FANGDA PARTNERS
方達律師事務所

PRC National Security Review: How It Applies to Foreign Investments in Financial Services Sector

Authors:

Jian Fang
Partner, Fangda Partners
jian.fang@fangdalaw.com

Grace Yu
Partner, Fangda Partners
grace.yu@fangdalaw.com

Siyuan Pan
Partner, Fangda Partners
siyuan.pan@fangdalaw.com

On January 18, 2021, the *Measures on Security Review of Foreign Investments* (the "**Security Review Measures**"), jointly issued by the National Development and Reform Commission ("**NDRC**") and the Ministry of Commerce ("**MOFCOM**"), will be formally implemented.

According to the Security Review Measures, foreign investments affecting or being likely to affect national security will be subject to national security review. A foreign investor who makes an investment in a target falling within one of the specified sectors (the "**Sensitive Sectors**") is required to make a submission to the Office of the Foreign Investment Security Review Working Mechanism (the "**Security Review Office**") before the investment is implemented, if such an investment would result in the foreign investor acquiring control over the target. The Security Review Office sits within the NDRC and is jointly led by the NDRC and the MOFCOM. Depending on the investment's impact on PRC national security, the review may go through a three-stage process: initial review, general review and special review, which respectively takes 15, 30 (which may not be extended, and does not include time for submitting supplementary materials) and 60 working days (which may be extended).

While there have been some references to national security review in respect of foreign investments in certain financial services sectors under applicable regulatory rules, the Security Review Measures have, for the first time, introduced "important financial services" as one of the Sensitive Sectors. This means that foreign investments in targets falling within the scope of important financial services will be subject to submission to the Security Review Office for national security review.

This article highlights some of key implications of the Security Review Measures on foreign investments in the PRC financial services sector and points up the key issues relating to the application of the Security Review Measures to foreign investments in the PRC financial sector.

Form of Foreign Investments

Unlike in the case of merger filing which applies to joint ventures and acquisitions, the establishment of wholly-owned entities by foreign investors in "important financial services" would be caught by the Security Review Measures. This is particularly important for international financial institutions as many of them are currently setting up wholly-owned financial institutions (including securities companies, asset managers and insurers) or converting their existing joint ventures into wholly-owned entities in the wake of the new round of opening-up of the financial services sector to foreign investments. Variable Interest Entities (VIEs) are not commonly set up by international financial institutions, but some other international investors have adopted VIE arrangements for their investments in some financial institutions in the PRC, so be aware that VIE arrangements are likely to fall within the definition of "foreign investments" under the Security Review Measures.

Scope of "Important Financial Services"

There is currently no definition of "important financial services" under the Security Review Measures, nor is there any guidance offered by the relevant regulatory rules of the PRC. From our experience and our understanding of the techniques applied to legislating laws, regulations and rules of a similar nature, it is unlikely that a clear definition will be offered in the future, and even if more clarity is added, a catch-all clause would remain and would leave the authorities with wide discretion. This is largely consistent with the approach taken by other countries in this regard.

What is beyond doubt is that "important financial services" would *not* extend to all financial services and should more be related to those financial services which may give rise to national security concerns. By reference to the focus of the PRC national security review in other areas, which highlights the likely impact on national economic stability, social order, national defense security, and on the research and development capabilities of key technologies related to national security, we believe that financial services or targets involving "financial infrastructure" (including the clearing system, payment system and credit system) or "systematically important financial institutions" as identified by the applicable financial regulators and/or the Financial Stability Committee of the PRC would likely fall within the scope of "important financial services". Foreign control of any of these types of institutions would likely face substantive challenges in passing the national security review.

In addition, if a foreign investment is in connection with a financial service which involves a significantly large number of retail clients or certain types of sensitive assets (such as pension funds), a national security review would likely be necessary, though the results may differ on a case-by-case basis.

By contrast, we tend to believe there is little risk that foreign control over financial institutions which offer general intermediary services or wholesale services primarily to institutional clients would be subject to national security review, considering the impact of such services on the general public or the country's financial system or infrastructure would be limited.

National Security Review vs Regulatory Approval

Foreign investments in the PRC financial services sector are generally subject to approvals from the applicable PRC financial regulators. The Security Review Measures are silent on how the national security review process would interact with the regulatory approval process. By reference to the merger filing process, we believe that, in general, any national security review would proceed in parallel with the relevant regulatory approval process. However, where new financial institutions are concerned, which typically involve a two-stage regulatory approval process, this is likely to involve a case-by-case analysis, and more clarity from the applicable authorities in this regard would be required. Technically speaking, as the investments that may fall within the Security Review Measures would only actually be made when the relevant entity is incorporated (which usually occurs after the grant of the first-stage regulatory approval), any national security review, if required, would be conducted after the first-stage regulatory approval being obtained and before the entity is incorporated. That said, from a foreign investor's perspective, it would be desirable to secure completion of the national security review before the first-stage regulatory approval to remove any uncertainty before the investor incurs significant investment costs.

