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China's New Measures on Security Review of Foreign Investments

Introduction

The National Development and Reform Commission ("NDRC") and the Ministry of Commerce ("MOFCOM") of the People's Republic of China issued the *Measures on Security Review of Foreign Investments* (the "Measures") on December 19, 2020. The Measures will take effect on January 18, 2021.

This is not the first time that China has issued regulatory guidance on national security matters. The first was the *Notice on the Establishment of a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the "Notice") in 2011, accompanied by the *Stipulations of the Ministry of Commerce on the Implementation of the System of Security Review for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*. These were followed by the *Trial Measures on the Security Review in Free Trade Zones* issued in 2015 (the "Free Trade Zone Trial Measures").

Without introducing radical changes to the previous regulatory guidance, the Measures expand the list of industries' foreign investments that will be subject to security review. The Measures also give the regulatory authorities more discretion in determining the type of transactions that may fall within their ambit. Helpfully, the Measures set out a clear declaration and clearance process, including statutory timetables within which applications are to be processed. However, whether the actual processing time will adhere to the statutory timetables will need to be tested in practice.

1. Regulatory Authority in Charge

An office of the working system of security review of foreign investment (the "Office") will be established under NDRC and led by NDRC and MOFCOM to be in charge of security review of foreign investment.

2. Types of Transactions

Any foreign investment that has or may have an impact on national security will be subject to security review under the Measures. "Foreign investment" is defined as any investment activity carried out by a foreign investor directly or indirectly within the territory of the People's Republic of China, including where:

- (i) a foreign investor, solely or jointly with any other investor, invests in the construction of a new project or the establishment of a new enterprise in China;
- (ii) a foreign investor, by means of merger or acquisition, acquires the equity or assets of any enterprise in China; and

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- (iii) a foreign investor makes investment in China by other means.

The catch-all references to an investment made by “other means” and an investment made “directly or indirectly” in the PRC gives the Office discretion in determining the type of transactions falling within the ambit of the Measures. It is not clear to what extent reference will be drawn to the Free Trade Zone Measures that expressly include investment through agreements conferring controlling, nominee arrangements, trusts, re-investments, offshore transactions, leasing and subscription of convertible securities.

Article 22 of the Measures further contemplates that acquisition of shares in domestic enterprises through stock exchanges will also be subject to security review if the acquisition has or may have an impact on national security. The application of the Measures to these transactions will be formulated by the China Securities Regulatory Commission.

3. Prescribed Industries

A declaration is required to be made to the Office with respect to foreign investment in the following:

- (i) such areas as the military industry and ancillary industries that concern national defense or security;
- (ii) military facilities and areas surrounding military facilities;
- (iii) obtaining actual control over the enterprise invested in by the foreign investor involving the following products or services that concern national security:
 - (a) important agricultural products;
 - (b) important energy and resources;
 - (c) major equipment manufacturing;
 - (d) important infrastructure;
 - (e) important transportation services;
 - (f) important cultural products and services;
 - (g) important information technologies and internet products and services;
 - (h) important financial services;
 - (i) key technologies; and
 - (j) other important industries.

Compared to the previous regulatory guidance, the main additions to the prescribed list of industries in the Measures are important internet products and services and important financial services. The previous qualification that military facilities and surrounding areas must be “important” or “sensitive” facilities has also been removed.

4. Actual Control

As mentioned above, in the non-military sector, only an investment resulting in the foreign investor obtaining “actual control” over the enterprise in the prescribed industries will fall within the ambit of the Measures.

The definition of “actual control” is substantially the same as the previous regulatory guidance. “Actual control” is obtained by a foreign investor over an enterprise where:

- (i) the foreign investor holds 50% or more of the equity interests in the enterprise;
- (ii) the foreign investor holds less than 50% of the equity interests in the enterprise but the voting rights enjoyed by the foreign investor can have a material influence over the resolutions of the directors or shareholders; or (iii) other circumstances that may result in the foreign investor having a material influence over the business decision-making, personnel, finance, technology, etc. of the enterprise.

5. Declaration and Clearance Process

(a) Initiating a Declaration

The foreign investor or the relevant domestic person (the “Relevant Person”) is required to make a declaration to the Office of a foreign investment falling within the ambit of the Measures. The Relevant Person may make a pre-declaration consultation with the Office, including on whether a declaration is required.

The Office is also given the power to require the Relevant Person to make a declaration. In addition, any other institution, enterprise, collective or the public who considers a foreign investment to have or may have an impact on national security may also report to the Office. This avenue may potentially be used by competitors or disgruntled employees.

The Office may authorize the relevant departments at the level of provinces, autonomous regions and municipalities directly under the central government to receive the application for forwarding to the Office.

(b) Determining whether a Security Review is Required

Within 15 working days from the date of receipt of a declaration, the Office will make a decision on whether a security review of the declared foreign investment is required and will notify the Relevant

Person in writing. The declared foreign investment cannot be consummated until a decision is made by the Office that a security review is not required.

(c) General Review

Where the Office has determined that a security review is required, a general review will be commissioned and will be completed within 30 working days after the date of decision. The declared foreign investment cannot be consummated until clearance is given after the general review.

(d) Special Review

If the Office determines that the declared foreign investment has or may have an impact on national security, the Office will initiate a special review. A special review will be completed within 60 working days after the date of initiation. In exceptional circumstances, the review period may be extended, in which case the Relevant Person will be notified of the extension.

After completing the special review, the Office may determine that:

- (i) the declared foreign investment does not have any impact on national security, in which case clearance will be granted;
- (ii) the declared foreign investment has an impact on national security but the impact can be eliminated through the imposition of conditions, in which case conditional clearance will be granted; or
- (iii) the declared foreign investment has an impact on national security, in which case the investment will be prohibited.

6. Sanctions

Where a foreign investment falling within the ambit of the Measures is made without any declaration having been made, the Office has the power to compel a declaration and to require divestment and impose other restoration measures in case of a refusal to declare.

Where a foreign investment has been made and is subsequently prohibited by the Office, the Office has the power to require divestment and impose other restoration measures.

In case of any false representation or omission made in a declaration, the Office has the power to require correction. In case of fraud, the Office has the power to revoke any decision made and to require divestment and impose other restoration measures.

The Office will monitor the compliance with the conditions imposed in the case of a conditional clearance. In case of non-compliance, the Office has the power to require correction. In case of refusal to correct, the Office has the power to require divestment and impose other restoration measures.

Conclusion

Since national security review requirements were first introduced by the Notice in 2011, there has only been one published case of rejection. The clearance process and timetable, on the whole, have been relatively opaque. The Measures have helpfully clarified the clearance process and laid down a statutory timetable. Whilst the Measures have not introduced any radical changes and have retained the existing definition of when a foreign investor is considered to have acquired “actual control” over a domestic enterprise, the Measures have expanded the list of prescribed industries potentially requiring a security review to include important internet products and services and important financial services. The Measures have also given the Office broad discretion to deem foreign investment that is made by “other means” or “directly or indirectly” in the PRC and that satisfies the other pre-conditions to be falling within their ambit. Foreign investors should be aware of these changes.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Xiaoyu Greg Liu
+86-10-5828-6302
gliu@paulweiss.com

Judie Ng Shortell
+86-10-5828-6318
jngshortell@paulweiss.com

Betty Yap
+852-2846-0396
byap@paulweiss.com