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# **China's National Security Review: Key Q&As for Foreign Investors**

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*Foreign investors are increasingly subject to China's new national security review (NSR) regime, effective on January 18, 2021, which can require them to make changes to their proposed investments or, in the worst case, cause them to divest. However, the regulations are not always clear, especially when it comes to the threshold of the review, and investors need to be aware of how they should factor in these uncertainties. In this article, our partners Michael Han, Yingjie Kang and associate Derek Liu suggest 10 key Q&As that will help foreign investors when structuring and managing their investments in China as they might be impacted by the NSR.*

While China has been striving to facilitate foreign investment over past years, including largely shortening the Negative List (i.e. the list of the sectors with restrictions and prohibitions on foreign investors' access) and simplifying the foreign investment application procedures, foreign investment in certain critical and sensitive sectors in China is subject to increasing regulatory scrutiny from the national security perspective, i.e. the national security review ("**NSR**").

On December 19, 2020, China's National Development and Reform Commission ("**NDRC**") and the Ministry of Commerce ("**MOFCOM**") jointly released the *Measures for the Security Review of Foreign Investment* (外商投资安全审查办法) (the "**NSR Measures**"). The NSR Measures revamped the previous NSR system with broader transaction coverage and a more defined review process, signaling that China is giving more prominence to national security considerations in relation to foreign investment.

The new NSR system has impact on a wide range of investment transactions by foreign investors, which are playing a significant role in the current booming M&A market in China. For foreign investors, in particular those (i) focused on investing in certain critical and emerging technologies and (ii) requesting greater participation, access, and information over the portfolios, the NSR requirement nowadays should not be underestimated in its impact on the decisions that foreign investors into China need to take.

The below questions and related discussion address key points for foreign investors to consider in structuring and managing their investment in China so far as the NSR applies.

## 1. How does the NSR impact transactions for foreign investors?

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The NSR can potentially impact a transaction by foreign investors in the following three aspects:

**(1) The closing of the investment.** The foreign investment falling into the NSR-covered scope (申报范围) is subject to mandatory pre-closing notification. The parties are obliged to stand still on the closing of the investment until obtaining the final NSR decision. Considering the review generally takes several months (or maybe even longer), the closing timetable of the investment could be longer than foreign investors are generally accustomed to.

**(2) The certainty of the investment structure.** The interagency NSR Working Mechanism (the “NSR Authority”, the office of which comes under NDRC) is empowered under the NSR Measures to require and decide on remedies that the investors need to take so far as the foreign investment’s impact on national security is concerned. That may have impact on the investment structure, and in the worst case, defeat the purpose of the investment. If the investment in case has already been implemented, the NSR Authority even has the power to order a divestment.

**(3) The strategy of exit.** If a foreign investment was previously subject to the NSR, the investors’ exit either through disposal to other foreign investors or through an IPO in an overseas stock market may also trigger the NSR notification requirement, which could bring more complexity to the exit transactions; and if the investment has been subject to imposed remedies for national security concerns, the value and returns of such investment may also be materially affected.

## 2. When is an investor determined as a “foreign investor”?

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The definition of “foreign investor” for the NSR jurisdictional purpose is currently taken by reference to the foreign investment registration practice, i.e. the individual of foreign nationality or the entity incorporated in any foreign state or region (including Hong Kong SAR, Macau SAR and Taiwan Region). Therefore, an entity (e.g. a PE fund) will be considered as “foreign investor” as long as it is incorporated outside China with no regard to who controls the fund.

In particular, USD funds incorporated outside China, albeit managed and controlled by Chinese fund managers, will be counted as the foreign investors subject to the NSR jurisdiction (in practice, for such Chinese manager-controlled USD funds, the NSR Authority may also review the details of the non-controlling foreign LPs to consider the proposed investment’s potential impact on the national security).

### 3. What is the NSR-covered scope?

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The NSR-covered scope includes two categories of target Chinese business: the defense-related sectors (the “**Category A**”) and the sensitive sectors (the “**Category B**”).

- **Category A:** all foreign investment in the defense-related sectors (e.g. weapons, military equipment, etc.) or areas adjacent to military facilities and military industrial facilities will fall within the NSR-covered scope, regardless of whether such investment might or might not result in the effective control of the target by the foreign investor.

