

# China releases Foreign Investments Security Review Measures to strengthen regulatory control over foreign investment

December 2020

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## Introduction

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The National Development and Reform Commission (“**NDRC**”) and the Ministry of Commerce (“**MOFCOM**”) jointly released the *Foreign Investments Security Review Measures* (Decree No.37, “**SRM**”) on December 19, 2020, with the aim to effectively prevent and defuse national security risks while actively promoting foreign investment. The SRM is based on the *Foreign Investment Law of the People's Republic of China* (“**FIL**”) and requires foreign investors to pass relevant reviews from the perspective of national security when investing in specific areas. The SRM will come into force on January 18, 2021 and will have major and material impacts on foreign investment projects in certain areas of investment.

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## Key content of the SRM

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There are 23 articles under the SRM, including provisions on the foreign investment types subject to review, review scope, review authority, review declaration mechanism, review procedures, decisions, as well as punishments for violation.

This briefing summarises and briefly analyses the key content of the SRM as follows:

### 1. Foreign investment types subject to security review

Article 2 of the SRM provides that investment activities carried out by foreign investors directly or indirectly within the territory of China are subject to foreign investment security review, including three scenarios:

- (1) where foreign investors invest, solely or jointly with other investors, in new projects or in establishing enterprises in China;
- (2) where foreign investors acquire equity or assets of domestic enterprises through M&A transactions; or
- (3) where foreign investors make investments in China in any other form.

Based on the above, in addition to the M&A and green investment mechanisms clearly mentioned, the SRM also contains a catch-all provision in scenario 3 which may mean it is likely that certain structural arrangements (such as VIE structures or control agreements) would also be included in the scope of application of the SRM.

Whether VIE or control agreements shall be considered “foreign investment” remains an issue that has been attracting broad discussion. Reference may be made to the *Provisions on the Implementation of the Security Review System for M&A of Domestic Enterprises by Foreign Investors*, which was issued by the MOFCOM in 2011 and stipulated that “for mergers and acquisitions of domestic enterprises by foreign investors, the merger and acquisition transactions shall be analysed based on their substantial contents and actual impact to determine

whether they fall within the scope of security review on mergers and acquisitions; foreign investors shall not substantially avoid security review on mergers and acquisitions in any way, including but not limited to holding shares on behalf of others, trust, re-investment at multiple levels, lease, loan, control agreement, overseas transactions, etc.” This is to say, the authority will look through the investment structures to determine whether the transaction shall be subject to security review under the de-facto control principle.

Subsequent regulations such as the FIL and its implementation regulations failed to further clarify this. As indicated above, it remains unclarified in the SRM as to whether the SRM’s supervision on foreign investment will apply to VIE structures or control agreements. However, from the perspective of judicial practice, the State Administration of Market Regulation recently conducted an investigation into three transactions involving control agreements, and ultimately punished the party concerned after such party was found to have failed to file a merger control review in accordance with the *Anti-Unfair Competition Law* and other relevant regulations. Therefore, we can reasonably infer that investments made by foreign investors through VIE structures or other indirect methods are likely to be subject to the security review.

What is also worth noting is that any purchase by foreign investors of domestic company stock at stock exchanges or elsewhere may also be subject to security review under the SRM if such purchase affects or may affect national security. The China Securities Regulatory Commission will formulate specific measures separately in accordance with the SRM.

## 2. Sectors subject to security review

It should be noted that not all foreign investments may be required to pass a security review. Article 4 of the SRM provides that the security review shall apply to the following foreign investments:

- (1) investments in the arms industry, an ancillary to the arms industry, or any other field related to national defence security and investments in an area surrounding a military installation or an arms industry facility;
- (2) 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 fields relating to national security, and obtaining the actual controlling stake in the investee enterprise.

Under scenario 1 above, the SRM does not provide guidance on the minimum threshold for the foreign investment, which means that even an extremely small percentage of shares or equity interests may trigger a security review for foreign investment in arms, national defence, military facilities and other such sectors. The SRM fails to provide any express guidance on how “an ancillary to the arms industry”, “arms industry facility” and “surrounding areas” should be construed. A clear definition may be provided in the detailed rules subsequently promulgated, or properly handled by the competent regulatory authority in practice on a case-by-case basis.