National security review and regulatory approvals are two independent processes, but they are also inter-related. In deciding whether to approve or disapprove an investment in a particular financial services sector, the Security Review Office should generally seek the views of the relevant financial regulators. At the same time, when a financial regulator is assessing an investment falling within its jurisdiction, it is likely to also (even informally) consider the potential impact of the investment on national security. Therefore, where regulatory approval for an investment has been obtained before the conclusion of the national security review, we believe that investors may draw comfort from the result of such regulatory approval so far as the substantive aspects of the national security review are concerned, even though the process for obtaining separate national security review approval may still need to be gone through subject to separate analysis.

Foreign Control

A foreign investment in an important financial service will be subject to national security review only if such investment results in foreign control over the target. The Security Review Measures have adopted an expansive definition of "control" to cover a foreign investor exerting "significant influence" over the target's business operation, human resources management, finance or technologies. This is similar to the broad definition of "control" under the PRC antitrust rules (if not broader), and, pending further rules from the PRC regulators, may potentially capture foreign investments which give international investors veto rights over certain operational matters of the target - an arrangement which is not uncommon in connection with international investments in PRC financial institutions—although we also reckon that national security review does not introduce the concept of "joint control" as in the case of antitrust review.

Existing Investments vs New Investments

The Security Review Measures do not have retrospective force and, therefore, do not apply to existing foreign investments in the PRC financial services sector. The position is not entirely clear as to whether the Security Review Measures would apply to the establishment of new financial institutions which have been granted first-stage regulatory approval pending incorporation of the invested entities or those in respect of which application for the first-stage regulatory approval has been submitted pending the grant of such approval. Depending on the nature of the services that the new entities are seeking to undertake, a consultation with the relevant authorities may be required.

Observations and Tips

Opening up the financial services sector to foreign investments is seen by the PRC government as critical to reforming and therefore developing a mature PRC financial market. We believe the PRC government is likely to take a cautious approach when applying the rules of national security review - at least in the near to medium term- to provide comfort to international investors. In fact, this was also the message clearly passed by the relevant government authorities when the Security Review Measures were announced.

In addition, from a policy perspective, the PRC government shall fully appreciate the critical importance of consistency in its policies. We anticipate that, except in certain extreme cases, the PRC government would be reluctant to disapprove, on the ground of national security, investments in those sectors which have been fully opened to foreign investments, such as the establishment of commercial banks, securities companies and fund managers.

In this light, while we advise adopting a case-by-case analysis in respect of individual investments, taking into account such factors as the nature of the business, sensitivity of the industry/assets, and the number of retail investors involved in a proposed investment, we believe that national security review should *not* be a concern to most of the recent investments by international financial institutions in the PRC financial services sector which concentrate on asset management/wealth management and traditional investment banking businesses.

Looking ahead, special attention should be given to investments in the following circumstances:

(1) Investments to control special-type institutions, in particular financial infrastructure-related institutions, such as clearing houses and personal credit information/data collectors;

(2) Investments to control "systematically important financial institutions", including systemically important banking institutions, securities institutions (including futures, funds), insurance institutions, and other institutions of systemic importance in the financial business as identified by the Financial Stability Committee; and

(3) Investments that, using special technologies or service models, may have relatively large impact on the sound operation of the market, public interest or national security in terms of technology, data, and customer base, among others.

Beijing

27/F, North Tower
Beijing Kerry Centre
1 Guanghua Road
Chaoyang District
Beijing 100020, China

Tel: +86 10 5769 5600
Fax:+86 10 5769 5788

Guangzhou

17/F, International Finance Place, 8 Huaxia Road,
Zhujiang New Town
Guangzhou 510623, China

Tel: +86 20 3225 3888
Fax:+86 20 3225 3899

Hong Kong

26/F, One Exchange Square
8 Connaught Place, Central
Hong Kong

Tel: +852 3976 8888
Fax:+852 2110 4285

Shanghai

24/F, HKRI Centre Two,
HKRI Taikoo Hui
288 Shi Men Yi Road
Shanghai 200041, China

Tel: +86 21 2208 1166
Fax:+86 21 5298 5599

Shenzhen

17/F, Tower One, Kerry Plaza
1 Zhong Xin Si Road
Futian District
Shenzhen 518048, China

Tel: +86 755 8159 3999
Fax:+86 755 8159 3900