China Issues Measures on National Security Review of Foreign Investment

December 22, 2020
Foreign Direct Investment

On December 19, 2020, China’s National Development and Reform Commission (“NDRC”) and Ministry of Commerce (“MOFCOM”) jointly issued the Measures on Security Review of Foreign Investment (the “Measures”) (an official Chinese version is available here; an unofficial English translation is available here), revamping the country’s regulatory framework for scrutinizing foreign investment that may implicate China’s national security. The Measures will take effect on January 18, 2021, 30 days after issuance. Their promulgation, coming after a long period of development, represents a significant change in how China screens foreign investment that may implicate its national security.

China first introduced its national security review framework on February 3, 2011 when the State Council, China’s cabinet, released the Circular on the Establishment of a System for Security Review of Acquisition of Domestic Enterprises by Foreign Investors (the “Circular of 2011”). To implement this framework, MOFCOM issued the Regulations on the Implementation of the System for Security Review of Acquisition of Domestic Enterprises by Foreign Investors on August 25, 2011 (the “Implementing Regulation of 2011”), specifying how foreign investors may apply for a security review and obtain clearance for their acquisitions of Chinese domestically invested companies and assets in covered sectors. On April 8, 2015, the State Council issued the Trial Measures for the National Security Review of Foreign Investments in Pilot Free Trade Zones (“FTZ Measures”, collectively with the Circular of 2011 and the Implementing Regulation of 2011 as the “Previous Review Framework”) to further introduce a pilot program that would be applicable to foreign investment into China’s free trade zones. In practice, since 2011, only selective transactions have been reviewed under the Previous Review Framework, and for the majority of transactions in China involving foreign investors, security review filings and/or clearances have not been required as a condition of implementing a transaction.

Since 2015, two important laws have paved the way for an enhanced national security review process. On July 1, 2015, China issued its National Security Law, which mandates security reviews of "foreign investment that infringes upon, or may infringe upon, national security" (Article 59). This law does not provide further details on how the framework will be operationalized. Then, on January 1, 2020, China’s new Foreign Investment Law came into effect - this law explicitly calls for the establishment of an updated national security review framework to supplement the “negative list” approach that China is taking to otherwise treat foreign investors and their investments no less favorably than domestic investors at “the stage of investment access” (Article 35).
To implement these two laws, the Measures amend the Previous Review Framework and provide detailed rules to tackle the rising national security concerns and to address the global trend of strengthening national security review on foreign investment. Depending on how some key terms in the Measures are interpreted (as explained below), it is possible that the Measures, which introduce mandatory pre-closing filing obligations on foreign investors, will have a significant impact on certain inbound investments into China and even potentially some “foreign-to-foreign” transactions involving China.

**Scope of the Security Review**

Broadly speaking, the Measures mandate pre-closing filings, and authorize the “Foreign Investment Security Review Working Mechanism” (“Working Mechanism”) to review certain “foreign investments” in various “covered sectors” (Article 3). We discuss these concepts in further detail below, even though many key questions are left unanswered in the Measures.

**Foreign Investment**

“Foreign investment” is defined in the Measures as investments “directly or indirectly” made by foreign investors in China, including (Article 2):

- investment in new projects or the establishment of new enterprises by an individual foreign investor or by a foreign investor jointly with other investor(s) (e.g., other foreign or Chinese investors);
- the acquisition of equities or assets of “domestic enterprises” through mergers and acquisitions; and
- investments made through other means.

Such a definition leaves a couple of important questions unanswered. First, the definition includes investment “directly or indirectly” made by foreign investors in China. That is consistent with the text of the Foreign Investment Law and indicates that the Measures may apply to “reinvestment” conducted by foreign invested enterprises incorporated in China. In practice, however, if an enterprise is indirectly invested by a foreign investor (i.e. an enterprise reinvested by a foreign invested enterprise), China’s enterprise registration system does not necessarily reflect that information. This could mean that the Chinese authorities may not be able to know whether an enterprise is indirectly invested by a foreign investor simply by reviewing its registration information. It is therefore important to see how the practice is going to be developed around the review process.