The investment areas mentioned under scenario 2 above have been broadened from those under the *Pilot Free Trade Zone Security Review Measures* issued by the State Council in 2015, by adding in the new terms “**important internet products and services**” and “**important financial services**”, and also a catch-all wording of “**other important fields**”, which grants authorities greater discretion in their interpretation. As to the definition of “obtaining the controlling stake”, the SRM notes that the actual controlling stake refers not only to the shareholding proportion (more than 50% of the equity interests), but also to the material impact on the decision-making of the enterprise in terms of operational decisions, human resources, finance and technology, etc.

## 3. Security review authority

A working mechanism for the foreign investment security review is to be established in accordance with the SRM, and the office of the working mechanism (the “**Working Mechanism Office**”) is to be set up under the NDRC. It will be led by the NDRC and the MOFCOM and will undertake the routine work of performing security reviews of foreign investments.

## 4. Review declaration mechanism

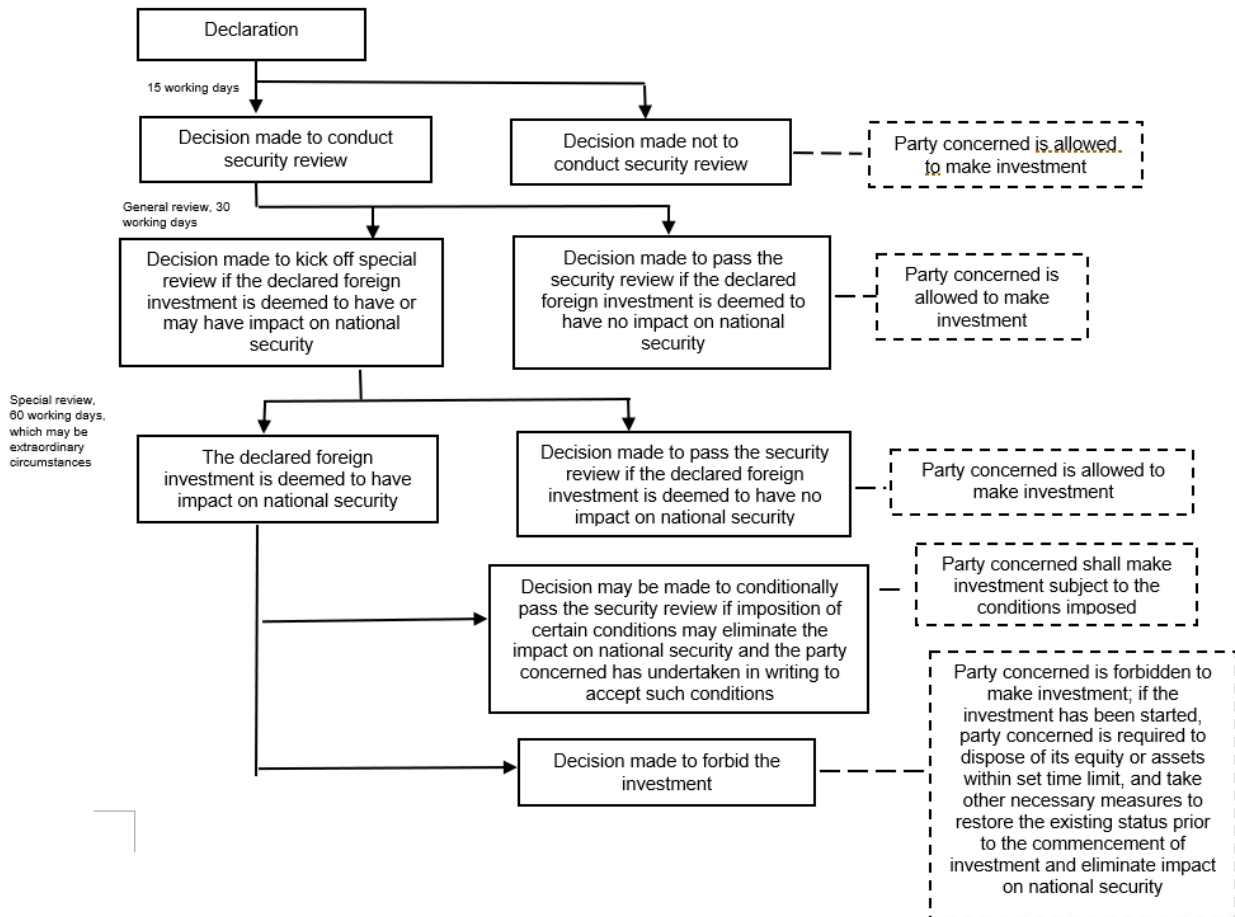
Under the SRM, the security review procedure may be triggered under the following circumstances:

