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CHANCE

CHINA'S NEW NATIONAL SECURITY REVIEW REGIME

In recent years, governments in a number of countries have tightened up their foreign direct investment control regimes.

China is now doing the same with its national security review ("**NSR**") regime through the introduction of the *Measures for the Security Review of Foreign Investment* (the "**New NSR Measures**"). The New NSR Measures were jointly released by China's National Development and Reform Commission ("**NDRC**") and Ministry of Commerce ("**MOFCOM**") on 19 December 2020 and became effective on 18 January 2021.

Key points

- China released its new rules on national security review, which took effect on 18 January 2021. The new rules build upon the prior rules and contain several key changes.
- The new rules apply more broadly to foreign investments in China, and give the Chinese regulators the ability to scrutinize investments which were made through offshore structures or contractual arrangements. The sectors subject to China's national security review regime have also been expanded under the new rules.
- The potential for regulatory approval risks in China needs to be fully analysed and assessed at a very early stage if a foreign investment involves sectors which may have national security implications.
- There remain areas of uncertainty under these new rules, leaving the Chinese regulators with interpretive freedom in their application. Furthermore, it is yet to be seen whether the new rules will be more practically enforced by the Chinese regulators than the prior rules.

OVERVIEW

The New NSR Measures build upon the prior NSR rules by expanding their application as follows:

(1) applying more broadly to investments in China made by foreign investors;

(2) giving Chinese regulators the ability to scrutinize investments made through offshore structures or contractual arrangements, which are viewed as indirect investments in China;

(3) expanding the sectors which are subject to the New NSR Measures compared to the prior NSR regime;

(4) introducing a new NSR authority established under NDRC and jointly led by NDRC and MOFCOM; and

(5) introducing an application process which may be time-consuming and extensive.

In light of these changes, it remains to be seen whether the New NSR Measures will be applied more regularly than its predecessor regime which was rarely invoked.[1]

1 NDRC's intervention in Yonghui Superstores' proposed acquisition of a controlling stake in Zhongbai Holdings in 2019 is one o f the few publicly known cases in which the NSR was reportedly triggered. In this transaction, Yonghui Superstores intended to acquire a controlling interest in Zhongbai Holdings, a Chinese state-owned retailer. NDRC intervened as 19.99% of the shares in Yonghui was owned by a foreign entity, namely Dairy Farm International which is ultimately controlled by Jardine. It is widely believed that the NDRC commenced its NSR process primarily due to the national defence concerns considering Zhongbai's critical role as a major provider of warehousing and distribution to the 2019 Military World Games and Zhongbai's store network in certain military colleges in Wuhan. Eventually, Yonghui withdrew its tender offer in December 2019 f ollowing the NDRC's commencement of a special review process on this transaction.

PREVIOUS NSR MEASURES

China first introduced an NSR regime in 2009 under legislation[2] published in 2011 by China's General Office of the State Council and under the relevant provisions[3] issued by MOFCOM (collectively, the "**2011 M&A NSR Rules**")[4]. The 2011 M&A NSR Rules laid out a scheme for NSR, which was applicable to acquisitions by foreign investors in certain sensitive sectors in China. However, in practice, the 2011 M&A NSR Rules have not been widely nor strictly enforced by the Chinese regulators.

HIGHLIGHTS OF THE NEW NSR MEASURES

Transactions subject to NSR

An investment transaction in China will be subject to the New NSR Measures if the following two conditions are satisfied: (i) it is classified as a "foreign investment" as defined under the New NSR Measures; and (ii) it involves one of the specific sectors identified under the New NSR Measures.

The 2011 M&A NSR Rules only applied to mergers and acquisitions (i.e. for shares or assets of a Chinese domestic company) involving foreign investors in China. By contrast, under the New NSR Measures, foreign investment in China within an NSR jurisdiction is broadly defined as any investment activity carried out by foreign investors directly or indirectly within the territory of China, including:

(i) any investment in a new project or establishment of an enterprise in China by a foreign investor individually or jointly with other investors;

(ii) any acquisition of equity or assets of an enterprise within the territory of China by a foreign investor through a merger or acquisition; or

(iii) foreign investment in China in any other way.

