



## Security review on foreign acquisitions to focus on substance of transactions

### Regulations discussed in this issue:

- Rules of MOFCOM on the implementation of a security review system for foreign investors seeking to acquire Chinese enterprises - MOFCOM Announcement [2011] No.53, issued on 25 August 2011, effective from 1 September 2011
- Notice of the General Office of the State Council on initiating a security review system for foreign investors seeking to acquire Chinese enterprises - Guo Ban Fa [2011] No.6, issued by the General Office of the State Council on 3 February 2011, effective from 5 March 2011
- MOFCOM Announcement [2011] No.8, issued on 4 March 2011, effective from 5 March to 31 August 2011

### Background

The Ministry of Commerce (MOFCOM) issued Announcement [2011] No. 53 (Announcement 53) on 25 August 2011, to modify MOFCOM Announcement [2011] No.8 (Announcement 8), based on the feedback from the public on the latter. Announcement 53 provides formal guidance in respect of the detailed procedures of implementing a security review system and the relevant documentation requirement for foreign investors seeking to acquire Chinese enterprises. Announcement 8 ceased to be effective on 31 August 2011 and Announcement 53 came into force from 1 September 2011.

For details on Announcement 8, please refer to [KPMG China's China alert 2011 Issue 9](#).

The key changes made by Announcement 53 to Announcement 8 and our comments on them are highlighted below:

#### 1. Review on substantive content of acquisition transactions

Announcement 53 introduces an additional provision regarding the review on substantive content of acquisition transactions. It is stipulated in Article 9 that when the authorities perform a security review on foreign investors seeking to acquire Chinese enterprises, they shall determine whether such transactions should be subject to a security review based on the substantive content and actual impacts of the transactions. Foreign investors are prohibited from circumventing the security review by any means including, but not limited to, nominal holdings, holdings on trust, multi-level investments, leases, loans, protocol control (i.e. use of Variable Interest Entities (VIE)) and offshore transactions.

Such changes have not come as a surprise. In [our China alert 2011 Issue 9](#), we highlighted arrangements such as nominal holdings and holdings on trusts that might be challenged by the authorities involved in security reviews. For details, please refer to Point 2 of the alert.

## **2. Legal effect of advance consultation**

Announcement 8 provides that a foreign investor may file an application for consultation with MOFCOM in respect of procedural issues of its proposed acquisition of a Chinese enterprise before it submits a formal application to MOFCOM for national security review. Announcement 53 further clarifies that it is not a requisite that a foreign investor should go through an advanced consultation procedure prior to filing a formal application for a security review. Such an advanced consultation does not have any binding and legal effect and cannot be viewed as the basis for submitting a formal application.

## **3. Participation of stakeholders**

In this regard, Announcement 53 follows the rules in Announcement 8 and stipulates that where a foreign investor seeks to acquire a Chinese enterprise, the relevant departments of the State Council, national industry associations, enterprises in the same industry or 'upstream or downstream' enterprises may propose to MOFCOM that a security review be carried out if they deem it necessary. The abovementioned parties shall provide the approving authorities with a written statement setting out the basic information of the acquisition transaction and its specific impacts on national security.

In addition, Announcement 53 specifies that under the above circumstances, MOFCOM may request the stakeholders to provide relevant statements. However, Announcement 53 is silent on the scope of 'stakeholders' and the content of such statements.

## **4. Confidentiality obligation of the approving authority**

The newly-added Article 11 of Announcement 53 highlights the duty of confidentiality of the approving authority. The relevant departments in charge of commerce and the relevant authorities and personnel that are involved in a security review process shall assume the confidentiality obligation in terms of state secrets, trade secrets and other information that shall be kept confidential.

