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New National Security Review Process in China

By David Wang, Jia Yan, Meka Meng, Sophie Han & Jialing Xiong

On January 18, 2021, a new national security review process went into effect in the People's Republic of China with respect to foreign investments. We believe the impact is that a significant number of foreign investments in China will require a national security review analysis with legal counsel given the expanded broad scope and the lack of formal guidance.

Government Agencies

Office of Foreign Investment Security Review (外商投资安全审查工作机制办公室) in the National Development and Reform Commission (国家发展和改革委员会) in conjunction with the Ministry of Commerce (商务部).

Scope

All foreign investments in China, including formation of a new company; acquisition of equity, convertible note or asset; and investments through other means (such as establishment of VIE, nominee or trust structure, or through offshore transaction that indirectly involves a covered transaction).

Covered Transactions

1. ***Any investment*** in:
   - the military industry, industries that support the military and other industries related to national defense and security, and
   - the land areas around critical or non-critical military installations and military facilities.
2. ***Control investment*** in:
   - critical agricultural products,
   - critical energy and resources,
   - critical equipment manufacturing,
   - critical infrastructure,
   - critical transportation services,
   - critical cultural products and services,
   - critical information technology and Internet products and services,
   - critical financial services,

– key technologies, and

– other critical areas.

"Control" includes, individually or collectively with all other foreign investors: (1) holding at least 50% of the equity; (2) holding less than 50% of the equity but having voting rights with significant impact on board resolutions or shareholder resolutions; and (3) other circumstances in which the foreign investor has a significant impact on the operations and decisions, human resources functions, finances, and technology of the target.

Covered Transactions

While there is little guidance on what constitutes a covered transaction, previous transactions shed some light. The first publicly reported transaction that was reviewed under the existing regulation was Yonghui Superstores' (永辉) acquisition of Zhongbai Holdings Group (中百), an operator of chain supermarkets based in Wuhan, China. Presumably, this transaction was reviewed because Yonghui's largest shareholder is a Hong Kong company, which makes Yonghui a foreign buyer. The national security review process was eventually terminated because the parties voluntarily terminated the acquisition in December 2019. However, the fact that this acquisition was considered to be a covered transaction surprised industry experts since the chain supermarket industry would not ordinarily be considered as one of the industries subject to national security scrutiny. Our view is that given the lack of guidance on key terms such as "critical" (重要 / 重大), the regulators will likely have significant leeway to apply either a narrow or broad interpretation based on the facts and circumstances of each transaction. We also believe the industries that are considered "restricted industries" in the NDRC's *Foreign Investment Negative List* have a relatively higher risk of being reviewed for national security scrutiny.

Comparison

The 2021 version of the regulation has a few key differences compared to the existing regulation, including: (1) the "critical and sensitive" requirement is removed from investment in land areas around military installations, and (2) "critical Internet products and services" and "critical financial services" are newly added as covered transactions. We believe these changes are aligned with the Chinese government's tightening of security measures over military-related assets and technology-related industries that have the potential to threaten China's national security.

Review Period

The entire process (including initial review, general review, and detailed review) could take up to five months or more, but most transactions should be cleared after the 15-business day initial review period after a determination that a national security review would not be required.

Potential Consequences for Violation

The consequence of non-compliance, including a failure to seek national security review before closing a covered transaction, could include forced divestiture of equity or assets acquired and other sanctions.

Deal Recommendations

- Pre-deal: Carefully assess whether the transaction is reportable/reviewable in China with legal counsel; initiate a direct dialogue with the Office of Foreign Investment Security Review as early as possible if the target's business could be considered to be a covered industry.

- Pre-signing: Continue dialogue with the Office of Foreign Investment Security Review to assess whether the transaction could trigger a reporting obligation and ensure that deal timetable includes the review.

Prediction

The United States likely has one of the most active and transparent national security review regimes, which offers potential insight into the new national security review process in China. In 2019, the Committee on Foreign Investment in the United States (CFIUS) preliminarily reviewed 231 written notices of covered transactions and performed full reviews on 113 of the 231 transactions. Of the 113 full reviews, CFIUS required mitigation measures for 33 transactions, refused to approve only eight transactions and one transaction was prohibited by the U.S. President. Our prediction is that the national security review process in China would follow a similar pattern—most transactions would not be subject to review and of the reviewed transactions, only a fraction would require a detailed review and of those, some may be approved with mitigation conditions, and only a handful would be rejected.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Beijing

Meka Meng
86.10.8567.5303
mekameng@paulhastings.com

Jia Yan
86.10.8567.5269
jiayan@paulhastings.com

Shanghai

Sophie Han
86.21.6103.2727
sophiehan@paulhastings.com

David S. Wang
86.21.6103.2909
davidwang@paulhastings.com

Jialing Xiong
86.21.6103.2908
jialingxiong@paulhastings.com