

Legal Commentary

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Analysis of China's Foreign Investment Security Review Measures

Author: Han Kun Law Offices

On December 19, 2020, the Ministry of Commerce (the “**MOFCOM**”) and the National Development and Reform Commission (the “**NDRC**”) jointly promulgated the *Measures for Security Review of Foreign Investment* (the “**FISR Measures**”), which will take effect on January 18, 2021.

The FISR Measures should not come as a surprise, as they form part of the broader framework of the Foreign Investment Law that came into force on January 1, 2020. The FISR Measures, coupled with the annually updated *Special Administrative Measures (Negative List) for the Access of Foreign Investment* (the “**Foreign Investment Negative List**”), the recently promulgated revised Export Control Law and the announcement of the Unreliable Entities List, provide a framework for foreign investment and trade administration that on paper aligns itself with international standards (e.g. the Committee on Foreign Investment in the United States (CFIUS), U.S. export controls, and the U.S. entity list and SDN list).

What has concerned market participants is the scope of the FISR Measures and their potentially broad application through vague provisions, though this is not uncommon with foreign investment review regimes (e.g. the lack of defined parameters and constantly evolving contours of “national security” in the context of CFIUS). We are hopeful that further guidance will soon be issued to clarify these vague provisions, and in fact a Q&A issued by the NDRC on December 19, 2020 strongly suggests that further guidance is forthcoming. In this note, we introduce the background and context of the FISR Measures, summarize the key takeaways of the FISR Measures, compare the FISR Measures with the U.S. Foreign Investment Risk Review Modernization Act of 2018 and its implementation regulations (“**FIRRMA**”) as well as related U.S. foreign investment review laws and executive actions, and provide our preliminary analysis on the potential impact of the FISR Measures. The key points of the FISR Measures and comparable provisions in FIRRMA are set forth in [Exhibit I](#).

Background and context

Foreign investment review regimes are nothing new in China, and have co-existed with robust foreign direct investment and venture capital and private equity in Chinese targets, though in practice few reviews have been publicized. Relevant rules include the *Provisions on the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the “**M&A Security Provisions**”) and supporting regulations and the *Measures for Trial Implementation of National Security Review of Foreign*

Investment in the Pilot Free Trade Zones (the “**FTZ Security Measures**”). Accordingly, the FISR Measures may be viewed as an update of China’s foreign investment review regime, akin to how FIRRMA was an update to CFIUS. Similarly, China’s new Export Control Law may be viewed as an update to the existing export control regime, just as the Export Control and Reform Act of 2018 was an update of U.S. export controls. Other Western jurisdictions have also recently updated their foreign investment review regimes, such as the European Union’s Foreign Direct Investment Framework regulations and the White Paper on foreign subsidies, the Canadian Policy Statement on Foreign Investment Review and Covid-19 relating to the implementation of the Investment Canada Act, the proposed U.K. National Security and Investment Bill, the amendments to Australia’s Foreign Acquisitions and Takeovers Act and Foreign Acquisitions and Takeovers Regulations, the amendments to the German Foreign Trade and Payment Ordinance, and the amendments to the German Foreign Trade and Payments Act, the French decree and ministerial order relating to foreign investment, and Italian Law Decree No. 23.

Accordingly, while the existence of an updated foreign investment review regime is not surprising, and in line with international trends, the elephant in the room is whether China will use the FISR Measures in a manner that in any way reciprocates the intent and application of Western foreign investment review regimes as they apply to Chinese outbound investment. The implementation of predecessor rules (i.e. the M&A Security Provisions and the FTZ Security Measures) suggest a measured approach.

Key takeaways of the FISR Measures

I Regulatory body

The FISR Measures establish a new Foreign Investment Security Review Working Mechanism to be led by NDRC and MOFCOM (the “**Working Mechanism**”), which will oversee implementation of the measures. Like CFIUS, the Working Mechanism is an inter-disciplinary body, though its internal members and composition is yet to be made public. As the Working Mechanism is a new body, we anticipate a transition period will be needed for the body to be established and become operational.

