

National security review creates FDI hurdle

China's new National Security Law makes it clear that national security review is a priority, but the widened scope and vague language used for the types of inbound transactions subject to the process may create additional uncertainty for foreign investors

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On July 1 2015, the Standing Committee of the National People's Congress (NPC), China's top legislative body, adopted the new *PRC National Security Law* (Law), which took effect the same day. Beyond setting out a broad definition of national security and providing an overarching framework for safeguarding China's security interests, the Law's implications for national security reviews of investments are potentially far-ranging, as Article 59 mandates the security reviews of "foreign investment that infringes upon, or may infringe upon, national security", among other items.

The legislative history of China's national security review, the procedures for national security reviews applicable to foreign investments within and outside of the Free Trade Zones (FTZs) and the changes contemplated by the draft *PRC Foreign Investment Law* (FIL) all hold significant implications for inbound investors' access to the Chinese market.

Legislative history

China first formalised its procedures for national security reviews in February 2011 when the State Council issued its *Circular on the Establishment of a System for Security Review of Acquisition of Domestic Enterprises by Foreign Investors* (Circular). The Circular was followed by implementing regulations from the Ministry of Commerce (MOFCOM), namely the *Provisions for the Implementation of the System for Security Review of Acquisition of Domestic Enterprises by Foreign Investors* (Implementing Rules).

Although the government has yet to take formal action against foreign investors under these rules, efforts have been made recently to reinvigorate the system. On May 8 2015, the State Council issued the *Trial Measures for the National Security Review of Foreign Investments in Pilot Free Trade Zones* (Trial Measures), which slightly modified the procedures for national security reviews applicable to **foreign investments in key industries within the pilot FTZs**, currently in Shanghai, Tianjin, Guangdong Province, and Fujian Province. On April 22, the State Council, in its decision to open up the bank card clearing sector, for the first time explicitly required foreign investors that wish to acquire a domestic enterprise in the sector to undergo a national security review. Finally, the newly adopted National Security Law contains an explicit reference to the national security review and monitoring process in

Article 59 and requires that "each central state organ" should take responsibility for national security reviews and "supervise the implementation of national security review decisions" for matters falling within its portfolio in accordance with relevant laws and regulations.

At this early stage, the full impact of these legislative developments on foreign investors is difficult to predict.

Review criteria and procedures

Outside of the FTZs, national security reviews are governed by the Circular and its Implementing Rules. The Circular provides that if a foreign investor plans to obtain "actual control" (defined below) of the following types of domestic enterprises, the proposed mergers or acquisitions (M&A) will be subject to national security review:

- 1) military and military support enterprises;
- 2) enterprises in the vicinity of key and/or sensitive military facilities;
- 3) other entities associated with national defence and security; and
- 4) domestic enterprises engaged in sectors that "relate to national security":
 - a) important agricultural products;
 - b) important energy and resources;
 - c) important infrastructure;
 - d) important transportation services;
 - e) key technologies; and
 - f) major equipment manufacturing industries.

Actual control occurs when, post-transaction:

- 1) a foreign investor, together with its controlling parent company and controlled subsidiaries, holds 50% or more of the domestic enterprise's equity;
- 2) several foreign investors, in aggregate, hold 50% or more of the domestic enterprise's total equity;
- 3) one or more foreign investors, in aggregate, holds less than 50% of the domestic enterprise's equity, but the voting power of the held shares is sufficient to give it material influence over the resolutions adopted at shareholders meetings, the general assembly of shareholders, or board of directors meetings; and
- 4) other circumstances that result in the foreign investor(s) obtaining *de facto* control of the domestic enterprise's business decision-making processes on matters such as operations, finances, personnel, and technology.

The Circular tasks MOFCOM with accepting applications for security reviews and notifying foreign investors of final decisions. An inter-ministerial joint conference (Joint Conference) is to be established under the State Council to conduct the reviews, with the National Development and Reform Commission (NDRC) and MOFCOM playing a coordinating role. Different departments may be called upon to join the review process, depending on the sector to which a proposed transaction pertains.

Under the Circular, the Joint Conference evaluates the proposed M&A transaction on the basis of its impact on:

- national defence and security (specifically, impact on production capacity, service capacity, and equipment and facilities associated with national defence);
- national economic stability;
- social order; and
- research and development capacity for key technologies related to national security.

The review process is carried out in two phases. First, within five business days, MOFCOM will forward the application to the Joint Conference, which will then start a written consultation process within another five business days with relevant agencies. All departments are required to provide written feedback within 20 business days following initiation of the consultation process. If all agencies consulted agree that the proposed transaction does not implicate national security concerns, the review will be closed by then.

If any agency being consulted is of the view that a proposed transaction could raise national security concerns, a second phase – namely a "special review" phase – will commence. The Joint Conference has 60 days in which to complete this special review. If the agencies cannot reach a consensus on the effect of the proposed transaction on national security, then the State Council will make the final decision – a process for which no time limit is specified.

