

China Issues Rules on Foreign Investment Security Review to Stay in Line with International Practice

by Karen Yiqin Fan

On December 19, 2020, China published the *Rules on Foreign Investment Security Review* (in Chinese, 外商投资安全审查办法) (“**Security Review Rules**”). Security Review Rules lay out the grounds by which foreign investments in China are required to be reviewed for national security concerns by the Foreign Investment Security Review Office of Work Mechanism (“**Office of Work Mechanism**”), a body headed by the National Development and Reform Commission (“**NDRC**”) and the Ministry of Commerce. It is intended to help balance the economic benefits of further opening-up markets to foreign investment with the need to ensure national security, which is in line with international practice, according to NDRC. The Rules will take effect on January 18, 2021.

1. What is the scope of Security Review Rules’ jurisdiction?

The Office of Work Mechanism is empowered to conduct a national security review of any foreign investment project in the People’s Republic China (“**PRC**”) with respect to:

- a) national defense sectors, including military, products associated with military, and places where military facilities are located or in close proximity to military bases; or
- b) sectors such as essential agriculture products, essential energy and resources, key equipment manufacturing, key infrastructure, key transportation services, important cultural products and services, important information technology and internet-based products & services, key financial services, critical technologies and any other key sectors concerning national security (each associated with national security interest), and through such investment project, a foreign investor would gain “actual control” of the target company.

Foreign investment projects are broadly defined to cover both direct and indirect investments, including green-field projects in the PRC and new PRC companies established by foreign investors on their own or with other joint venture partners, as well as acquisitions by foreign investors of equity interests or assets of PRC domestic

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companies. For the purpose of the Security Review Rules, investors from Hong Kong, Macau or Taiwan are also considered foreign investors. The Security Review Rules also set out a catchall provision to cover other forms of foreign investment that are not explicitly provided in the context of the rules, which leaves room for the regulatory body to interpret the rules at its discretion in order to capture foreign investment projects that fall outside of the scope discussed above.

2. What constitutes “actual control” by a foreign investor of a target company?

As discussed in paragraph 1.(b) above, a foreign investment project in an identified sector would not be subject to security review under the Security Review Rules unless a foreign investor gains actual control of the target company through such investment. “Actual control”, as defined in Article 4 of the Security Review Rules, includes power gained by a foreign investor:

- a) by holding 50% or more of the ownership of the target company;
- b) by holding no more than 50% of the ownership of the target company, as well as the voting power which is perceived to significantly influence decisions of the board or shareholders of the target company; or
- c) in other circumstances where the foreign investor is perceived to have significant influence on business decision-making, human resources, finance, technology and other matters of the target company.

Paragraph (c) above is also a catchall provision which enables the regulatory body to capture any foreign investment project where a foreign investor purposefully design a corporate structure to avoid hitting ownership thresholds or voting power requirements so as to circumvent the required security review.

3. Is it mandatory or voluntary for a foreign investor to make a filing to the Office of Work Mechanism with respect to a proposed foreign investment project?

In contrast to the national security regimes of other countries (such as the CFIUS review in the United States), it is a mandatory obligation of a foreign investor to make a filing to the Office of Work Mechanism before it proceeds with a proposed foreign investment project that falls within the jurisdiction of the Security Review Rules.

Because of China’s long-existing foreign investment regime that requires review and scrutiny of each foreign invested company before its incorporation, there is a well-developed information-sharing system maintained by Chinese authorities regarding foreign-invested companies. The Office of Work Mechanism can easily identify an unreported foreign investment project and get access to detailed information, including shareholding structure and identity of each shareholder, through the State Administration of Market Regulation and the Chinese Securities Regulation Commission.

It is also worth noting that the Security Review Rules encourages any government

agency, enterprise, organization and group of individuals to report to the Office of Work Mechanism any foreign investment project that is perceived to, or likely to, have an impact on national security.

4. What is the consequence of failing to make a filing for a foreign investment project that falls within the jurisdiction of Security Review Rules?

The Security Review Rules empowers the Office of Work Mechanism to order a foreign investor to make a filing regarding an unreported investment it has made into the PRC that falls within the jurisdiction of the Security Review Rules. Where the Office of Work Mechanism orders a foreign investor to make such a filing and the foreign investor refuses to obey the order, the Office of Work Mechanism has the power to impose punishment on the foreign investor with the effect of unwinding the investment transactions.

5. What is the review process and review timeline under the Security Review Rules?

The review process under the Security Review Rules is initiated by the submission of a filing by a foreign investor to the Office of Work Mechanism. The contents of the filing are prescribed by the Security Review Rules, and include a filing report, an investment plan, a study report on the investment project's potential impact on national security, and other materials as required by the Office of Work Mechanism. The Security Review Rules also allow the Office of Work Mechanism to request supplemental materials and/or information from foreign investors. We expect an implementation rule will be published by the Office of Work Mechanism to provide more detailed requirements on the documents that foreign investors should include in the filing submissions.

After a filing is submitted, the Office of Work Mechanism initiates a 15-business-day assessment period to identify any national security concerns in the investment project and to decide whether they should conduct a security review of the investment project. The Office of Work Mechanism needs to inform the foreign investor who has made the filing of their decision after the assessment process in writing. The foreign investor should withhold from proceeding with the investment during the initial assessment period and until the Office of Work Mechanism issues a written decision not to conduct a security review of the investment project.

When the Office of Work Mechanism decides that they need to conduct a security review of a reported investment project, they will first initiate a 30-business-day general review. At the end of the 30-business-day review period, the Office of Work Mechanism would conclude whether the investment project will have an impact on national security. If the Office of Work Mechanism concludes that the investment project is perceived to, or is likely to, have an impact on national security, the Office of Work Mechanism has the right to conduct a 60-business-day special review and may extend the special review period where necessary. Depending on the nature and severity of perceived national security risks identified during the special review process, the Office of Work Mechanism may (i) issue an order preventing the foreign investor from proceeding with the investment

project, or (ii) propose certain mitigation measures on the investment project and issue a clearance decision only if the foreign investor undertakes to implement such mitigation measures in writing. The time periods of security review discussed in this paragraph do not include the days that foreign investors spend on preparing supplemental materials or information in response to inquiries from the Office of Work Mechanism following the initial submission. Therefore, in the event the Office of Work Mechanism sends several rounds of follow-up inquiries to a foreign investor, the review period could be prolonged substantially.