

## MOFCOM Issues Final National Security Review Rules

On August 25, 2011, the PRC Ministry of Commerce (“MOFCOM”) issued final rules regarding China’s national security review scheme for transactions by foreign investors (“Circular 53”).<sup>1</sup> Circular 53 became effective September 1, 2011, and replaces the *Interim Provisions of the Ministry of Commerce on Matters regarding the Implementation of the Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the “Interim Rules”). The national security review scheme was initially established by China’s cabinet in February 2011 via the *Notice on Establishing Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the “Notice”). Most of Circular 53’s changes to the Interim Rules are minor.<sup>2</sup> That said, however, foreign investors should be attentive to certain changes to the Interim Rules.

### I. THE ANTI-CIRCUMVENTION CLAUSE

The text of the Notice makes four types of acquisitions by foreign investors potentially subject to national security review:

- *Type 1*: acquisition of an existing or new equity interest in a non-foreign-invested enterprise;
- *Type 2*: acquisition of an existing equity interest in a foreign-invested enterprise (“FIE”) from the Chinese shareholder or subscription of new equity interest in a FIE;
- *Type 3*: acquisition of assets or equity of a domestic enterprise through a newly established FIE;
- *Type 4*: acquisition of assets of a domestic enterprise and contributing such assets to a newly established FIE that will operate such assets.

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<sup>1</sup> Circular 53 is titled, *Provisions of the Ministry of Commerce on the Implementation of the Security Review Mechanism for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*.

<sup>2</sup> Regarding the Notice and the Interim Rules, please see our alert memoranda, “[China’s State Council Issues Notice on National Security Review of Foreign Acquisitions](#)” and “[China’s MOFCOM Issues Interim Rules on National Security Review of Foreign Acquisitions](#)”, available at [www.cgsh.com](http://www.cgsh.com).

Article 9 of Circular 53 is a newly added anti-circumvention clause. It emphasizes that MOFCOM will look into “the substance and the actual impact” of a transaction when assessing whether the transaction is subject to national security review. Specifically, Article 9 states that foreign investors may not circumvent national security review by structuring a transaction using nominee holdings, trusts, multiple levels of re-investment, leases, loans, agreements granting contractual control, offshore transactions, or any other method.

**A. THE VIE STRUCTURE**

The use of the term “contractual control” in the anti-circumvention clause raises issues regarding the variable-interest entity structure (the “VIE structure”).

The VIE structure has been used by many foreign investors to indirectly enter certain sectors in China where foreign direct investment is restricted or prohibited. Pursuant to this structural arrangement, the Chinese founders of a domestic Chinese business and foreign investors invest in a new offshore holding company that owns a Chinese onshore subsidiary that is a “wholly-foreign owned enterprise” (“WFOE”) under PRC law. The WFOE enters into a series of contractual arrangements with the existing Chinese entity (the VIE) that is owned by the Chinese founders. As a Chinese company, the VIE holds the necessary operating licenses and conducts the relevant business. This structure allows for the WFOE’s control of the VIE, the transfer of the economic benefits of the VIE to the WFOE, and offshore financing of the offshore holding company, which could include an offshore IPO. The VIE structure has been a grey area under Chinese law since its inception, and governmental agencies, including MOFCOM, have neither expressly prohibited nor permitted it.

Due to the anti-circumvention clause, MOFCOM likely will have a legal basis to examine certain VIE structures when they are established on the theory that they represent an indirect acquisition through contractual control and are subject to national security review. However, it is unlikely that this clause was inserted solely to restrict VIE structures. It is more likely that MOFCOM is simply clarifying that it will have the power to review acquisitions of onshore businesses through VIE structures and assess a transaction’s “actual impact” on national security and will not be bound by the narrow language of the Notice.

**B. OFFSHORE TRANSACTIONS**

Pursuant to the language of the Notice, an equity transaction between foreign investors regarding shares in an offshore company that owns a Chinese subsidiary is not subject to national security review. If as a part of a global transaction, there is an asset deal in China falling under Transaction Type 3 or Type 4 (described above), the onshore asset deal could be subject to national security review. In addition, the anti-circumvention clause prescribes that offshore transactions may not be used as a device to avoid national security review. However, the clause does not explain what kind of offshore transaction would qualify. Rather, on a case by case basis, MOFCOM will review the “substance” and “actual impact” of an offshore transaction. As a result, seemingly offshore transactions may be subject to national security

review. It is not clear at this stage how these new terms introduced by Circular 53 will shape the scope and standard of review.

## II. OTHER SIGNIFICANT NEW POINTS

Other significant new points in Circular 53 include:

- *Timing at the local MOFCOM level.* As the Interim Rules made clear, if a local MOFCOM office handling a general foreign investment approval finds that a transaction raises national security issues, it must suspend its review. Circular 53 states that within five working days of the suspension, the local MOFCOM office must notify both MOFCOM and the foreign investor. The Interim Rules were silent on this timing. Please see our alert memorandum regarding the Notice for a more detailed discussion of the overall timing of a national security review.
- *Change of offshore de facto controller.* Pursuant to Article 10 of Circular 53, if a transaction is not subject to national security review or has previously cleared a national security review, and there is any change in the identity of its offshore, de facto controller, the transaction is required to undergo the national security review (again) if the transaction otherwise falls under the scope of review under the Notice.
- *Confidentiality obligations.* Circular 53 expressly requires that participants in a national security review keep state secrets, trade secrets and other secrets confidential.

## III. CONCLUSION

Circular 53 does help to clarify certain points in the Interim Rules. However, in general, Circular 53 does not provide additional on the scope of the application of national security review, such as the definition of “national security” or the criteria used by MOFCOM to determine whether a transaction should be subject to review. Moreover, the anti-circumvention clause creates additional unanswered questions regarding the regulation’s scope. Foreign investors may be advised to prepare for these uncertainties.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under China or Antitrust and Competition in the “Practices” section of our website at <http://www.clearygottlieb.com>.

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