

Check If You Are Ready for China's New National Security Review Rules in 2021

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1. Background

The national security review of foreign investment is not a novel topic throughout the world. Nor is it alien to China. China has implemented the national security review regime for years, but it will enter a new era by unveiling a new regulation recently. On December 19, 2020, the National Development and Reform Commission (“**NDRC**”) and the Ministry of Commerce (“**MOFCOM**”) jointly issued the *Measures on Foreign Investment Security Review* (hereinafter as the “**Measures**”).

The person in charge of the Foreign Investment Security Review Mechanism Office explained that the introduction of the Measures aims to adapt to the need of deepening opening-up, and at the same time to effectively prevent and mitigate national security risks. Therefore, openness and national security are two axes of the Measures.

However, the document should be read in a broader context. This is against the backdrop of the close scrutiny paid by the U.S. government to Chinese investment in recent years. China has topped the list of nations of origin for foreign companies under the U.S. CFIUS review since 2012. Earlier this year, Trump administration has sought to unwind the TikTok deal (a video-sharing social media owned by a Beijing-based tech company ByteDance) and divest itself of U.S. operations.

2. Quick Glimpse at the History of China’s CFIUS

The Measures is not the first regulation to provide for a security review mechanism for foreign investment in China. It dates back to the enactment of the *Anti-monopoly Law* (hereinafter as the “**AML**”) in 2008, which briefly mentioned national security review in parallel with the merger control regime.

The mechanism was officially established in 2011, when the *Notice of the General Office of State Council on the Establishment of Security Review System Pertaining to Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (hereinafter as the “**2011 Notice**”) was issued in February. In September 2011, the MOFCOM formulated the *Interim Provisions on Matters Relating to the Implementation of the Security Review System for Foreign Investors’ Mergers and Acquisitions of Domestic Enterprises* aiming to give practical guidance to relevant parties.

In April 2015, the General Office of the State Council further issued the *Trial Measures for National Security Review of Foreign Investment in Pilot Free Trade Zones* to implement national security review measures for foreign investment in pilot free trade zones.

Therefore, the Measures is released based on the practices in the past ten years since the establishment of the foreign investment security review system in China in 2011. The Measures comes with a total of 23 articles, with changes in the types of foreign investment subject to review, the review authority, the scope of review, the review procedures, the supervision and implementation of review decisions and the consequences of violations. The Measures will come into force 30 days after the date of publication (i.e. January 18, 2021).



3. Legal Basis of the Measures

The enabling statutes for the Measures are the *National Security Law* (2015) and the *Foreign Investment Law* (2019). On the one hand, the *National Security Law* specifies that the state shall establish systems and mechanisms for national security review and supervision, and conducts national security review of foreign investment, and other important matters and activities that affect or may affect national security, in order to effectively prevent and mitigate national security risks.

On the other hand, the *Foreign Investment Law* and its implementing regulations also formally establish at the legal and regulatory level that the State adopts the management system of pre-establishment national treatment and negative list for foreign investment. It clearly stipulates that a national security review system for foreign investment shall be established to conduct security review of foreign investment that affects or may affect national security.



4. New Sectors Subject to the Security Review

According to the Measures, the term “foreign investment” refers to investment activities carried out by foreign investors directly or indirectly within the territory of China, including establishing wholly foreign-owned enterprises or sino-foreign equity joint ventures, acquiring equity or assets of domestic enterprises by way of M&A, or foreign investment in China in other forms. The definition is broader than in the 2011 Notice, which did not cover greenfield investment.

There are two major categories of foreign investment that entails compulsory declaration obligations

- Where the **military industry** is involved, as long as it constitutes foreign investment, it needs to be declared;
- Where the following industries are involved, only when (i) the industry involved is considered important, and (ii) the foreign investor obtains actual control, its declaration is required. Such industries include: agricultural products, energy and resources, equipment manufacturing, infrastructure, transport services, cultural products and services, information technology and internet products and services, financial services, key technologies and other important fields relating to national security.