Second, the Measures do not provide a definition of “domestic enterprise.” Nor do they clarify whether “domestic enterprise” include foreign invested enterprises incorporated in China. The Previous Review Framework explicitly excluded foreign invested enterprises established in China from the scope of “domestic enterprises” for the purpose of national security review. It is however unclear whether the Working Mechanism will take a similar approach moving forward. The interpretation of this term could significantly change the scope of covered transactions under the Measures, as it will determine whether “foreign-to-foreign” transactions that could result in the change of “actual control” (explained below) of foreign invested enterprises in China in covered sectors will trigger the pre-closing security review.
Foreign Direct Investment

In addition, comparing to the Previous Review Framework, the Measures expand the scope of covered foreign investment outside of FTZ to include not only the acquisitions of Chinese domestic companies and assets, but also “greenfield investments” in the form of establishing “investment projects,” wholly owned subsidiaries, and joint ventures.

Covered Sectors

Article 4 provides that the review requirements apply to foreign investments in the following sectors:

- investments in “military, military support and other sectors related to national defense and security,” as well as investments in proximity to military facilities and military-industrial facilities;
- investments in the sectors below that would result in foreign investors obtaining “actual control” over the “domestic enterprises” they invest in:
  - “important” agricultural products,
  - “important” energy and resources,
  - “major” equipment manufacturing,
  - “important” infrastructures,
  - “important” transportation services,
  - “important” cultural products and services,
  - “important” information technology (IT) and Internet/online products and services,
  - “important” financial services,
  - critical technologies, and
  - other important sectors/areas.

Appendix 2 provides a detailed comparison of sectors covered under the Previous Review Framework (within and outside of FTZ) and the Measures.

Note that consistent with the Previous Review Framework, the term “actual control” is defined to include any of the following circumstances:

- foreign investor(s) holds more than 50% of the equity interests in an enterprise;
- foreign investor(s) holds less than 50% of the equity interests in an enterprise, but its voting rights may exert significant influence on the resolutions of the board or the shareholders’ meeting; and
- other circumstances that enable foreign investor(s) to exert significant influence on the decision-making of the enterprise with regard to “business operations, personnel, finance and technology.”

Acquisitions of publicly-traded securities from stock exchanges by foreign investors are excluded from the Measures but will be subject to separate regulatory rules to be issued later.
Mandatory Pre-closing Filing and Review

For covered investments, foreign investors or “relevant stakeholders in China” are required to file for the security review and wait for the result of review prior to “implementing” their investments (Articles 4, 7, and 9). So unlike the national security reviewed by the Committee on Foreign Investment in the United States (CFIUS), which is a largely voluntary process, the Measures mandates the pre-closing security review of foreign investment falling into the scope of covered sectors (for certain sectors, actual control is needed), without specifying any other thresholds or criteria.

The Measures are silent on which parties are “relevant stakeholders in China,” and what activities will be deemed as “implementing” an investment. Given that foreign investments in sectors that do not fall into the “negative list” under China’s Foreign Investment Law may take effect upon execution, and the filing materials specified by the Measures do not include the acquisition/investment agreement (although the materials include “investment plans”), it is possible that the security review filing must be made prior to the execution of an acquisition/investment agreement. It is also possible that consistent with NDRC’s rules governing outbound investments by Chinese companies, “implementation of projects” will be defined as “contribution of assets and interests, as well as provision of financing and guarantees.” Uncertainties will remain until further regulatory guidance is provided.

Apart from the mandatory filing requirements, the Measures also provide that the Office of the Working Mechanism (as defined below) may in its own discretion request foreign investors to submit for review transactions falling under the scope of the covered sectors (Article 4). If any “government agencies, enterprises, social organizations or the public” believe that a certain foreign investment will or may impact China’s national security, they also have the right to submit “recommendations” to the Office to initiate a review (Article 15).

