

The US-China Business Council Comments on the Provisional Regulations on Issues Related to the Security Review System for Foreign Enterprises' Mergers and Acquisitions of Domestic Companies

The US-China Business Council (USCBC) represents more than 220 US companies with significant operations in China and strong, consistent interests in the continued development and fair enforcement of China's Antimonopoly Law (AML). We would like to thank the PRC Ministry of Commerce (MOFCOM) for providing USCBC the opportunity to offer comments on its Provisional Regulations on Issues Related to the Security Review System for Foreign Enterprises' Mergers and Acquisitions of Domestic Companies ("Provisional Regulations").

We believe the comment solicitation process reflects a positive effort to provide more transparency in the formulation of policy and legislation and will result in better regulatory outcomes that are widely supported by various stakeholders in China. We appreciate MOFCOM's compliance with The State Council General Office Notice on the Printing and Distribution of the State Council 2010 Legislative Work Plan, which states that all draft administrative and departmental rules and regulations, except those with statutory confidentiality requirements, must be published on the State Council Legislative Affairs Office's (SCLAO) Chinese Government Legislative Information Network website to publicly solicit comments, as well as China's similar commitment at the June 2008 Strategic Economic Dialogue. We have some concerns, however, that MOFCOM is soliciting comments from the public on rules that took effect immediately on March 5, 2011. We encourage MOFCOM to release drafts of future documents so that the measures may be improved based on public comments prior to implementation, even on a provisional basis.

We respectfully offer the following comments on the security review process described in the Provisional Regulations. Because the State Council's earlier Notice on the Security Review of Foreign Mergers and Acquisition (M&A) of Domestic Enterprises ("Notice") was not offered for public comment, our comments encompass both the Notice and the Provisional Regulations. We hope that MOFCOM will forward our comments on the Notice to the State Council for their further consideration. USCBC recognizes China's authority to put in place a process to review foreign acquisitions for legitimate national security concerns, and appreciates efforts to make such M&A reviews more transparent. In the interests of consumers and open commerce, such a process should not be used as a means of economic protectionism. We suggest further clarification and appropriate changes to both the Notice and the Provisional Regulations to ensure an appropriate balance between national security and the interests of consumers and open commerce. We respectfully request MOFCOM to consider and incorporate comment submissions and issue a final version well in advance of the August 31, 2011 expiration of the Provisional Regulations.

Scope of Review

Article 1.1 of the Notice defines the scope of industries and areas that will be subject to security reviews. It is an important provision for companies seeking to better understand the potential for review of a transaction. However, the scope as currently defined remains vague, using general language to describe broad industries in which M&A transactions may be subject to review (e.g. "other enterprises related to national security") without identifying the specific sectors that fall within those industries. Such general language creates

significant uncertainty for foreign investors considering M&A in China, and it could result in investors' unwillingness to pursue transactions that would bring beneficial capital, technology, and management expertise to China.

In addition, Article 2 of the Provisional Regulations stipulates that local Commerce departments should not accept an M&A application if the transaction falls under the scope of security review and has not already been submitted to MOFCOM. In the absence of details on the scope of the review, local departments will likely default to the judgment that an acquisition involves national security to ensure compliance with Article 2. The likelihood of most transactions being thus submitted to MOFCOM for review risks stretching the limited resources of security review authorities and delaying non-critical business transactions. USCBC has supported MOFCOM's recent efforts to streamline the process for foreign investment approvals by delegating greater approval authority to local departments. Currently, only the largest projects require central government review and approval, resulting in a faster investment approval process. The lack of clarity on the scope of the review, combined with Article 2 of the Provisional Regulations, may reverse this progress in decentralizing the investment approval process.

We respectfully suggest that the State Council and MOFCOM consider these effects and further limit the scope of the security review. We suggest that Article 1.1 of the Notice be revised to identify the specific sectors that may be subject to security reviews, and that general language such as "other enterprises related to national security" and "key... technology and equipment manufacturing related to national security" be removed. We also suggest that Article 2 of the Provisional Regulations be revised to provide clearer guidance to local authorities about the criteria they should use to decide whether to pass a transaction to MOFCOM for a security review.