Different from the 2011 Notice as we previously discussed, for the first time in history, the Measures brings both the internet industry and the financial industry under the scope of security review.

5. Clarification on the Concept of “Control”

It is worth noting that the definition of “**control**” in the Measures has also been clarified, which is a decisive factor in determining the declaration obligations under the second category as described above.

A comparison to the concept under the AML is shown as follows:

“Control” under the Measures	“Control” under the AML
<p>“Obtaining the actual control of the investee enterprise” in the Measures shall include the following circumstances:</p> <ul style="list-style-type: none">(i) Where the foreign investor holds more than 50% of the equity of an enterprise;(ii) Where the foreign investor holds less than 50% of the equity of an enterprise, but the voting rights held by it can have significant impact on the resolutions of the board of directors, the board of shareholders or the general meeting of shareholders; or(iii) Other circumstances where the foreign investor may have significant impact on the enterprise’s business decision-making, human resources, finance, technology etc.	<p>“Control” in concentration of undertakings includes sole control and joint control. Whether an undertaking obtains control over other undertakings or is able to exercise decisive influence over other undertakings through transactions depends on a number of legal and factual factors, including but not limited to:</p> <ul style="list-style-type: none">(i) The purpose of the transaction and future plans;(ii) The shareholding structure of the target and the changes to that structure;(iii) Reserved matters and voting mechanism of the shareholders’ meeting of the target and its historical attendance rate and voting record;(iv) The composition and voting mechanism of the board of directors and board of supervisors of the target;(v) The appointment and dismissal of senior management of the target;(vi) The relationship between the shareholders and directors of the target, including whether there is any proxy voting arrangement or person acting in concert; and(vii) The existence of any material business relationship or cooperation agreement between the acquirer and the target.

6. Beware the Change of Authority

Previously, the application materials for security review of foreign investment need to be submitted to the MOFCOM as stipulated in the 2011 Notice. However, due to the adjustment of departmental responsibilities, starting from April 30, 2019, the authority receiving the relevant materials has been changed to the NDRC.

According to Article 3 of the Measures, the State will establish a working mechanism for foreign investment security review. The working mechanism office (hereinafter as the “**Office**”) will be set up under the NDRC. Led by the NDRC and the MOFCOM, the Office will undertake the day-to-day work of foreign investment security review.

7. Paperwork Still Matters

A foreign investor will have to file a notification with the Office regarding any transaction falling under the scope of the Measures. Parties concerned may consult with the Office on relevant issues. Where relevant organs, enterprises, social groups or the general public deem that a foreign investment affects or may affect national security, they may also propose security review to the Office.