The scope of defense-related sectors is very vague and there has been no defined list published by the NSR authority or other relevant departments yet. In practice, it is advised to make case-by-case assessment with internal and/or external counsels if the Chinese target business (regardless of the business sector) is found to have been supplying critical products or services directly or indirectly to any military body, as well as public security force, or hold any certificate/qualification for developing, testing or manufacturing weapons and military equipment.

The latter military adjacency coverage impacts the foreign investment in real estate sector more. The foreign investors focused on the commercial properties (e.g. offices, logistic properties, hotels, and so on) are well advised to consider the NSR implications early when investigating if the target commercial properties are located close to, or of sufficient height for taking an aerial view of, a sensitive military or governmental site.

- **Category B:** the investment resulting in foreign investors’ acquisition of the effective control of the Chinese target in any of the following sectors will also fall within the NSR-covered scope: 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, critical technologies and other important fields relating to national security (although it is not always clear what is meant by “important”).

The NSR Measures does not further define such Category-B sectors, nor does the NSR Authority provide any official guidance. Based on our experience, the foreign investment in or concerned with any of the following (but not exhaustive) specific areas is likely to fall within Category B and should be further assessed for NSR requirement:

Sectors	Specific Areas
Health, Pharmaceuticals and Biotechnology	Human genetic resources Bio laboratories Advanced medical devices and medicine Critical vaccines Agricultural genetic engineering Biological breeding
Sensitive Personal Data and Important Data	Million-level personal data Personal sensitive data (particularly personal biometric data and medical data) Public health data Geolocation data Geological exploration data Major and sensitive state-funded R&D project data
Core Communication Equipment, Software and Service	Core network equipment Important telecommunication products and services High-performance computers and servers High-capacity storage equipment Large databases and application software Cybersecurity equipment Cloud computing services
New Digital Infrastructure	Data center Industrial IoT “Critical information infrastructure”
Fin-tech	Online payment services Personal credit investigation
merging Technology (particularly provided under the <i>China Catalogue of Technologies Prohibited or Restricted from Exporting</i> (中国禁止出口限制出口技术目录))	Artificial intelligence interface technology Speech evaluation technology Technology of personalized information recommendation service based on data analysis Cryptographic security technology Remote sensing imagery Metal 3D printing Robot manufacturing technology Unmanned aerial vehicle technology

## *4. Will a minority equity investment be subject to the NSR requirement?*

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Minority equity investments may also be subject to the NSR requirement.

(1) First, if the target Chinese business falls into the Category A, the investment transaction will trigger a mandatory notification requirement with no regard to the interest percentage to be acquired by the foreign investors.

(2) Second, regarding the Category B which requires the control test, such control test is not tied to a particular percentage interest in the target Chinese business, and “effective control” cannot be presumed to be ruled out just because there is a minority equity holding. In assessing “effective control”, in addition to shareholding, the NSR also looks at a whole host of factors, including the voting mechanism of shareholders’ meeting and the board, the investor’s special rights or interests on the operation and decision-making, appointment of management personnel, finances, technologies or other aspects of the target Chinese business. In extreme cases, less than 10% equity investment can also meet the control test and therefore, in turn, will trigger the NSR requirement.

## *5. Will an offshore transaction be subject to the NSR requirement?*

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That depends on whether the offshore transaction concerns the change of ownership interests in any target Chinese business.

If the offshore transaction could result in the change of (i) ownership interests in a target Chinese business under the Category A or (ii) “effective control” of a target Chinese business under Category B, to a new foreign investor, such offshore transaction will fall within the NSR-covered scope and trigger the NSR notification requirement.

## *6. Will an incremental acquisition be subject to the NSR requirement?*

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Yes, incremental acquisition may also be subject to the NSR requirement.

If the NSR authority has reviewed and approved the initial investment, the subsequent acquisition by the same foreign investor to increase its ownership percentage in the target is less likely to trigger the NSR requirement. Otherwise, if the initial investment does not trigger a NSR review (because the initial investment does not result in the foreign investor's acquisition of control of the target Chinese business), the incremental acquisition is deemed to be a separate investment transaction and should be assessed for the NSR requirement, taking into account the prior existing ownership and governance rights on an aggregated basis.