Key Regulators and Process of the Security Review

Under the Measures, an interagency Working Mechanism will be established to coordinate and guide the security review process. This Working Mechanism will be jointly led by NDRC and MOFCOM, and an office is to be set up in NDRC to lead the process (the “Office”) (Article 3). Other sectoral regulators may join the security review process.

The flowchart in the Appendix 1 summarizes the key steps in the review process and the associated timelines. Note that the Measures do not specify what materials or information need to be provided in the filing with respect to how the investment may (or may not) implicate China’s national security and what criteria will be taken by the Office when conducting the review. We expect that further guidance will be provided by the Office.
Upon conclusion of the review, the Office may issue the following four types of decisions:

<table>
<thead>
<tr>
<th>National Security Implication</th>
<th>Determination</th>
</tr>
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<tbody>
<tr>
<td>No national security implication (outside the scope of national security review)</td>
<td>The foreign investment does not need to undergo the security review process.</td>
</tr>
<tr>
<td>No national security implication (within the scope of national security review)</td>
<td>A clearance is granted.</td>
</tr>
<tr>
<td>National security implications can be mitigated by imposing certain conditions on the transaction</td>
<td>A conditional clearance is granted and these conditions will be enforced through post-implementation review of materials or on-site inspection.</td>
</tr>
<tr>
<td>National security will be implicated and cannot be mitigated</td>
<td>The foreign investment is prohibited.</td>
</tr>
</tbody>
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**Penalties for Failure to Comply**

The Office may order foreign investors, within a specified time limit, to dispose of their equity interests or assets and take other necessary measures to “restore the investment to its original state” and eliminate any impact on China’s national security, under the following circumstances (Article 16-18):

- the foreign investor fails to file for the security review prior to “implementing” its investment and refuses to make such a filing after ordered by the Office to do so;
- clearance is obtained by providing fraudulent filing materials or concealing key facts; or
- the foreign investor fails to comply with the conditions imposed by the Office when the clearance is granted, and refuses to make amends.

While there is no monetary penalty specified in the Measures, any violation of the Measures may also be recorded in China’s social credit system, which may result in penalties by other regulators.

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Appendix 1 - Foreign Investment Security Review Process

Submission of Filing Materials to the Office (Article 6)
- Application Form
- Investment Plan
- Statement on whether the foreign investment may impact national security

The Office determines whether a national security review is needed (Article 7).

A security review is needed

The Office conducts "General Review" (Article 8).

National security will or may be impacted

The Office conducts "Special Review," i.e., in-depth review (Article 9).

National security will be impacted
- Foreign investment is prohibited; or
- approved subject to certain conditions, e.g., mitigating measures or "remedies" (Article 12)

National security will not be impacted

Clearance granted (Article 8).

National security will not be impacted

Clearance granted (Article 12).

A security review is not needed

The investment can be implemented (Article 7).
**Appendix 2 - Comparison of Covered Sectors between the Previous Security Review Framework and the Measures**

Sectors bolded and underlined are the ones that are different from the original scope defined under the Circular of 2011

<table>
<thead>
<tr>
<th>Previous Security Review Framework</th>
<th>Amended Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Circular of 2011</strong></td>
<td><strong>Amended Measures</strong></td>
</tr>
<tr>
<td>military and military support enterprises, enterprises in proximity to key and/or sensitive military facilities, and other entities related to national defense and security</td>
<td>military, military support and other sectors related to national defense and security, as well as investments in proximity to key and/or sensitive military facilities</td>
</tr>
<tr>
<td>“important” agricultural products; “important” energy and resources; “important” infrastructure; “important” transportation services; critical technologies; and “major” equipment manufacturing.</td>
<td>military, military support and other sectors related to national defense and security, as well as investments in proximity to military facilities and military-industrial facilities [Removal of “key and/or sensitive” to broaden the scope]</td>
</tr>
<tr>
<td>obtain “actual control”</td>
<td>“important” agricultural products, “important” energy and resources, “major” equipment manufacturing, “important” infrastructure, “important” transportation services, “important” cultural products and services, “important” information technology (IT) and Internet/online products and services, “important” financial services, critical technologies, and other important sectors/areas.</td>
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