The New NSR Rules do not contain a definition f or "foreign investors". However, we can look to the 2011 M&A NSR Rules, which were stated to regulate investment in China by non-mainland China investors. Accordingly, a reasonable interpretation is that the Chinese authoriti es will consider non- mainland China investors as "foreign investors" for the purposes of the New NSR Rules. In determining whether investment is made by a foreign investor, we believe a "look through" approach will be adopted i.e. the regulators will look to the ultimate beneficial owner of the proposed investment, as opposed to the immediate investing vehicle.

Pursuant to the definition of "foreign investment", green-field investments by foreign investors now clearly fall into the ambit of the NSR regime in China under the New NSR Measures. In addition, the catch -all provision of "foreign investments in China in any other way" also affords Chinese regulator s the ability to scrutinize investments intended to be made by foreign investors through, for example, offshore or contractual arrangements. Moreover, the relevant language is unclear as to whether the New NSR

2 *Notice on the Establishment of a Security Review System Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, which took effect on 3 March 2011.*

3 *Provisions of MOFCOM on the Implementation of a Security Review System on Mergers and Acquisitions of Chinese Enterprises by Foreign Investors, which took effect on 1 September 2011.*

4 We prepared a client briefing titled "China finalizes national security review system" in September 2011 to introduce the 2011 M&A NSR Rules.

Rules apply to "foreign-to-foreign" transactions and whether this is captured by reference to foreign investors' investment activity being "indirectly" within China. This allows some leeway for Chinese authorities to expand the application of the New NSR

Rules to gain jurisdiction over foreign-to-foreign transactions. For example, where none of the parties to a transaction is a Chinese entity but the target group has Chinese subsidiaries or asset.

Foreign investors will need to obtain pre-approval from the Chinese regulator in charge of NSR if a foreign investment involves any of the listed sectors (the **"Sector List"**), being:

(i) investment in military industry, military industrial accessories and other national defense and security related sectors, and investment in areas surrounding military facilities and military industrial facilities; or

(ii) investments in important agricultural products, important energy and resources, important equipment manufacturing, important infrastructure, important transport services, important cultural products and services, important information technology and internet products and services, important financial services, key technologies and other important sectors that bear on national security; AND the foreign investor(s) will acquire de facto control over the invested enterprise in any of the foregoing sectors listed in this paragraph (ii).

To trigger NSR under paragraph (i) of the Sector List, the shareholding percentage to be held by a foreign investor is not relevant (i.e. even a minority stake will count). By contrast, transactions triggering NSR under paragraph (ii) of the Sector List must satisfy a two-pronged test (i.e. relate to the sector and involve a foreign investor having a controlling stake).

"Acquiring de facto control over the invested enterprise" is broadly defined under the New NSR Measures to capture each of the following scenarios:

(i) foreign investor(s) hold 50% or more than 50% of equity interest of the enterprise;

(ii) foreign investor(s) hold less than 50% of equity interest of the enterprise, yet the foreign investor(s)'s voting rights enable the foreign investor(s) to exert significant influence on the resolutions of the board of directors, the shareholders' meeting or the general meeting of shareholders of the enterprise; or

(iii) other circumstances which enable the foreign investor(s) to exert significant influence on the operation and decision -making, human resources, finances, technologies or other aspects of the enterprise.

Similar to national security review regimes in many other jurisdictions, the Sector List is broadly drafted with few details. This will enable Chinese regulators to widely apply the new NSR Measures to a broader range of transactions in these sectors. It is also worth noting that compared to the 2011 M&A NSR Rules, the New NSR Measures have included new sectors on the Sector List, namely: important cultural products and services, important information technology and internet business, and important financial services.