## **KPMG observations**

Announcement 53 requires the approving authorities to determine whether an acquisition transaction falls within the scope of a security review based on the substantive content and actual impacts of the transaction, using the principle of substance over form. Foreign investors shall, therefore, consider the substance behind a proposed acquisition transaction in assessing the risk of the transaction being subject to security review. For example, a security review will likely be required if a VIE structure is used by a foreign investor to bypass market entry restrictions in certain industries as imposed by the *Catalogue of Foreign Investment Industrial Guidance*.

In addition, it is reported by the Chinese media that the departments in charge of commerce are producing a list of approximately 60 industries in which foreign acquisitions shall be subject to a security review. The list has been circulated internally, but not been made available to the public yet. We expect that the departments in charge will provide more detailed guidance regarding the issues arising during the implementation of security review on foreign acquisition under Announcement 53. Besides the unclear issues discussed above, further written guidance may be provided on the criteria that will be used in a security review and the applicability of a security review system to various funds investment models.

# Contact us

## **Khoonming Ho**

Partner in Charge, Tax  
China and Hong Kong SAR  
Tel. +86 (10) 8508 7082  
khoonming.ho@kpmg.com

## **Beijing/Shenyang**

### **David Ling**

Partner in Charge, Tax  
Northern China  
Tel. +86 (10) 8508 7083  
david.ling@kpmg.com

## **Qingdao**

### **Vincent Pang**

Tel. +86 (532) 8907 1728  
vincent.pang@kpmg.com

## **Shanghai/Nanjing**

### **Lewis Lu**

Partner in Charge, Tax  
Central China  
Tel. +86 (21) 2212 3421  
lewis.lu@kpmg.com

## **Hangzhou**

### **Martin Ng**

Tel. +86 (571) 2803 8081  
martin.ng@kpmg.com

## **Chengdu**

### **Anthony Chau**

Tel. +86 (28) 8673 3916  
anthony.chau@kpmg.com

## **Guangzhou**

### **Lilly Li**

Tel. +86 (20) 3813 8999  
lilly.li@kpmg.com

## **Fuzhou/Xiamen**

### **Jean Jin Li**

Tel. +86 (592) 2150 888  
jean.j.li@kpmg.com

## **Shenzhen**

### **Eileen Sun**

Partner in Charge, Tax  
Southern China  
Tel. +86 (755) 2547 1188  
eileen.gh.sun@kpmg.com

## **Hong Kong**

### **Karmen Yeung**

Tel. +852 2143 8753  
karmen.yeung@kpmg.com

## **Northern China**

### **David Ling**

Partner in Charge, Tax  
Northern China  
Tel. +86 (10) 8508 7083  
david.ling@kpmg.com

## **Vaughn Barber**

Tel. +86 (10) 8508 7071  
vaughn.barber@kpmg.com

## **Roger Di**

Tel. +86 (10) 8508 7512  
roger.di@kpmg.com

## **John Gu**

Tel. +86 (10) 8508 7095  
john.gu@kpmg.com

## **Jonathan Jia**

Tel. +86 (10) 8508 7517  
jonathan.jia@kpmg.com

## **Vincent Pang**

Tel. +86 (10) 8508 7516  
+86 (532) 8907 1728  
vincent.pang@kpmg.com

## **Michael Wong**

Tel. +86 (10) 8508 7085  
michael.wong@kpmg.com

## **Irene Yan**

Tel. +86 (10) 8508 7508  
irene.yan@kpmg.com

## **Tracy Zhang**

Tel. +86 (10) 8508 7509  
tracy.h.zhang@kpmg.com

## **Abe Zhao**

Tel. +86 (10) 8508 7096  
abe.zhao@kpmg.com

## **Catherine Zhao**

Tel. +86 (10) 8508 7515  
catherine.zhao@kpmg.com

## **Central China**

### **Lewis Lu**

Partner in Charge, Tax  
Central China  
Tel. +86 (21) 2212 3421  
lewis.lu@kpmg.com

