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China expands sectors subject to national security review

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Key points

On December 19, 2020, the National Development and Reform Commission ("**NDRC**") and the Ministry of Commerce ("**MOFCOM**") jointly published the Foreign Investment Security Review Measures (the "**NSR Measures**"). The NSR Measures will take effect on January 18, 2021.

The NSR Measures do not introduce radical changes to China's existing national security review ("**NSR**") regime. Instead, they seek to clarify existing rules to add further transparency. This includes further details on reviewable transactions, the review time process, possible outcomes, and penalties for failure to notify. The most important change is the expansion of "Category B"-classified national security sectors, capturing investments into the cultural, IT/internet, and financial sectors.

Foreign investors interested in such sensitive sectors should:
- review their investment plan ahead of time to assess whether the transaction could trigger a NSR filing obligation;
- ensure the deal timetable caters for NSR filing; and
- avoid implementing the transaction before clearance is obtained.

1. Notifiable transactions

a) Expanding the scope of sectors subject to scrutiny

China's NSR regime targets foreign investments in two categories related to defense and national security in China (the "**NSR Categories**"):

- Transactions that fall under Category A (transactions in defense-related sectors) are notifiable regardless of whether the foreign investor will obtain control.

- Category B covers other sectors that may affect national security. Transactions falling within Category B are notifiable only if the foreign investor will acquire control. Category B sectors include agriculture, energy/natural resources, infrastructure, critical transportation, cultural products/services, IT/ internet, and financial services.

In comparison to the 2011 NSR rules, the NSR Measures extend the scope of Category B to cover important (i) cultural products and services, (ii) IT/internet products and services, and (iii) financial services. The reasons could be that since the Foreign Investment Law ("**FIL**") came into effect from January 1, 2020, the case-by-case foreign investment approval requirements under China's FIL regime has been eliminated and replaced with a "negative list", which prohibits or restricts investment in certain sectors (without the need for any standalone review). Thus, the NSR Measures provide the authorities with the jurisdiction to review transactions involving these potentially sensitive sectors.

b) Capturing a wide array of transactions

The types of transactions captured under the NSR Measures remain the same as those under the existing regime. But the NSR Measures provide certain clarifications, such as spelling out that greenfield projects are also reviewable. The table, below, summarizes the key factors in determining whether a transaction is reviewable.

Reviewable transactions	The NSR regime applies to investments by foreign investors in Chinese domestic enterprises, primarily in the form of: (i) establishment of a foreign-invested enterprise in China, independently or jointly with other investors, including greenfield projects; and (ii) M&A (covering asset or equity acquisitions). The NSR regime can also cover other transactions such as contractual control (i.e., VIE structure), trusts, multilayer investments, overseas transactions, leases or convertible bonds, and investment into public companies.
No monetary threshold	There are no monetary thresholds for a transaction to qualify for an NSR.
Changes to existing business structures may trigger filing obligation	As well as new transactions, changes to existing transactions, such as changes to the foreign investor's contractual rights, the business scope of the foreign-invested entity, or the foreign investor's identity, may trigger NSR notification obligations afresh.
Control factors	With regards to "Category B" investment, a foreign investor is regarded as having control if: (i) the foreign investor and its affiliates acquire 50% interest or more in an enterprise; (ii) the foreign investor with another foreign investor acquires 50% interest or more in an enterprise; or (iii) the foreign investor acquires less than 50% interest in an enterprise but has sufficient voting rights to materially influence shareholder meetings or board of director meetings; or (iv) there are other factors allowing the foreign investors to have significant influence over the enterprise's strategic decisions, human resources matters, financial matters, and technology.
Foreign-to-foreign transactions	The NSR Measures do not clearly state whether pure foreign-to-foreign offshore transactions will fall within the ambit of China's foreign direct investment regime. If interpreted broadly, the NSR Measures may catch transactions in which a foreign company acquires another foreign company which has a subsidiary registered or established in China.

2. What is the review procedure?

Review authorities	Under the NSR Measures, the NSR is undertaken by an inter-ministry office (the "NSR office"), led by the NDRC and MOFCOM. The NSR office may be joined by other government agencies depending on the specific sector involved. The NDRC is responsible for receiving application materials and consulting with foreign investors.
Notifying party	The notification can be submitted by the foreign investor, the domestic target, or even the domestic co-investor. If any third-party stakeholders consider that a proposed transaction might concern national security, they can report it to the NSR Office, and the NSR Office can decide to initiate an NSR of such transaction.
Notification materials	According to the NSR measures, the following materials are required: (i) notification form; (ii) investment plan; (iii) explanation as to whether the foreign investment will affect Chinese national security; and (iv) other materials required by the NSR office.
Review timeline	The NSR process is divided into three stages: (i) Preliminary consultation. The transaction parties consult with the NSR office as to whether an NSR is required. Within 15 business days of receiving the complete notification materials, the NSR office will decide whether NSR approval is needed. (ii) General review. Within 30 business days from starting the review, the NSR office will inform the parties whether it will close the review or proceed to the special review phase; and (iii) Special review. If the NSR office has national security concerns, the review will proceed to this phase. The NSR office should complete the review period within 60 business days but may extend the review period. The NSR office may suspend the review period (i.e., "stop the clock") while awaiting materials from the transaction parties.
Review considerations	The NSR Measures do not provide details of the review criteria adopted by the NSR office. Based on existing rules, an NSR is highly discretionary. The NSR review will consider the transaction's impact on national defense and security, including the production of national defense products and relevant equipment, national economic stability, basic social stability, the research and development of key technologies related to national security, national cultural safety, and public ethics and national network security.
Review outcome	At the preliminary review stage, the NSR office may determine that an NSR is not needed. If an NSR is needed, a transaction may be approved, modified, or prohibited—the latter two would happen where the transaction has impacted, or will likely significantly, impact national security.

3. Remedies and penalties

The following consequences are possible:

(i) **Remedies/unwinding of the transaction:** Transactions implemented without NSR approval can be modified or unwound if it raises national security concerns.

(ii) **Adverse record in China's credit information system:** Failures to notify relevant transactions will be recorded in China's credit information system. This will also likely result in reputational risks and an impaired relationship with the Chinese government.

(iii) **Other penalties:** Failures to notify can be otherwise penalized, including possible fines, although what levels of fines might be imposed has not yet been provided.

It is not certain whether the punishment will only be imposed on the foreign investor, or might also affect the domestic target and co-investor.

Our intern Yu Shang also contributed to this article.

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