

Observations on New Measures for China's Security Review of Foreign Investment

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On 19 December 2020, the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM) have jointly issued the Measures for the Security Review of Foreign Investment (Measures), with effect from 18 January 2021. The Measures provide clarity on Article 35 of the Foreign Investment Law and Article 40 of its Implementing Regulations which have been in force since 1 January 2020, among others.

The Measures are nationwide. They consists of 23 articles, mainly specifying the following content: the agency responsible for foreign investment security review; the scope of foreign investment security review; the declaration mechanism for foreign investment security review; the procedures and time limit for foreign investment security review; the implementation of the decision on foreign investment security review; and punishments on violations.¹

What is a Reportable Investment/Transaction Subject to Review?

The types of transaction carried out by foreign investors directly or indirectly in China that may be subject to security review include the following:

- Greenfield Investment: foreign investors by themselves or jointly with other investors, that are investing in any new project or establishing a business in China;
- M&A: foreign investors that are acquiring equity or assets of domestic business through mergers and acquisitions; and
- Others: foreign investors making investments into China through other methods.

It is worth noting that, according to the Provisions, whether a merger or acquisition of a domestic enterprise by a foreign investor falls within the scope of security review shall be determined from the substance and actual impact of the transaction. No foreign investor will be permitted to substantially evade the security review in any form, including but not limited to holding shares on behalf of others,

trust, multi-level reinvestment, leasing, loans, agreement-based control, and overseas transactions.

There is potentially a broad scope in terms of sectors that are subject to the Measures. In addition to military industry, industries related to national defense security and investments in the surrounding areas of military facilities will be subject to increased scrutiny. Important agricultural products, energy and resources, heavy equipment manufacturing, infrastructure, transportation services, cultural products and services, information technology and internet products and services, financial services, key technologies, among others, that relate to national security will also fall within the penumbra of reviewable investments/transactions under the Measures.

Declaration requirements are based on whether foreign investors have obtained de facto control according to the following circumstances:

- foreign investors with over 50 percent equity in the business;
- foreign investors with less than 50 percent equity but have decision-making authority that can influence decisions in board meetings etc.; or
- foreign investors that can exert influence over the business through other methods.

According to Article 22 of the Measures, foreign investment in capital markets in China is subject to rules which will be further formulated by China Securities Regulatory Commission and an office of the working mechanism established under the Measures.

Who are the Reviewing Authorities and Notifying Parties?

A foreign investment security review interagency working mechanism is established under the Measures to organize, coordinate, and guide foreign investment security work. The office of the working mechanism is located at NDRC. It will be jointly led by NDRC and MOFCOM and will undertake daily work of foreign investment security review (Working Group).

Foreign investors in sectors mentioned above should take the initiative and declare their investment plans before the investment is made. The Working Group may also require a foreign investor to declare its investment provided that it is a reportable investment under the Measures. The Measures also provide for third-party organizations such as government agencies, companies, social organizations, and the general public to recommend to the Working Group to initiate security review on foreign investments that may affect national security.

Procedures and Timing

Similar to an anti-trust filing in China, prior to foreign investors submitting a declaration, the Measures allow for initial consultation at the Working Group, though it is not mandatory.

A three-step review system is established under the Measures. Upon the receipt of a declaration from a foreign investor, the Working Group will issue a written notification of whether security review is required within 15 working days (Preliminary Review).

If the Working Group decides that security review is required, a general review will be conducted (General Review). Written notification of its decision will be provided within 30 working days to decision to initiate the General Review. If the Working Group is of the view that a proposed foreign

investment does not impact national security, the foreign investment is approved and passes the General Review.

If the Working Group is of the view that a proposed foreign investment may affect national security, a special review will be initiated (Special Review). Written notification of the decision will be provided within 60 working days. It may take longer under special circumstances and the foreign investors will be notified if there is a need for a longer period of review.

Below is a table summarizing the reporting procedures timeline:

Procedure	Timeline
Preliminary Review	Within 15 working days of receipt of declaration
General Review	Within 30 working days of decision to initiate General Review
Special Review	Within 60 working days of decision to initiate Special Review, it may take longer under special circumstances (no time limit)

The Working Group may make the following decisions:

- Foreign investment is approved if the proposed investment does not impact national security;
- Foreign investment is prohibited if the proposed investment impacts national security; or
- Foreign investment is allowed subject to additional conditions that can eliminate the impact of the proposed investment on national security. Foreign investors will be required to accept the additional conditions in an undertaking in writing.