## **Anthony Chau**

Tel. +86 (21) 2212 3206  
+86 (28) 8673 3916  
anthony.chau@kpmg.com

## **Cheng Chi**

Tel. +86 (21) 2212 3433  
cheng.chi@kpmg.com

## **Dawn Foo**

Tel. +86 (21) 2212 3412  
dawn.foo@kpmg.com

## **Chris Ho**

Tel. +86 (21) 2212 3406  
chris.ho@kpmg.com

## **Sunny Leung**

Tel. +86 (21) 2212 3488  
sunny.leung@kpmg.com

## **Martin Ng**

Tel. +86 (21) 2212 2881  
+86 (571) 2803 8081  
martin.ng@kpmg.com

## **Yasuhiko Otani**

Tel. +86 (21) 2212 3360  
yasuhiko.otani@kpmg.com

## **Jennifer Weng**

Tel. +86 (21) 2212 3431  
jennifer.weng@kpmg.com

## **Lachlan Wolfers**

Tel. +86 (21) 2212 3515  
lachlan.wolfers@kpmg.com

## **Grace Xie**

Tel. +86 (21) 2212 3422  
grace.xie@kpmg.com

## **Zichong Xu**

Tel. +86 (21) 2212 3404  
zichong.xu@kpmg.com

## **William Zhang**

Tel. +86 (21) 2212 3415  
william.zhang@kpmg.com

## **David Huang**

Tel. +86 (21) 2212 3605  
david.huang@kpmg.com

## **Amy Rao**

Tel. +86 (21) 2212 3208  
amy.rao@kpmg.com

## **Leonard Zhang**

Tel. +86 (21) 2212 3350  
leonard.zhang@kpmg.com

## **Southern China**

### **Eileen Sun**

Partner in Charge, Tax  
Southern China  
Tel. +86 (755) 2547 1188  
eileen.gh.sun@kpmg.com

## **Jean Jin Li**

Tel. +86 (755) 2547 1128  
+86 (592) 2150 888  
jean.j.li@kpmg.com

## **Jean Ngan Li**

Tel. +86 (755) 2547 1198  
jean.li@kpmg.com

## **Lilly Li**

Tel. +86 (20) 3813 8999  
lilly.li@kpmg.com

## **Kelly Liao**

Tel. +86 (20) 3813 8668  
kelly.liao@kpmg.com

## **Angie Ho**

Tel. +86 (755) 2547 1276  
angie.ho@kpmg.com

## **Hong Kong**

### **Ayesha M. Lau**

Partner in Charge, Tax  
Hong Kong SAR  
Tel. +852 2826 7165  
ayasha.lau@kpmg.com

## **Chris Abbiss**

Tel. +852 2826 7226  
chris.abbiss@kpmg.com

## **Darren Bowdern**

Tel. +852 2826 7166  
darren.bowdern@kpmg.com

## **Alex Capri**

Tel. +852 2826 7223  
alex.capri@kpmg.com

## **Barbara Forrest**

Tel. +852 2978 8941  
barbara.forrest@kpmg.com

## **Ken Harvey**

Tel. +852 2685 7806  
ken.harvey@kpmg.com

## **Nigel Hobler**

Tel. +852 2143 8784  
nigel.hobler@kpmg.com

## **Charles Kinsley**

Tel. +852 2826 8070  
charles.kinsley@kpmg.com

## **John Kondos**

Tel. +852 2685 7457  
john.kondos@kpmg.com

## **Curtis Ng**

Tel. +852 2143 8709  
curtis.ng@kpmg.com

## **Kari Pahlman**

Tel. +852 2143 8777  
kari.pahlman@kpmg.com

## **John Timpany**

Tel. +852 2143 8790  
john.timpany@kpmg.com

## **Jennifer Wong**

Tel. +852 2978 8288  
jennifer.wong@kpmg.com

## **Christopher Xing**

Tel. +852 2978 8965  
christopher.xing@kpmg.com

## **Karmen Yeung**

Tel. +852 2143 8753  
karmen.yeung@kpmg.com

[kpmg.com/cn](http://kpmg.com/cn)

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