II Scope

The FISR Measures cover both investments and the establishment of subsidiaries. A filing obligation is required for matters relating to the military and where “actual control” is obtained over enterprises in industries designated as “important”, a term that is currently undefined. The list of “important” industries is as follows: agricultural products, energy and resources, equipment manufacturing, infrastructure, transportation services, cultural products and services, information technology and online products and services, financial services, “critical” technologies (an undefined term) and other “important” fields. Actual control is deemed to occur in cases of (i) greater than 50% shareholding, (ii) less than 50% shareholding but where voting rights significantly influence the board of directors and shareholders resolutions, (iii) or other means whereby the foreign investor exercises significant influence over business decisions, personnel, finance, and the enterprise’s technology. There is no further elaboration on “significant influence” or “other means”.

“Important” is a key undefined term in the FISR Measures. However, “important” is similar to the term “sensitive” in the M&A Security Provisions and the FTZ Security Measures, a term which also remains

undefined. However, what is “sensitive” and what is not has always been tied in practice to the Foreign Investment Negative List (items for which foreign investment is prohibited or restricted). We would welcome clarity on whether the term “important” will follow a similar approach. If it does, then multinationals can breathe a sigh of relief.

The FISR Measures contain catch-alls for “other means” and “significant influence on an enterprise”, which are currently undefined. However, the M&A Security Provisions and the FTZ Security Measures may serve as a reference, as they both clearly set forth the types of transactions that fall within their ambits—namely, contractual control, proxy holdings, trusts, reinvestments, and overseas structures. We see two methods of interpreting these terms in subsequent guidance, which is hopefully forthcoming. One method would be to follow the specific list of “control” items in the M&A Security Provisions and the FTZ Security Measures, which would follow traditional understandings of “control”. Alternatively, the definition of “control” could be broadened to include veto rights over operational matters, board representation, and/or shareholdings of over 10%, which would conform to the definition in FIRREA.

III Filing procedures

The FISR Measures allow for an advance consultation to ascertain whether the foreign investor is subject to a filing obligation. Assuming a filing obligation exists based on the advance consultation, there are three potential review periods, set forth below.

Step 1: Initial period of 15 business days from the date the submission is accepted to determine whether a review is necessary. If not, approval is granted.

Step 2: If a review is deemed necessary in Step 1, 30 business days to determine whether there are national security concerns. If not, approval is granted.

Step 3: If the review in Step 2 reveals national security concerns, 60 business days, which may be extended in “special circumstances”. Decision may be approval, conditional approval, or denial. Conditional approval may involve follow-up compliance requirements.

IV Addition of financial institutions

The FISR Measures add “important financial services” to their scope, a deviation from the M&A Security Provisions and FTZ Security Measures. The item “important financial services” applies to both domestic and foreign financial institutions. In light of recent reforms permitting foreign investors to establish certain wholly-owned subsidiaries in China, there will need to be further guidance clarifying what types of financial services are “important” so as to invite a filing.

V Enforcement

The FISR Measures contain additional provisions on enforcement that give teeth to its provisions. For example, there is a whistleblower provision and consequences for non-filing, including the unwinding of unreported transactions and the imposition of conditions.

The FISR Measures do not set forth any factors for the Working Mechanism to consider when

evaluating transaction filings. However, the M&A Security Provisions and the FTZ Security Measures may serve as a guide in this regard. Under those measures, factors include the “influence on national defense security, stable operation of the national economy, basic social order, national cultural security, public morals, national cybersecurity, and research and development capabilities for critical technologies.” In addition, a consultation draft of the Foreign Investment Law set forth other factors to be considered, namely, the “influence on the proliferation of dual-use items and technology subject to import and export control, whether the foreign investment is controlled by a foreign government, and the country’s long-term demand for energy, food, and other critical resources.” These standards, while arguably also vague, at least suggest that the review will be narrowly tailored and not targeted at specific policy goals under the guise of “national security”.