Article 1.3.4 of the Notice stipulates that any circumstance leading to the transfer to a foreign investor of a domestic enterprise's actual controlling power over business decisions, financial affairs, personnel, or technology may also be subject to a security review. This qualification is very broad, and may be difficult to prove in many circumstances. USCBC suggests that this article be deleted to ensure smooth implementation of the security review process and to prevent the unnecessary extension of the review process to routine transactions, which would tie up regulators and delay necessary reviews.

Security Implication Criteria

Article 2 of the Notice describes the content of the security review, but provides insufficient guidance to regulators and companies seeking to prepare for security reviews. In addition, neither the Notice nor the Provisional Regulations specify how regulators will determine whether a transaction has national security implications and is thus subject to the review process in the first place. Though Article 3 of the Provisional Regulations states that investors can receive guidance regarding procedural issues of a review from MOFCOM through a pre-application consultation process, there is little information or procedural transparency within the measures regarding how security review authorities will assess a transaction, in practice.

Such a lack of clarity can cause problems for participants in an M&A transaction and may also complicate the process for regulators. Participants may not be able to predict whether their transaction is likely to trigger a security review or be rejected on national security grounds, and thus may be reluctant to consider complex transactions. Review authorities may also face difficulties without comprehensive guidance as to how they should evaluate transactions. Furthermore, the lack of clear guidelines could open the review process to accusations of protectionism when transactions are blocked.

To address these issues, USCBC respectfully suggests that new language be added to clarify the basis for determining whether a transaction has national security implications and is thus subject to a security review. We also suggest that Article 2 of the Notice be revised to provide details about the specific criteria for deciding whether a deal will be subject to the actual review, and to stipulate procedural transparency requirements during the review.

Moreover, we respectfully suggest that the scope of the pre-application consultations stipulated in Article 3 of the Provisional Regulations be broadened to address substantive issues, such as the likelihood of a particular transaction triggering a security review, even if that necessitates a caveat that MOFCOM's feedback on substantive issues is not binding. We also suggest that language be inserted to state that this broadened consultation process serve as an informal pre-review mechanism to facilitate M&A negotiation by giving foreign investors—when key terms of a transaction have been agreed on by the participants—an idea about whether a transaction could pass security review. This would smooth the review process and allow participants to comfortably spend the time and energy required to fully prepare for the formal security review.

Review Authorities and Overlapping Reviews

Article 3 of the Notice renders authority to MOFCOM and the National Development and Reform Commission (NDRC) to coordinate the Joint Committee for Security Reviews, but does not delineate the specific authorities for each agency. To provide greater clarity and ensure that stakeholders contact the correct authorities with questions, USCBC requests further clarification on this point.

Additionally, though the Provisional Regulations provide some guidance on how MOFCOM will internally coordinate the security review process with the investment review process, the Provisional Regulations do not clarify the relationship between the security review process (conducted by MOFCOM's Foreign Investment Department) and the concentration review process (conducted by MOFCOM's Antimonopoly Bureau). If an M&A transaction meets the thresholds for both reviews, it is unclear whether the parties should apply for both reviews simultaneously or consecutively.

As these reviews cover different areas and are handled by different departments, we respectfully suggest that MOFCOM issue clear written guidance that these reviews be conducted simultaneously. If the reviews are not to be conducted simultaneously, we suggest that MOFCOM provide guidance about the timelines for the two processes to minimize delays and provide certainty to applicants.

Required Documentation

Article 4 of the Provisional Regulations requires that the applicant submit to MOFCOM extensive documentation with the security review application. Though some of the documentation requirements are legitimate for the nature of a security review, others—including certification of the foreign investors' credit standing and the audited financial statements of the target enterprise—are unnecessary for assessing potential security implications. Many PRC companies involved in M&A transactions may not even have audited financial statements, particularly if they are subsidiaries of a larger company. Preparing these materials would increase costs for applicants without providing any additional benefit to a security assessment. Furthermore, requiring these documents as part of the security review application will open the review process to criticism that it is not exclusively concerned with national security, but instead is protectionist.

Moreover, because M&A transactions arise from temporary market and business realities, the delay inherent in finalizing some of the required documentation that would not otherwise be finalized until the details of the transaction are completed—including the Articles of Association and name list of board members of the post-merger company—could derail a transaction. This effect could discourage investors from pursuing M&A in China.

