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FOREIGN INVESTMENT & NATIONAL SECURITY

Financier Worldwide canvasses the opinions of leading professionals around the world on the latest trends in foreign investment and national security.

PEOPLE'S REPUBLIC OF CHINA

Clifford Chance LLP

Respondents

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Q. How would you describe recent foreign investment activity in the People's Republic of China? How are macroeconomic and geopolitical trends impacting the flow of inbound capital?

A: Despite the global economic downturn and fluctuating geopolitical relationships between China and the West, foreign investments into China have rallied recently, with an increase of 9.9 percent as of November 2022 compared to 2021. Foreign investments in the high-tech sector contributed significantly to this growth, recording a 31.1 percent increase in 2022, which dovetailed with the Chinese government's policy initiative to encourage foreign investments in advanced technology manufacturing and high-tech service areas.

Q. What key issues are dominating the regulatory climate around foreign investment? To what extent have national security concerns – actual or perceived – increased in the People's Republic of China in recent years?

A: China's policy on foreign investments has encouraged inbound investments, as demonstrated by the significant relaxation of foreign investment regulations thanks to the introduction of the Foreign Investment Law in 2020 and reductions to the negative list for foreign investments seen in consecutive years. However, as protectionism still persists in many parts of the world, several governments have recently established new, or strengthened existing, foreign investment screening mechanisms. Partly as a regulatory response, China established its new national security review regime on 18 January 2021, expanding the Chinese government's national security review power over foreign investments in the defence sector as well as the scope of 'important sectors' subject to scrutiny. A specialised review regime focusing on data security also came into force one year later. National security concerns over outbound data transfers have drastically increased in recent years in the eyes of the Chinese government.

Q. What impact are political agendas and foreign investment policies having on foreign investment screening programmes, including national security assessments?

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> *In practice, foreign acquirers are encouraged to consider whether a target business falls within the negative list for foreign investments, has a high market share or has technologies subject to export control.*

A: The Chinese government has suggested that the establishment of its new national security review regime has not been driven by any protectionist agenda; rather it is seeking to balance an open economy and robust national security, particularly with respect to the relaxed foreign investment regulations. It is likely too early to tell whether Chinese government enforcements would give weight to any particular political or foreign investment policies, as we have not seen any blocks or conditional approvals since the new regime came into force. We have also not witnessed any blocked transactions or unconditional approvals, even under the predecessor regime, though one deal was allegedly abandoned before the authority made a final decision. Moreover, given the 'black box' mechanism and the fact that the national security authority rarely makes any direct policy statements, we would not be surprised if there was no clear indication that the screening programme reflects any specific political agenda or investment policies in the coming years. However, it is possible that transactions in those industries in which foreign investments are encouraged will

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be less susceptible to national security assessments going forward.

Q. Have there been any recent regulatory reforms in the People's Republic of China worth highlighting? What are they likely to mean for foreign acquirers and domestic sellers going forward?

A: In recent years, we have seen several important reforms to China's national security regime. The introduction of the Measures for the Security Review of Foreign Investment, effective from 18 January 2021, marked the beginning of a new era. Nevertheless, the new regime has inherited the vagueness that was a hallmark of its predecessor. For example, the definition of 'important sectors' and the precise scope of covered transactions remain unclear. It remains to be seen whether the new regime will be applied more regularly than its predecessor regime, which was rarely invoked. It is also worth mentioning that the Measures for the Security Review of Network Security, effective from 15 February 2022, established a novel filing regime for activities and transactions giving rise to data concerns. Foreign investments tied to personal information and critical data warrant extra caution.

Q. Could you outline the factors likely to trigger investigations and potentially result in blocks or conditions being placed on pending acquisitions? Which sectors and regions are more likely to give rise to national security reviews?

A: The previous national security regime defined the scope of 'important sectors' broadly as including military and related or adjacent activities, agricultural products, energy and resources, equipment manufacturing, infrastructure, transportation services, technologies and other key sectors that impact national security. However, the national security review power was rarely invoked, with only a few known investigations. Those known investigations had very little in common in terms of the sectors involved or the nationalities of investors, but none resulted in blocked transactions or conditional approvals. One was allegedly abandoned before the authorities made a decision, and others were unconditionally approved or determined to be not within the scope of national security review. It

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remains to be seen whether investigations under the new regime will reveal any characteristics of the transactions under the microscope. Notably, the Measures for the Security Review of Foreign Investment extend the scope of 'important sectors' to important cultural products and services, IT and internet products and services, and financial services, which suggests that these may be areas of interest. In addition, transactions with data security concerns should be analysed carefully.

Q. What advice and practical insights would you offer to foreign acquirers on navigating regulatory requirements in the People's Republic of China?

A: The scope of 'important sectors' is notoriously vague, as the terms referred to are broad concepts without an official interpretation of what business activities should be considered 'important'. In practice, foreign acquirers are encouraged to consider whether a target business falls within the negative list for foreign investments, has a high market share or has technologies subject to export control. For investments that may not result in an acquisition of control, it is also important to assess whether the target group is active in military-related sectors or has a physical presence in proximity to military facilities in China or triggers data security concerns. In terms of type of transactions, the relevant language is unclear as to whether the new regime will apply to 'indirect' foreign investment activity with China. However, where none of the sellers and their ultimate controllers are Chinese entities and the companies directly acquired are not Chinese entities, the overall national security risk is generally considered insubstantial.

Q. Looking ahead, what are your predictions for foreign investment levels in the People's Republic of China over the coming months? Do you expect to see a rise or fall in the number of overseas acquirers targeting domestic assets?

A: There are numerous reasons to expect continuous growth of foreign investment in China in the coming months. The sudden revocation of the long-enforced coronavirus (COVID-19) quarantine restrictions in December 2022 signalled the beginning of social and economic normalisation in China. Foreign investors

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who were spooked by uncertainties and higher business costs of operating under the COVID-19 restrictions are expected to return. For investors diversifying their investments in Asia, Chinese assets continue to play an important role in their strategic portfolios. In addition, recent macroeconomic policies revealed the Chinese government's desire to stimulate the Chinese economy in general, and many of these policies will benefit foreign investors. For example, the Chinese government has shown faith in some private sectors, revitalising the real estate market, and encouraging foreign investments in advanced technology. From a regulatory perspective, the Chinese government will continue to level the playing field for foreign investors by relaxing foreign investment regulations and fairly applying antitrust rules. That said, as China seeks an open economy but prioritises national security despite relaxing foreign investment regulations, foreign investors should be aware of the risks posed by a national security review. ❑

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CLIFFORD CHANCE has been in China for more than three decades. The firm uses its know-how, experience and full-service capability to get the best possible results for its clients. The firm has had a Hong Kong office since 1980 and was the first international law firm to open an office in Beijing in 1985, followed by its Shanghai office in 1993.

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