## *7. When to make the NSR notification? Who has the responsibility for notifying the NSR?*

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In practice, the notification is generally made after the execution of the binding transaction documents but no later than the implementation of the proposed foreign investment. In some special circumstances (e.g. the transaction has a very tight closing timetable), foreign investor can try to move forward the NSR notification with executed investment framework agreement (e.g. letter of intent) once the deal structure has been determined. The NSR Authority has the discretion to decide whether to formally accept the notification based on how certain it believes the investment is to be implemented.

The party subject to NSR notification obligation under the NSR Measures depends on the types of the foreign investment transactions as follows.

<b>Transactions</b>	<b>Party Subject to NSR Notification Obligation</b>
Merger & Acquisition of Equity/Assets	(1) Foreign investor(s) acquiring ownership interests or effective control; (2) Target Chinese business
Establishment of New Joint Venture	(1) Foreign investor(s) acquiring ownership interests or effective control; (2) Chinese joint venture partner (s)

## *8. How long does the NSR review take? How should foreign investors factor in the NSR review into the investment timetable?*

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The NSR process generally takes several months (including the pre-acceptance review), but could be even longer if the proposed foreign investment is initially identified with national security concerns and subject to special review (i.e. phase II review). Such special review is generally conducted by several ministries coordinated by the NDRC. No decision will be made until all ministries concerned have given the green light to the proposed foreign investment. The NSR Authority has the absolute power to decide the extension of the review without any time limit under the current NSR Measures.

We generally advise that foreign investors allow at least four to six months for investments to pass the NSR review, including notification and review.

## *9. What is the liability for failure-to-notify?*

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If the NSR Authority finds that the parties have failed to notify a foreign investment falling into the NSR-covered scope and are implementing (or have implemented) the investment, they can order the parties to make a NSR notification within a designated period of time. The NSR Authority also has the power to require a mandatory disposal of the investment within a designated period of time, along with other necessary measures to reinstate the pre-investment status, when either the following two occurs:

- (i) the parties refuse to make the notification within the designated period; or
- (ii) the NSR Authority identifies a national security concern which cannot be mitigated by the parties' proposed remedy measures.

Under the NSR Measures, there is no monetary penalty imposed on foreign investors for the failure-to-notify violation but such violation may be recorded as a negative credit record in the applicable national credit information systems, which may result in more regulatory attention and scrutiny if and when the foreign investor makes further investments in China, even the "joint punitive actions" by NDRC and other competent authorities (e.g. restrictions on financing through capital markets and bidding for governmental contracts, etc.).



## *10. How should foreign investors respond to the NSR Authority's query in relation to an ongoing or closed transaction?*

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Due to the lack of clarity of the scope of NSR coverage under the current NSR Measures, many foreign investors find it difficult to assess whether a transaction falls within the NSR-covered scope and therefore are reluctant to voluntarily notify the NSR for their investment. But to our knowledge, in quite a few transactions the NSR Authority has requested foreign investors to make the NSR notification during the deal process or even after closing of the deal.

The NSR Authority may - on its own initiative or based on information from other ministries (e.g. SAMR for merger control review) or from third parties - make queries of the target Chinese business and/or the foreign investors on the specific transactions to verify whether the transactions fall within the NSR-covered scope.

When the NSR Authority makes queries in relation to the NSR on a specific foreign investment transaction during or after the closing, the foreign investors are advised to consider the follows measures to minimize the consequences of the potential failure-to-notify violation:

- (1) Immediately assess the potential NSR nexus in the target Chinese business and provide a full-scope self-assessment report to convince the NSR Authority that no NSR notification will be required; at the same time, confirm with the NSR Authority whether the parties need to stand still on the closing of the contemplated investment transaction or take necessary measures to cease exercising the effective control over the target Chinese business if the transaction has been closed until the conclusion of the review by the NSR Authority;
- (2) If the transaction has not closed, work with the deal counsels to review and identify the applicable clauses that have a bearing on the potentially required mandatory NSR notification and for requesting cooperation from the target Chinese business and the seller in terms of the initial self-assessment and the subsequent NSR notification (if required);
- (3) Work with the target Chinese business (and the seller) to prepare the NSR notification documents alongside the initial self-assessment to ensure a swift submission of the NSR notification (within the designated period) once the NSR Authority has decided there needs to be a notification.

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