Comparison with FIRRMA

The FISR Measures contain many concepts that are similar to FIRRMA, but there are also crucial differences. We believe a comparative analysis is helpful given these similarities, and the reference to potential control of the purchase of securities, which mirrors recent U.S. actions. The timing of the FISR Measures is also noteworthy, as the date of release is just one day after U.S. President Donald Trump signed the Holding Foreign Companies Accountable Act (which will potentially impact U.S.-listed Chinese companies and was passed unanimously by the U.S. House and Senate), while the effective date is just two days prior to the inauguration of President-elect Joe Biden. We stress that these similarities (and differences) do not necessarily mean that the FISR Measures will be applied similarly to FIRRMA.

I Greenfield investments

The FISR Measures include in their scope “greenfield” investment, or the establishment of subsidiaries in China by non-Chinese entities. These are largely exempted by FIRRMA, which contains an “investment” requirement (i.e. direct or indirect investment), though we note that U.S. subsidiaries established by non-U.S. entities will still be subject to export controls for controlled items created by those U.S. subsidiaries. The inclusion of “greenfield” investment in the FISR Measures could create complications for multinationals and non-Chinese companies looking to expand into China, but this uncertainty can be greatly reduced if further guidance or market practice rely on the Foreign Investment Negative List as the barometer for filing obligations.

II Defined terms

As of now, FIRRMA contains more defined terms when compared with the FISR Measures, though the absence of a definition for “national security” in FIRRMA (and its predecessor) continues to present deal risk for Chinese investors who obtain “control” (as expanded by FIRRMA) and do not submit a voluntary filing.

One area to keep an eye on is the definition of “critical technology” in the FISR Measures, which may correlate to the definition of “critical technology” in FIRRMA, including newly designated “emerging and foundational technologies”. Another area of focus is the role of data-rich companies, as is the case with the definition of “sensitive personal information” of over 1 million users.

III Voluntary or mandatory?

The FISR Measures state that if a transaction is subject to filing, the parties are “actively” required to file prior to the closing of the transaction. We interpret this to mean that the filing obligation is mandatory and not voluntary.

IV Securities purchases

In a not-so-subtle move, the FISR Measures explicitly state that securities regulators are permitted to issue rules restricting foreign investment in listed Chinese companies. This stipulation is unusual, given that MOFCOM and NDRC do not regulate securities. Perhaps, the stipulation is a reference to a U.S. Executive Order dated November 12, 2020, which prohibits U.S. persons from investing in “Communist Chinese Military Companies” as determined by the Department of Defense (which currently includes entities listed outside of mainland China such as China Mobile, Hikvision and AVIC). It remains to be seen whether China will actually follow through and prohibit foreign investment in listed Chinese companies, as that would arguably be contrary to recent reforms such as easing QFII/RQFII access, expanding investment scope, and the Shanghai-Hong Kong Stock Connect.

Unresolved issues

I Role and application of the foreign investment negative list

As stated above, the predecessors to the FISR Measures tied filing obligations to the Foreign Investment Negative List as applied by the Foreign Investment Law. Assuming this mechanism continues to be applied to the FISR Measures, questions remain over whether partially restricted industries such as value-added telecommunication services are “important” information technology and online cultural products as stipulated in the FISR Measures. There is also a question of filing obligations for businesses upon their receipt of foreign investments that arguably fall into more than one category listed in the FISR Measures. Finally, questions arise over the treatment of Chinese subsidiaries of multinational companies if they change their scope of business activities to one that may fall under the ambit of the FISR Measures. All of these important questions will need to be clarified by further guidance.