- (1) Voluntary reporting by the foreign investors or the relevant domestic parties prior to the commencement of investment for any investment subject to security review;
- (2) The Working Mechanism Office issuing a demand for reporting within a set time period, applicable for those undeclared foreign investments that need to be declared;

- (3) Suggestions for security review by relevant government agencies, enterprises, social groups or the general public to the Working Mechanism Office.

**5. Security review procedures**

The SRM expressly sets forth the procedure, timetable, and documents to be submitted with respect to the foreign investment security review, which are summarised as follows:



During the security review of the declared foreign investment, the Working Mechanism Office may inquire with the parties concerned about the relevant information and may also require the parties concerned to provide supplementary materials. The parties concerned shall cooperate therewith and the time it takes for them to provide the supplementary materials will not be included in the examination period.

According to the FIL and SRM, the security review decisions made by the Working Mechanism Office are final decisions, which means that they could not be appealed through application for administrative reconsideration or administrative litigation if any party concerned has any objection to the decisions.

**6. Violation liability**

Any violation of the relevant requirements under the SRM may bring severe legal consequences to any foreign investor and to the projects invested in.

Under the SRM, with respect to violations such as failure to report upon demand, provision of false information, or failure to satisfy the conditions imposed, the Working Mechanism Office is entitled to take measures:

- to demand disposal of relevant equity or assets within a specified time period and to restore the equity or assets to their original status prior to the implementation of the investment, and eliminate the impact on national security;
- to include a negative credit record in the relevant credit information system of the State and subject the relevant party to joint punishment in accordance with the relevant provisions of the State.

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## Potential business impact

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In recent years, major countries and regions throughout the world have successively introduced or strengthened their foreign investment security review systems, such as the *Foreign Investment Risk Review Modernization Act* (FIRRMA) in the U.S. to strengthen the CFIUS review mechanism, the *Framework Regulations on Foreign Direct Investment* in the EU, and the recent draft *National Security and Investment Bill* in the UK. The Chinese government's promulgation and implementation of the SRM demonstrates that China will continue adopting a "two-handed approach" to promote foreign investment and address security, for the purpose of advancing the opening up of China to a higher level.

Given that the SRM will be applicable across numerous key sectors, its promulgation and implementation will have a major and far-reaching impact on foreign investment in China. As such, we recommend that:

- Foreign investors thoroughly assess whether an investment project or transaction is subject to security review prior to the commencement of such project or transaction, and get well prepared as may be required, such as by drafting and preparing relevant documents and materials and taking into account the timeframes involved;
- Given the existence of catch-all provisions in terms of foreign investment types and sectors subject to security review, foreign investors may consider whether it is necessary to consult with the Working Mechanism Office in advance depending on the specifics of the project or investment in question; if necessary, foreign investors should consider to what extent the transaction information should be disclosed;
- As Chinese governmental authorities aim to provide one-stop services to businesses to improve efficiency and this will become the trend in the coming years, it would be advisable for investors to take a holistic view in planning and processing security reviews and other applicable approvals such as merger control, the SASAC approval, NDRC ratification, etc., in order to efficiently drive the progress on respective projects;
- Since security review decisions are final, investors need to take into consideration a contingency plan in case a security review fails or is passed subject to conditions imposed by the authorities. Investors are advised to manage and reduce legal and business risks by using contractual terms (such as investment structures, representation and warranty clauses, closing conditions, means of payment, indemnification mechanisms, contract termination and such other terms) or by adopting other remedial measures.

Lawyers at Rui Bai Law Firm, Xin Bai Law Firm and Tiang & Partners have rich and extensive experience in the field of foreign investment and will keep a close eye on the implementation of the SRM and the latest developments of other foreign investment laws and regulations. Further updates will be issued as more information, and practical experience of the new law, becomes available.

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## Let's talk

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For a deeper discussion of how this impacts your business, please contact:

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