New NSR Authority

The New NSR Measures empower the national security review working mechanism office (the "**NSR Office**"), an inter-ministerial government body, to be responsible for overseeing, coordinating and guiding the foreign investment national security review process. The new NSR Office is officially established under NDRC and jointly led by NDRC and MOFCOM.

NSR Application Procedures

For a foreign investment involving a sector contained on the Sector List, the foreign investor(s) or the relevant Chinese domestic parties shall notify the NSR Office before the investment takes place. Prior to filing the formal notification, the parties may consult the NSR Office to seek guidance. The NSR procedure consists of the following stages:

(i) Preliminary review: the NSR Office will decide whether to initiate the NSR within 15 working days from the receipt of all the required materials;

(ii) General review: if the NSR Office determines that a NSR should be conducted, a "general review" will commence and will be completed within 30 working days thereafter (except if a special review is deemed necessary, as described below);

(iii) Special review: if after the general review, the NSR Office determines that a foreign investment has or may have national security concerns, it will initiate a special review. The special review will be completed within 60 working days and may be extended under certain special circumstances.

In contrast to the 2011 M&A NSR Rules, the New NSR Measures remove the requirement that certain cases (where there is significant divergence within the review panel) need to be reported to the State Council , which simplifies the review process.

After completion of the review process, depending upon whether a notified foreign investment has any national security concerns (and if so, to what extent such concerns could be mitigated by remedies), the NSR Office will approve the proposed foreign investment without conditions, approve with conditions, or reject it entirely.

Legal Liabilities for Violation

If a foreign investment is subject to the NSR under the New NSR Measures, investors are prohibited from completing the transaction prior to obtaining approval from the NSR Office.

If the parties fail to notify on a notifiable transaction, submit fraudulent information, conceal relevant information, or fail to comply with the imposed conditions for a conditional approval, the NSR Office may withdraw relevant approvals (if any) and order the parties to provide notification of such transaction within a specified period of time, make rectification, dispose of equity or assets within a specified period of time, along with other necessary measures to reinstate the original status prior to the investment to eliminate national security concerns. Further, such violation may be recorded as a poor credit record in the relevant national credit information systems, and joint punishments could be imposed in accordance with the applicable Chinese regulations.

OUR OBSERVATIONS

- The New NSR Measures are an important legislative step to accompany China's new Foreign Investment Law (which took effect on 1 January 2020) and a clear attempt to provide a legal basis for the Chinese regulators to scrutinize foreign investments in sensitive sectors in China. The potential for regulatory approval risks in China should be fully analyzed and assessed at a very early stage if a foreign investment involves sectors which may have national security implications.
- If a proposed investment transaction falls into the ambit of the New NSR Measures, at a very minimum, the timing implications need to be taken into consideration - the NSR process can last 15 to 105 working days, or even longer as (i) the NSR Office may request the parties to provide supplementary materials and the time spent on such an exercise will not be counted towards the review period; and (ii) there is no specified time limit for the NSR office to review and determine whether the submitted materials satisfy its requirements before the commencement of preliminary review. To the extent that a proposed foreign investment relates to a sensitive sector on the Sector List, the risk of not being approved by the Chinese authorities needs to be carefully assessed. Preliminary informal contact with the Chinese authorities may also be advisable depending upon the specifics of each case.
- There remain areas of uncertainty under the New NSR Measures, which provide the Chinese regulators with broad discretion when applying the new measures. This includes the scope of "indirect investment activities" or "foreign investments in China in any other way". Further, the New NSR Measures do not specify what substantive standards the NSR Office may employ when conducting reviews. This gives the NSR Office a great deal of flexibility and discretion to decide whether a foreign investment has national security concerns or not. Clarification on such ambiguities may become available, as and when a body of practice develops and national security review decisions start to be formally made by the NSR Office on specific transactions in the future. To this end, a detailed review of the rules for foreign investment in the securities sector is already underway, according to a recent statement made by NDRC.[5]

5 https://www.ndrc.gov.cn/xxgk/jd/jd/202012/t20201219_1255027.html

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