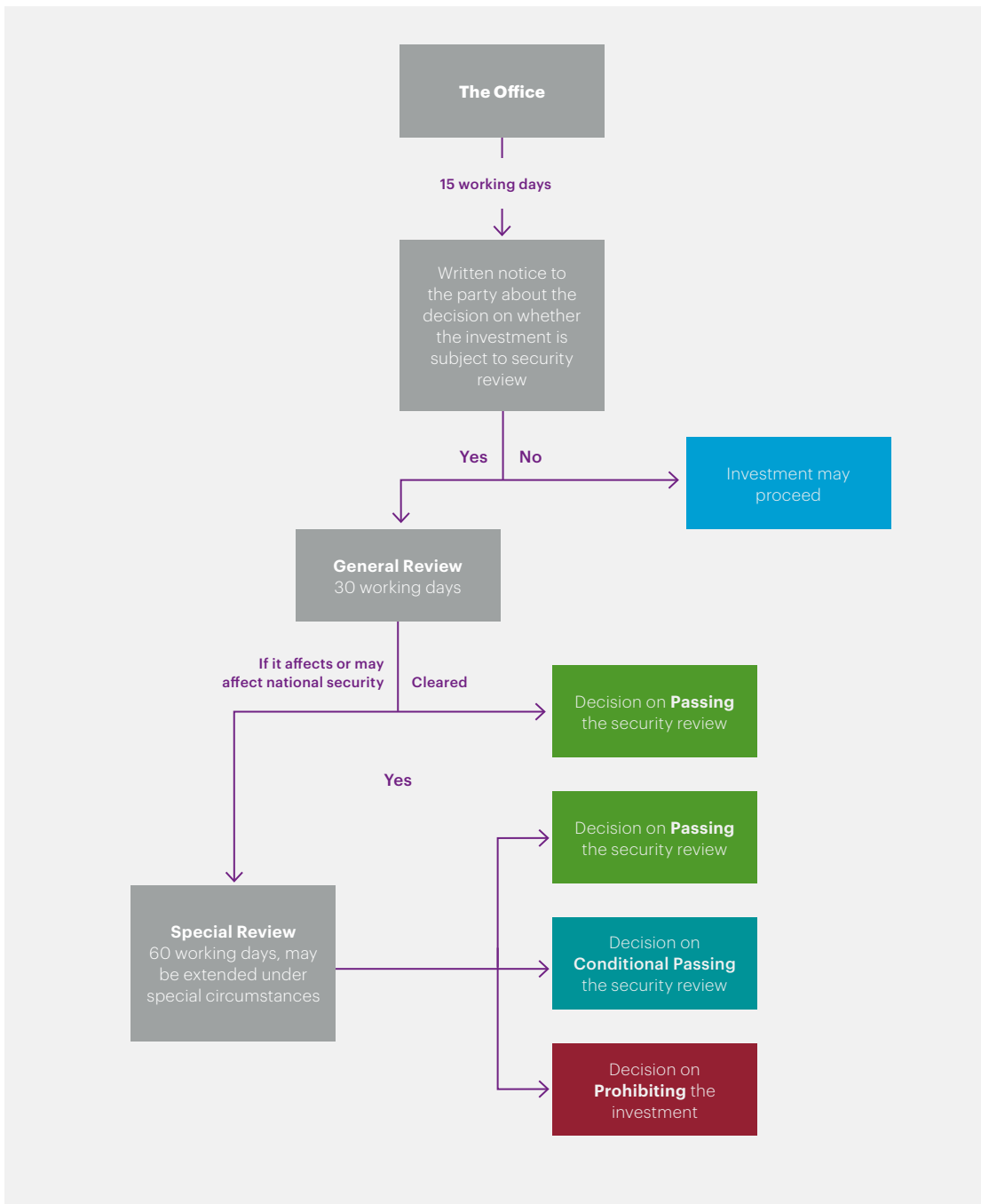
Once a foreign investor is prepared to file a declaration, the **following materials** shall be submitted to the Office: (i) a declaration letter; (ii) an investment plan; (iii) a statement on whether the foreign investment will have an impact on national security; and (iv) other materials stipulated by the office of the working mechanism.

The Office may, based on work needs, entrust relevant departments of provincial governments with collection and forwarding of the materials on its behalf.



8. Quick Guide to the Declaration Procedure

The following chart displays how the declaration procedure works:



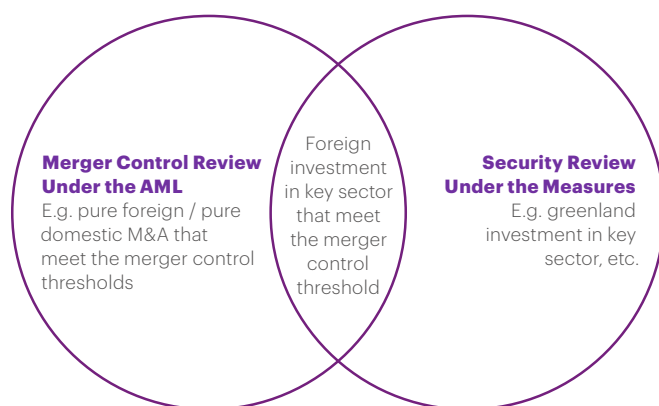
Additionally, the Office may require the parties concerned to supplement the relevant materials and the time for the parties concerned to provide supplementary materials will not be counted in the review period. **Therefore, the procedure may take even longer in practice.**

If the parties concerned wish to revise the investment plan, the review period will be re-counted from the date of receipt of the revised investment plan by the Office. If the parties concerned wish to cancel the investment, the review will be terminated by the Office.



