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China's New National Security Screening Rules on Foreign Investment

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China surpassed the United States as the world's largest recipient of foreign direct investment (FDI) in 2020 amid the COVID-19 pandemic. A huge contributor to this development is China's success in slowing down the spread of the virus and making a quick economic turnaround. Apart from the speedy economic recovery is China's strong foreign investment regime. China had been active in promulgating investment-inducing policies, such as the Foreign Investment Law promulgated in January 2020 and a shorten negative list of investment in July, to attract foreign investment in 2020.

A further sign that the Chinese government is doing all it can to stimulate FDI came on 19 December 2020 when the National Development and Reform Commission ("NDRC") and Ministry of Commerce ("MOFCOM"), on the approval of the State Council, jointly released the *Measures for the Security Review of Foreign Investment* (外商投资安全审查办法, hereinafter referred to as the *2020 NSR Measures*), which officially took effect on 18 January 2021. This newly released document, with 23 Articles in total, provides details of the review authority, scope of transactions, review initiation and procedures, possible review decisions, supervision and implementation of review decisions, and violations handling, all based largely on China's national security review practice of the past 25 years.

On the *2020 NSR Measures*, the Shanghai Chapter of the European Union Chamber of Commerce has voiced its concern that they may narrow the scope of foreign investment and are inconsistent with China's stated goals of further opening-up. In response, the Chinese

government declared that the *2020 NSR Measures* are not protectionist in nature[1] and are a critical part of the regulatory framework of its foreign investment law. They are an accepted concept in WTO regulation and like in other countries, the measures are to effectively monitor investment in order to avoid national security risks.

While the *2020 NSR Measures* have added new hurdles for investment in China which may prompt foreign companies to review their investment plans, it is an indication that the country is adopting policies to converge with international standards and is serious about ensuring a safe investment environment.

A rule-based national security screening system is also necessary for China to negotiate more high-standard bilateral investment agreements, like the one recently concluded with the EU. To the Chinese government, the China-EU investment agreement is testimony to the fact that the *2020 NSR Measures* did not impede but encourage investment negotiations between China and the EU.

The *2020 NSR Measures* also allow the Chinese government to balance the two somewhat conflicting objectives of ensuring national security and encouraging investment in certain high-tech sectors. The *2020 NSR Measures* specify foreign investment only in the area of military products and facilities, and the land use near to military base, the critical agricultural, energy and natural resources related to national security as well as the critical infrastructure, internet technology and financial service.

CHINA'S LATEST EFFORTS TO IMPROVE ITS REGULATORY REGIME

China has opened its door to foreign investors for more than 40 years since the enactment of the first law on inward foreign investment, "*The Law of the People's Republic of China on Chinese-Foreign Joint Ventures*", in 1979. However, it is not until 1995 that explicit rules to manage risks to its security interests associated with inward foreign investment were introduced in the document, "*The Interim Provisions on Guiding the Orientation of Foreign Investment*"[2] (*指导外商投资方向暂行规定*).

China has since developed, in roughly three stages, review mechanisms for national security risks management of inbound foreign investment. In the first stage, as the 1995 document only prohibited foreign investment that "harmed national security or impaired public interest" without detailing the implementation of the rule, China for the first time introduced review mechanisms, "*The Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*", to manage national security risks related to inward foreign investment in 2003.[3] However, this document and another document issued in 2006[4] did not include details of the review process and limited the scopes of review to national economic risks associated with foreign investment, particularly those of merger and acquisition (M&A). In this stage,

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[1] For more details, please refer to https://www.pillsburylaw.com/en/news-and-insights/china-rules-security-review-foreign-investment.html, accessed 10 January 2021.

[2] For more details, please refer to http://www.people.cn/zixun/flfgk/item/dwjjf/falv/2/2-1-23.html, accessed 8 January 2021.

[3] For more details, please refer to http://www.mofcom.gov.cn/article/b/f/200303/20030300074627.shtml, accessed 8 January 2021.

[4] China issued the *Regulation on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors* in 2006. For more details, please refer to http://www.mofcom.gov.cn/article/b/c/200608/20060802839585.shtml, accessed 9 January 2021.

rules to steer clear of foreign investment, mostly on M&A activities, were implemented to prevent investments that harm national security or impair public interest.

In the second stage, China officially established its security review system for foreign investors in 2011 with the release of the "*Notice of the General Office of the State Council on the Establishment of a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*" (henceforth, the 2011 Document), complemented by two other documents issued by MOFCOM.[5] These three documents provided details of the scope and content of review, the review authority, documents required for review as well as the review process, timeline and possible results. While the the national security review focused on the rules for free trade zones and intellectual property rights, the content of review had expanded from national economic security to security related to national defence, economic stability, social order and technology.