II Treatment of foreign investment in VIE structures

Recent proposed antitrust legislation helpfully noted that entities with variable interest entity (VIE) structures would be required to submit merger review filings if the underlying transaction met the relevant thresholds. The FISR Measures currently contains no such provisions on the treatment of VIE structures. Therefore, questions remain over what happens when an enterprise creates a VIE structure (i.e. enters into VIE contracts, and obtains through a VIE entity value-added telecommunications licenses restricted or prohibited to foreign investment) and then receives foreign investment (e.g. from international venture capital and private equity funds). We note that the M&A Security Provisions and the FTZ Security Measures expressly list contractual arrangements as a form of “control”, but there are questions over the application of the FISR Measures in partially restricted industries (see the analysis immediately above), the extent of “control” under the FISR Measures, and

the consequences of non-filing.

In the absence of specific guidance, international venture capital and private equity funds may consider adopting risk allocation provisions similar to the provisions over the stability of the VIE structure in current practice.

III Treatment of investment activities of red-chip enterprises and PRC USD funds

Market participants include investors who themselves have VIE structures or other “red-chip” structures where the parent entity of a Chinese business is located outside of China. Furthermore, the market also contains USD fund investors whose general partners are themselves Chinese. A consultation draft of the *Regulations for the Implementation of the Foreign Investment Law* once stated that investments from “red-chip” enterprises will not be subject to the Foreign Investment Negative List restrictions (as they are in fact Chinese). We believe that the regulatory intent of the FISR Measures is to exclude from their purview investments made by entities or funds whose ultimate controller is Chinese, but this will have to be clarified by further guidance.

IV Consequences of regulatory action

The FISR Measures contain no provisions on whether transaction parties can seek redress or demand reconsideration for a decision made by regulators, such as rights available under the Administrative Reconsideration Law. One additional option would be a fresh filing or a re-negotiation of conditions. These issues will need to be settled during the actual implementation of the FISR Measures.

What's next

The FISR Measures, like most Chinese legislation, is a beginning, not an end. That is to say, the measures set parameters to be followed by further guidance that should be forthcoming. The context of the FISR Measures' promulgation should not be surprising in light of the updates to the foreign investment review regimes in other jurisdictions. What will be important while the market waits for additional clarity is to understand the contours and various iterations of the FISR Measures so as to perform a risk analysis for each transaction. We note there was a time period between the passage of FIRRMA (August 13, 2018) and the issuance of detailed implementation guidelines (January 13, 2020, which still did not clarify all matters). During this stub period, we noticed that market participants carefully monitored regulatory developments and clues from regulators on a rolling basis. We believe that a similar approach can be taken with the FISR Measures. In particular, multinational companies should perform an internal review and risk analysis and consider availing themselves of pre-filing consultations as the FISR Measures allow. International venture capital and private equity funds should work with current and prospective portfolio companies to develop an agreed-upon strategy and, where appropriate, include risk allocation provisions in transaction documents. Chinese enterprises with red-chip structures and PRC USD funds should also monitor developments to confirm that they are indeed excluded from the ambit of the FISR Measures.

