterprises” engaged in businesses having national economic security concerns. The Notice describes a significantly broader application of infrastructure concerns, however, than that covered in the CFIUS context.

The scope of the security review envisioned by the Notice thus differs significantly from the scope of the review under CFIUS. Whereas CFIUS is solely concerned with whether the transaction threatens to impair the national security of the United States, the Chinese security review process is substantially broader. Specifically, the Notice states that the security review process must consider the following:

1. The impact of the transaction on the national security, including the domestic product manufacturing capacity, domestic service provision capacity, and relevant equipment and facilities needed for the national security.
2. The impact of the transaction on the stable operation of the national economy.
3. The impact of the transaction on the basic living of the people.
4. The impact of the transaction on the research and development capacity for key technologies related to the national security.

Such economic consequences have clearly and consistently been considered outside the purview of CFIUS determinations, which are limited to the potential effect on national security of acquisitions and investments, and this difference in scope and focus may lead to tensions similar to those that have affected several aborted Chinese acquisitions of U.S. businesses, including by CNOOC and Huawei Technologies.

The new China security review process does share a number of structural and procedural similarities with the CFIUS review process. Both processes are administered by a multiagency body. CFIUS is a committee composed of representatives of the Department of the Treasury, the Department of Justice, the Department of Homeland Security, the Department of Commerce, the Department of Defense, the Department of State, the Department of Energy, the Office of the U.S. Trade Representative, and the Office of Science and Technology Policy, with input from various other agencies as appropriate. According to the Notice, an interministerial panel is to be formed under the leadership of the State Council. China's Ministry of Commerce (MOFCOM) and the National Development and Reform Commission (NDRC) will take the lead in conducting the security review and coordinating with other agencies, in much the same way that the Department of Treasury chairs CFIUS and coordinates with CFIUS's other member agencies.

The CFIUS review process, and its lack of transparency for foreign investors, has been the source of tension and misunderstanding, particularly in recent years as the Committee's authority was expanded. The new China security review process for foreign investments similarly can be expected to cause uncertainty among foreign investors, particularly in the near term as the new interministerial panel undertakes its first reviews and develops its approach to assessment of proposed foreign investments. Investors need to both be aware of the evolving nature of the new China security review process and be appreciative of the significant differences between the new China system and the CFIUS review process in evaluating potential investments.

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