Sanctions

Parties that fail to declare investment that is within the scope and implement an investment, or fail to comply with additional conditions imposed on a reviewed and approved foreign investment, may be ordered to take actions to correct non-compliance within a prescribed time limit, or to unwind the investment, such as disposing of equity or assets and to take necessary measures within a certain period of time in order to eliminate the impact on national security if non-compliance is not corrected within the prescribed time limit. Credit records of such parties will be negatively impacted, and accordingly, these parties may also face disciplinary action.

Observations

- **Sectors extended**

Compared with a circular issued by the General Office of the PRC State Council in March 2011 (Circular), the circular issued in April 2015 by the General Office of the PRC State Council on tentative measures of security review in Pilot Free Trade Zones (Tentative Measures), which only applies in pilot free trade zones, extended the scope of reportable investments to important culture, internet products and services. The Measures further

include important financial services in the scope of industries. Coincidentally, one of the reasons for the intervention of the PRC government in the planned Ant IPO was also national security in financial services.

- **Sectors vaguely defined**

The broad scope of sectors involved is vaguely defined in the Measures. This will increase the uncertainty of the types of investment by foreign investors that will be subject to the Measures. According to a Q&A made by an officer-in-charge in the Working Group on 19 December 2020, phone enquiries may be made with NDRC through phone numbers provided under the Announcement if a foreign investor is not sure whether an investment is within the scope or not. The Measures also allow for foreign investors to consult the Working Group before submitting a declaration, which may, to some extent, clear up some ambiguities and guide foreign investors on whether a declaration is needed. It is important to note that declaration is mandatory for investment by foreign investors that falls within the scope.

- **Standards of security review**

Unlike the Circular or the Tentative Measures, factors or standards of security review is not mentioned in the Measures. This increases the uncertainty on how this security review mechanism will be implemented and the factors that may be taken into account by the interagency working mechanism in its decision making process. In this regard, relevant provisions in the Circular may apply regarding the factors and standards of security review.

- **Relationship with the Provisions**

The Measures introduce different procedures and interagency working mechanisms for security review but do not supersede provisions published by MOFCOM, which came into effect in September 2011 (Provisions) literally. However, given that the Working Group is housed in NDRC and the Measures were approved by the State Council and jointly issued by the NDRC and the MOFCOM, we infer the Measures will prevail in the event of any conflict between the Measures and the Provisions.

- **Grandfather clause and time limit**

It is not clear whether the Measures will be applied retrospectively. This is subject to further observation and clarification. In addition, there is no time limit for the security review. Even if an investment is completed without declaration under the Measures, the Working Group may still request the investor to make the declaration under the Measures.

- **Punishment**

Different from investment screening by the Committee on Foreign Investment in the United States (CFIUS), in case of a foreign investor's failure to make a mandatory declaration, there is no administrative fine under the Measures.

WHAT LIES AHEAD?

“The life of the law has not been logic: it has been experience.” (*Oliver W. Holmes*)

The issuance of the Measures means the Chinese government is now serious for and has necessary experience in nation security review for foreign investments after 10 years practice in this area. However, terms under the Measures are vague to some extent, which reflects a high degree of ambiguity and uncertainty regarding how this review mechanism will be implemented in the future. Practice of the Working Group and the interagency working mechanism will be the life of China foreign investment security review regime in this regard. We will report as the enforcement agencies take action and clarify ambiguities. From an investor’s perspective, conditions for closing for investment in China, among others, should take into account the timing and uncertainty of obtaining national security approval.

¹ China’s security review of foreign investments in domestic companies date back to Article 31 of the Anti-Monopoly Law which came into effect in 2008, which requires a security review for mergers and acquisitions of domestic companies by foreign investors. A circular issued by the General Office of the PRC State Council in March 2011 (the Circular), and provisions published by MOFCOM which came into effect in September 2011 (Provisions),

provided more detail on the scope, content, mechanism and the procedures of the security review. In April 2015, the General Office of the PRC State

Council issued a circular on tentative measures of security review in Pilot Free Trade Zones (Tentative Measures), which applies in pilot free trade

zones only, with provisions on the scope and content of review, as well as the mechanism and procedures of the review. In April 2019, the NDRC issued

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