Exhibit I: Comparison of the FISR Measures with FIRRMA

Item	FISR Measures	FIRRMA
Regulatory body	Newly established Foreign Investment Security Review Working Mechanism, led by the National Development and Reform Commission and the Ministry of Commerce.	Federal inter-agency committee (Department of the Treasury, Department of Justice, Department of Homeland Security, Department of Commerce, Department of Defense, Department of State, Department of Energy, Office of the U.S. Trade Representative, Office of Science & Technology Policy) led by the U.S. Department of Treasury, as part of the executive branch.
Investment scope	FDI (including establishing subsidiaries in the PRC), equity or asset acquisition, investment through other means.	Direct or indirect investment in a U.S. business (any person engaged in interstate commerce in the U.S.), which includes investments in parent entities that have U.S. subsidiaries. “Greenfield” safe harbor (i.e. a PRC entity that has not received investment establishing a U.S. subsidiary).
Filing obligation	<p>“Active” (i.e. mandatory) filing for the following:</p> <ul style="list-style-type: none"> ■ Military ■ “Important” (an undefined term) agricultural products, energy and resources, equipment manufacturing, infrastructure, transportation services, cultural products and services, information technology and online products and services, financial services, “critical” technologies (an undefined term) and other “important” fields where actual control over the invested enterprise is obtained (over 50% shareholding, less than 50% shareholding but where voting rights significantly influence the board and shareholders resolutions, other means whereby the foreign investor exercises significant influence over business decisions, personnel, finance, technology of the enterprise). 	<p><u>Voluntary filing</u></p> <p>Control and national security (except Mandatory Declarations as set forth below):</p> <ul style="list-style-type: none"> ■ Control: not necessarily determined by board control or over 50% equity ownership. Exists where a party has the right to determine, direct, or decide important matters affecting an entity, including without limitation the entry into significant contracts, major expenditures, the appointment and dismissal of officers, and relocating R&D facilities. ■ National security: never been defined (even under the old CFIUS law), at the discretion of CFIUS. <p>Minority investment in a “TID” business (except mandatory declarations as set forth below):</p> <ul style="list-style-type: none"> ■ “TID” business: critical technology (list provided, includes military dual use items and “emerging and foundational technology”, which has not been defined yet), critical infrastructure (specific list provided), sensitive data (over 1 million U.S. users). ■ Minority investment: access to material nonpublic information, board or observer seat or involvement in “substantive decisionmaking” (e.g. operational veto rights). <p><u>Mandatory filing</u></p> <ul style="list-style-type: none"> ■ Whether a control transaction or a minority investment, in a TID business, substantial interest (direct or indirect

Item	FISR Measures	FIRMA
		<p>voting interest of 25% or more) by a government entity (other than the Canada, U.K., Australia).</p> <ul style="list-style-type: none"> ■ Whether a control transaction or a minority investment (including 25% ultimate beneficial owners along with the investor itself), in a TID business that involves “critical technology”, which would require an export control license if exported to the investor’s jurisdiction.
Request by governmental authority	Permitted at the discretion of the Working Mechanism Office	Permitted at the discretion of CFIUS
Advance consultation	Available prior to filing	Available prior to filing
Review period	<p>Step 1: Initial period of 15 business days from the date the submission is accepted to determine whether a review is necessary. If not, approval is granted.</p> <p>Step 2: If a review is deemed necessary in Step 1, 30 business days to determine whether there are national security concerns. If not, approval is granted.</p> <p>Step 3: If the review in Step 2 reveals national security concerns, 60 business days, which may be extended in “special circumstances”. Decision may be approval, conditional approval, or denial. Conditional approval may involve follow-up compliance requirements.</p>	<p>Short-Form notice: 30 days from date of acceptance of submission.</p> <p>OR</p> <p>Long-Form notice: 45 days from date of acceptance of submission, with an additional 45 day investigational period if needed, and a 15 day presidential review if needed. Conditions may be attached to an approval with subsequent follow-up compliance requirements.</p> <p>Only the president can block a transaction where the parties do not voluntarily withdraw the transaction.</p>
Third-party feedback	General public may submit feedback on the security review of relevant transactions.	Not expressly permitted by law, but occurs in practice.
Retroactive action	May order filing by parties who failed to file, may unwind unfiled transactions.	Permitted at the discretion of CFIUS.
Foreign investment in public companies	Specific rules may be adopted by securities regulators.	Not within the remit of CFIUS, but restrictions may be instituted by the executive branch (e.g. executive orders, regulations from agencies such as the Securities and Exchange Commission) or the legislative branch (i.e. legislation passed by Congress).

Important Announcement

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If you have any questions regarding this publication, please contact:

David TANG

Tel: +86 21 6080 0905
Email: david.tang@hankunlaw.com

Chen MA

Tel: +86 10 8525 5552
Email: chen.ma@hankunlaw.com

Aaron ZHOU

Tel: +86 10 8516 4156
Email: aaron.zhou@hankunlaw.com

Charles WU

Tel: +852 2820 5617
Email: charles.wu@hankunlaw.com