

The People's Republic of China (PRC or China) established a foreign investment security review in 2011 that focused exclusively on the merger and acquisition of domestic companies by foreign investors in a notice issued by the State Council (the 2011 Notice)¹. On December 19, 2020, the National Development and Reform Committee (NDRC) and the Ministry of Commerce (MOFCOM) jointly released the Measures on Foreign Investment Security Review (the Measures) that expand the scope of such reviews.

The Measures have taken effect from January 18, 2021, and will be enforced by a "working mechanism" to be jointly established by NDRC and MOFCOM (the Working Mechanism).

Here, we take a closer look at the key sections of the Measures:

1. Foreign Investment Subject to National Security Review

The Measures cover almost all direct or indirect investment activities by foreign investors in China, including greenfield investments and joint ventures. The complete list of covered investments are:

- Establishment of new projects and new entities by foreign investors
- Acquisition of equity or assets of domestic companies by a foreign investor
- Other forms of investment made by a foreign investor in China

The last point is exceptionally vague. Under the 2011 Notice and the relevant rules applicable in free trade zones, "other forms of investment" is interpreted to include structures such as control through agreements (or the so-called VIE structure), nominee shareholding, trust arrangement, offshore transaction, leasing and subscription of convertible bond.

2. Industries Subject to National Security Review

In addition to the forms of investment, the Measures significantly expand the list of industries in which foreign investment will be subject to national security review. These include "critical cultural products and services, critical information technology and internet products and services, and critical financial services."

The Measures divide the industries subject to national security review into two categories: (i) military-related industries regardless of the element of control, and (ii) non-military industries where foreign investors may exercise "actual control." Specifically:

- a. Military-related industries** – Any investment by a foreign investor is subject to a national security review if (i) it invests on military or national defense and security-related industries or (ii) it is located in the surrounding areas of military facilities and military-related facilities, regardless if the investment will result in any control by the foreign investor.
- b. Other industries with "control"** – Investment by foreign investor(s) in the following industries that involve national security concern is subject to national security review, if such investment will result in the foreign investor(s) to have "actual control" over the target:
 - i. Critical agricultural products
 - ii. Critical energy and resources
 - iii. Major equipment manufacturing
 - iv. Critical infrastructure
 - v. Critical transportation services
 - vi. Critical cultural products and services
 - vii. Critical information technology and internet products and services
 - viii. Critical financial services
 - ix. Key technologies
 - x. Other essential industries

As mentioned above, items (vi) to (ix) are newly added to the list.

According to the Measures, "actual control" may include:

- Foreign investor(s) owning more than 50% equity interest
- Foreign investor(s) owning less than 50% equity interest but its voting rights may materially impact the decision of the board of directors or shareholders' meeting

¹ Notice on Establishment of Security Review Mechanism on Foreign Investors' Merger of Domestic Companies, effective from March, 2011.

- Other circumstances where a foreign investor may materially impact the subject company's decisions, human resources, finance, technologies, etc.

The Measures, however, do not define “foreign investor”. As a result, it is not clear whether China will trace to the ultimate owners when determining if an investor is “foreign” or whether, in the case of multiple shareholders, the ultimate foreign ownership should be combined. Some of these questions were clarified in the 2011 Notice, so it is puzzling that such clarifications have not been included in the Measures. The promulgators of the Measures may prefer to leave the details to the future in implementing rules.

3. National Security Review Procedures

- Reporting** – Generally, the Measures require the parties involved in a covered transaction to voluntarily report the transaction to the Working Mechanism. The Working Mechanism may also proactively require the parties to report. In addition, the Measures encourage other government authorities, companies and the general public to inform the Working Mechanism of any foreign investment that may be deemed to influence national security.
- Preliminary review (15 working days)** – Upon the receipt of a report, the Working Mechanism will first conduct a preliminary review to determine whether a national security review is required for the particular foreign investment. The Measures specify that the determination must be issued within 15 working days from the date the report is filed.
- General review (30 working days)** – If the Working Mechanism determines that a national security review is required, a general review of the foreign investment should be completed within 30 working days after the decision. Within the 30 working days, the Working Mechanism should decide either (i) to initiate a special review if it considers the foreign investment may impact national security, or (ii) to grant a clearance to the investment.
- Special review (60 working days)** – The Working Mechanism is obligated to complete the special review within 60 working days after its initiation, which may be extended by the Working Mechanism under special circumstances. The Special Review may result in any of three outcomes: (i) denial, (ii) clearance, or (iii) conditional clearance, whereby the Working Mechanism would impose conditions that would eliminate the investment's impact on national security and the parties involved should commit to fulfill such conditions.
- Extension of review period** – Notably, during the security review, the Working Mechanism has the right to require the parties to submit supplementary information, and the time for providing such additional materials will not be counted in the review period. Further, during the review period, the parties involved may revise or cancel the investment. In case of an amendment, the review period should be recalculated from the date of resubmission. Therefore, in reality, the timeline as stated above may be extended without limit.

- No closing before clearance** – Before clearance is granted, the parties may not close the subject transaction.

- No appeal** – Decisions made by the Working Mechanism are final and not appealable.

4. Substantive Review

The Measures are silent on the standards of the substantive review. According to the 2011 Notice and the relevant rules applicable in free trade zones, the factors to be considered when conducting a national security review would include the impacts on the following: (i) national defense and security; (ii) national economy stability; (iii) social order; (iv) the R&D ability of key technologies in relation to national security; (v) cultural safety; (vi) public interest; and (vii) cybersecurity.

5. Consequences and Potential Penalties

If a foreign investor either fails to report an investment to the Working Mechanism when required or carries out the investment in violation of the Working Mechanism's decision, the investor may be required to dispose of the relevant equity and assets, or to take other measures to restore the original status as existed prior to the investment. Such violation will also be recorded in China's company credit system and may result in other administrative penalties. Nevertheless, the Measures do not specify any economic penalties.

The Measures significantly expand the scope of foreign investments that will be subject to PRC national security review, both in terms of the type of investment and the industries covered. China's foreign direct investment national security review mechanism, although established nearly 10 years ago, has rarely been used in practice. However, given the US-China trade tensions of recent years, China's national security concern has increased, particularly in terms of cultural, media and IT/internet security, which have been added by the Measures as industries subject to national security review.

The Measures may also be viewed as a response to the considerably tightened national security reviews of Chinese investments, particularly in the US by the Committee on Foreign Investment in the United States or CFIUS. The Measures are part of China's attempt to establish a more robust legal framework for national security reviews. The action is taken in combination with a series of measures published by the PRC recently, including the [Unreliable Entity List](#), the [Export Control Law](#) and the [blocking statute](#). Each of these topics has been hyperlinked to our analysis on the [Trade Practitioner](#) blog.

It remains to be seen how China will leverage its strengthened legal framework, given that China remains committed to attracting more foreign investment and further opening its markets.

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