Finally, Article 4.9 stipulates that applicants may also be required to submit additional, unspecified documents along with their security review applications. Because the timeline stipulated for the security review process does not begin until MOFCOM accepts the security review application and its supplemental documentation as complete, this provision raises concerns that regulators could use requests for additional documents to delay transactions for non-security-related reasons. We suggest that requests for additional documents are more appropriate for the Joint-Ministry Conference's special review process following the initial MOFCOM application process.

USCBC respectfully suggests that MOFCOM revise the list of documents in Article 4 required for the security review application to include only those that are necessary for judging national security implications and remove all others, including (but not limited to) certification of the applicant's credit standing and the audited financial statements of the target enterprise. We also suggest that Article 4 be revised to accept draft forms of documents that may not otherwise be finalized until participants have completed all the details of the transaction—including the Articles of Association and name list of board members of the post-merger company. This would allow participants to apply to MOFCOM for a security review earlier in the M&A negotiations, reducing delays caused by the review process. Furthermore, we request that Article 4.9 be removed to prevent unnecessary delays in the application process.

Length of Review

According to the timelines stipulated in Article 4 of the Notice and Articles 5, 6, 7, and 8 of the Provisional Regulations, a security review can take up to 115 business days from the time that MOFCOM accepts an application—or longer if MOFCOM deems the initial application incomplete. This timeframe of nearly six months is unnecessarily long and exceeds that of security review processes in other countries. (For example, the Committee of Foreign Investment in the United States review process can take no longer than 75 calendar days.) The long review period will significantly delay transaction approvals, resulting in the loss of business for foreign and domestic participants, and will increase the backlog for regulators, particularly when combined with possible delays in application acceptance. USCBC suggests that the State Council and MOFCOM streamline the process by reducing the length of time stipulated for each step of the security review process and by changing the timelines for the security review from business days to calendar days.

In addition, the Notice does not stipulate the length of time allotted for consideration once a transaction has been submitted to the State Council for final review. USCBC suggests that new language be added to clearly define the length of State Council review.

Security Review Requested by Third Parties

Article 8 of the Provisional Regulations stipulates that relevant departments of the State Council, national industry associations, competitors, and upstream and downstream companies may request a security review on transactions they are not involved in. Though we recognize the importance of including input from stakeholders about potential transactions for review, such language raises several concerns related to the motivation of the parties requesting the security review.

As drafted, Article 8 could allow a company to use the security review process to block a competitor's M&A activities in China for their own commercial benefit. Concerns with this provision are exacerbated by the absence of provisions in the Notice and Provisional Regulations stating that security reviews cannot be applied retroactively to completed transactions or to those that have already been submitted but are still awaiting approval. Without such limits, a third party may request a security review to interfere with a competitor's business long after a transaction is complete.

To ease these concerns, USCBC suggests that MOFCOM remove Article 8 of the Provisional Regulations and add new language to the Notice or Provisional Regulations to limit security reviews to M&A transaction applications submitted after the measures' implementation date.

Security Review Response

Article 5 of the Provisional Regulations states that if MOFCOM does not inform the applicant in writing that its transaction falls under the scope of the security review after 15 working days, the applicant can proceed with relevant procedures according to laws and regulations. This language helps to ensure that transactions will not be delayed by potential issues with notification. We suggest that new language be added to Article 5 to stipulate that local Commerce departments also proceed with relevant investment approval procedures immediately after the 15 working days to ensure that no additional delays occur because of the absence of feedback from MOFCOM.

Finally, neither the Notice nor the Provisional Regulations provide a formal mechanism for the Joint-Ministry Conference or State Council to notify applicants about their concerns and opinions during the general or special reviews. These concerns should be made known to the investors so that they can address the concerns, if appropriate, or consider remedial measures to alleviate those concerns. USCBC suggests that a provision establishing such a mechanism be added to the Notice or the Provisional Regulations.

Conclusion

USCBC thanks MOFCOM for this opportunity to submit comments on the Provisional Regulations. We hope that these comments will prove constructive to the positive development of China's security review process. USCBC welcomes any feedback that MOFCOM may have and would be pleased to further discuss the content and various provisions at MOFCOM's request.

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