9. Interplay Between the AML and the Measures

Further, the interplay between the AML and the Measures is another interesting topic worth discussing. Briefly speaking, not all transactions subject to merger control review under the AML will be subject to the Measures, only those involving foreign investment in key sector as discussed above. Mergers between foreign companies or between domestic companies will not be subject to the Measures, either. Conversely, not all transactions subject to the Measures will be subject to merger control review, such as when the parties do not meet the merger control thresholds.



However, there are circumstances when a transaction may involve both procedures, such as when a transaction involves foreign investment in key sector and also meets the merger control threshold. For instance, last year, shortly after the antitrust approval of Yonghui Superstores Co., Ltd.'s (hereinafter as "**Yonghui**") equity acquisition of Zhongbai Holdings Group Co., Ltd. (hereinafter as "**Zhongbai**"), Yonghui received another notice from the NDRC on the security review of foreign investment. After almost three months' general review, the case entered the special review procedure and Yonghui finally announced the decision to cancel the acquisition previously proposed.

Compared with merger control review, national security review has been initiated less frequently in practice. In the process of merger control review, if it is believed that the relevant transaction may trigger security review, the NDRC may be informed of the transaction and the parties may be prompted to submit an application for security review to the NDRC. Although this practice is not expressly provided in the current regulations, it has in fact become a practice in the antitrust filing process. The antitrust filing form in China explicitly includes an item that requires the filing party to state what other reviews are required, the current progress of such reviews, and provide the approval opinions of the relevant department (if any). Therefore, the filing party may go through both procedures at the same time and should provide explanation during the filing process.

10. Consequences for Violation of the Measures

Article 16 to 18 of the Measures stipulate possible consequences for violations of the Measures.

- For any foreign investments that try to evade obligation of declaration from the very beginning, the Office may order the party concerned to make declaration within a time limit; if the party concerned still refuse to make declaration, the Office may order to dispose of equity or assets and to take other necessary measures within a time limit to restore the equity or assets to the status before the implementation of the investment to eliminate impact on national security.
- For any foreign investments that provide false materials to or conceal relevant information from the Office, the Office may order the party concerned to make correction; or where the parties concerned pass the security review by cheating, relevant decisions shall be revoked; if the investment has been made, the parties concerned may be ordered to dispose of equity or assets and to take other necessary measures within a time limit to restore the equity or assets to the status before the implementation of the investment to eliminate impact on national security.
- For any foreign investment that passes the security review with conditions, if the parties concerned fail to make investment under the additional conditions, the Office may order to make correction; in case that the party concerned refuse to make correction, the Office may order to dispose of equity or assets and take other necessary measures within a time limit to restore the equity or assets to the status before the implementation of the investment to eliminate impact on national security.

Further, the parties concerned falling under any of the above described circumstances shall be included in the relevant credit information system of the State as parties with poor credit records, and be subject to joint punishment in accordance with the relevant provisions of the State.



11. What's Next

The release of the Measures is a progressive supplement to the current landscape regulating foreign investment activities. The enactment of the *Foreign Investment Law* and the adoption of national treatment and negative list signal the shift away from regulating through market entry licenses or registrations. Consequently, the national security review and the merger control will be two of the few remaining ex ante regulatory regimes that may cause most uncertainty for foreign investors in China.

However, there are still questions remaining to be clarified. For instance, the Measures mentioned in Article 22 that where foreign investors' purchase of the shares of any domestic enterprise through stock exchanges affects or may affect national security, the specific measures for the application shall be developed by the securities regulatory authority under the State Council in conjunction with the office of the working mechanism.

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