Foreign investors are required to file national security review applications with MOFCOM if they believe the transaction potentially implicates national security concerns. The filing is voluntary and does not connect with the approval process of inbound investment. If the investors decide not to file, the Joint Conference can also initiate reviews on its own initiative, or in response to proposals made to MOFCOM from other government agencies, trade associations or companies in the subject industry, or upstream or downstream industries.

Special rules in the FTZs

The FTZ-specific Trial Measures are important because they not only govern the national security review process in **the country's four FTZs**, but also because they likely foreshadow future changes to the national security review regime nationwide.

The Trial Measures reiterate that the working mechanism and procedures for security reviews within the FTZs are to be arranged in accordance with the Circular. However, they go on to extend the scope of review beyond M&A transactions to include greenfield projects, widening the potential scope of exposure for foreign investors. More specifically, Article 1.2 provides that investments are to be scrutinised in the following additional scenarios:

- Foreign investors solely or jointly invest in a greenfield project or set up an FIE; and
- Foreign investors gain control over a domestic enterprise through contractual arrangements, commissioned shareholding, trust, reinvestment, overseas transaction, lease, or subscription of convertible bonds.

The Trial Measures also move beyond the Circular in the way they explicitly link national security reviews to the foreign investment approval process in the FTZs. When approving or making a record filing for a foreign investment project, local authorities are required to notify the investor if a national security review will be required (even if the investor does not voluntarily file the review), and to temporarily suspend the approval process pending the results of the review. Once the review is completed, MOFCOM will notify the foreign investor, as well as local authorities, of the results.

Other new features of the Trial Measures include:

- Two more broad sectors that relate to national security, namely "cultural development" and "IT products and services," have been added to the list of sectors in which M&As of domestic enterprises by foreign investors will be subject to national security reviews;
- "Cultural security and public morality" and "network security of the state" have been added to the list of criteria to be applied by the Joint Conference when evaluating the impact of a proposed investment project on national security;
- Investments by foreign-invested equity investment companies, venture capital firms and investment companies are also subject to the Trial Measures; and
- Foreign investment in the financial sector has been excluded from the scope of the Trial Measures.

Foreign Investment Law

Earlier this year, MOFCOM published a new draft Foreign Investment Law that, if implemented, would **fundamentally revamp the system for managing foreign investment** in China. At its core, **the draft FIL proposes a "national treatment" regime** (i.e. a regime in which foreign and domestic investors are to be treated equally), subject to certain exceptions to such equal treatment that are to be set forth in a negative list. It devotes an entire chapter to national security reviews, and contemplates a wider application of the national security review system based on a sweeping conception of "national security".

On the procedure side, the draft FIL imposes a duty on foreign investors to self-assess whether their proposed investments implicate national security concerns if their investments are in sectors covered by the negative list. Article 50 provides that foreign investors "may" generally submit an application for security review if they believe the investments might infringe upon China's national security. However, for sectors where foreign investment is restricted (i.e. listed on the negative list) or for investment projects for which the value of the investment exceeds a certain threshold, foreign investors must, in their application for approval, state for the record whether anti-monopoly and/or national security reviews are required based on their self-assessment. MOFCOM, as the designated foreign investment approval agency, is obliged to consider the national security implications of proposed investments when granting approvals, and is to suspend the investment approval process if a transaction raises national security concerns.

On its face, the proposed system is still a voluntary filing system, consistent with the approach taken by the Circular, but slightly different from the approach taken by the Trial Measures (under which local authorities must take the initiative to notify a foreign investor in

the foreign investment approval process if they believe a transaction triggers a national security review). However, since there are no objective criteria on what kind of investment projects can trigger a security review (unlike the turnover-based thresholds that automatically trigger anti-monopoly reviews), this self-assessment requirement imposes additional burden on foreign investors and creates uncertainties even for foreign investment projects that in other jurisdictions would not normally raise national security concerns.

Awakening of a dormant regime

Recent efforts to reinvigorate the national security review system seem to signal the awakening of a rather dormant regime that existed under the Circular. These developments must be read in the broader context of the Chinese government's campaign to strengthen the protection of national security, with the national security system intended to work in tandem with other rules such as the new National Security Law to fend off potential threats. They also come at a time when the government is preparing for the ultimate adoption of a national treatment regime with a country-wide negative list of exceptions, ostensibly reducing government oversight over foreign investment. The national security review process will allow Chinese authorities to retain authority to review foreign investment applications in cases where such investments may pose a threat to China's national security.

Concerns, however, have been raised about the potential overly broad application of this system and the inclusion of vague criteria, with, for instance, authorities asked to evaluate the effect of a transaction on national security interests that include the "stability and operation of the national economy," "fundamental order of social life" and "cultural security." The wide scope of and ambiguous grounds for national security reviews will increase the uncertainty associated with China's review process for inbound foreign investment.

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