In 2015 and 2018, China released two other documents, namely, "*Trial Measures for the National Security Review of Foreign Investment in Pilot Free Trade Zones*" (The document for FTZs) and "*Measures for the Overseas Transfers of Intellectual Property Rights*"[6] (The Document for IPR Transfer), to improve its security review system in specific areas. The Document for FTZs aimed to expand the application of the review system.

For the third (the most recent) stage, China formally established its national security review system for foreign investment at the legal level by releasing its *Foreign Investment Law*, and the associated *Implementation Regulations* in 2019.[7] However, these two documents only mentioned that "[t]he state establishes a foreign investment security review system to conduct security reviews of foreign investments that affect or may affect national security. The safety review decision made in accordance with the law is final". There are no further details on criteria, procedures and responsibilities, and so on.[8]

The newly launched *2020 NSR Measures* are an important document that complements the *Foreign Investment Law* and provides clear legal basis and practice details for the Chinese authorities to supervise foreign investment that may affect national security. The *2020 NSR Measures* signal that the Chinese government is taking a more proactive approach to managing national security risks associated with inbound foreign investments.

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[5] The two associated documents are *The Interim Provisions on Matters Relevant to the Implementation of the System for Security Review of Acquisition of Domestic Enterprises by Foreign Investors* (March 2011), and *Provisions of the Ministry of Commerce on Implementing a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (August 2011). For more details, please refer to http://www.mofcom.gov.cn/aarticle/b/f/201102/20110207403117.html, http://www.mofcom.gov.cn/article/b/g/201103/20110307432771.shtml and http://www.mofcom.gov.cn/aarticle/b/c/201108/20110807713530.html, all accessed 9 January 2021.

The entry into force of the National Security Law on 1 July 2015 brought further changes to the system, according to statements by the Chinese government (see Summary of discussions of Freedom of Investment Roundtable 23 (October 2015), DAF/INV/WD (2015)15, p.19).

[6] For more details, please refer to http://www.gov.cn/zhengce/content/2015-04/20/content_9629.htm, http://www.gov.cn/zhengce/content/2018-03/29/content_5278276.htm, accessed 9 January 2021.

[7] For more details, please refer to http://gkml.samr.gov.cn/nsjg/fgs/201908/t20190829_306349.html, http://www.gov.cn/zhengce/content/2019-12/31/content_5465449.htm, accessed 9 January 2021.

[8] The earlier draft of the Foreign Investment Law released in 2015 has a full section on the scope and procedures for the security review, which was however not included in the final version released in 2019.

While the two documents released during the second stage detailed the review process (the 2011 Document and the Document for FTZs), the new document has made changes mainly in six aspects: the types of foreign investment applicable to security review; the shift in review authority from the non-established institution (the Inter-Ministerial Joint Meeting on the Security Review of Foreign Investors' Mergers and Acquisitions of Domestic Enterprises) to a permanent institution (the Office of the Foreign Investment Security Review Mechanism); the revision to the sectors for national security review based on industrial development; the simplified procedure and time limit of the review; the revision of review decisions with details on the implementation and supervision; and the details of regulation violations.

In spite of the efforts made, improvement to some specific aspects of China's NSR system for inward foreign investment is still lacking. For example, the specific content of the security review declaration remains unclear, likewise for the linkage mechanism between the working mechanism office and the relevant departments of the provinces, autonomous regions and municipalities. The security review regulations for foreign investment in the securities sector have yet to be issued.

INVESTMENT SCREENING WITH CHINESE CHARACTERISTICS

The release of China's *2020 NSR Measures* can be seen as a response to the recent global wave of FDI security screening. Although FDI can help enhance growth and innovation in host countries, contribute to quality job creation and human capital development, and improve management practices, the inward FDI may also bring risks to the security interests of host countries. According to an OECD research,[9] the introduction of risk screening rules for foreign investment can be traced back to the 1960s in some countries.

Since 2016, major economies around the world have been taking these risks seriously and have successively introduced or improved their foreign investment NSR systems (Figure 1). For example, the United States issued the "*Foreign Investment Risk Review Modernization Act*" in 2018 and the EU adopted its first foreign investment screening regulation, namely, Regulation 2019/452 (the FDI Regulation) in 2019. Germany (2018), Japan (2019) and Australia (2020) have also amended their regulations on foreign investment to enhance national security protection. The United Kingdom is currently formulating its "National Security and Investment Act".[10]

The ongoing COVID-19 pandemic has reinforced the importance of FDI screening. While the pandemic is unveiling the importance and weaknesses of the health sector and its associated supply chain, it has also seriously disrupted the global value chain on which many multinational companies depend for survival. This has triggered a global wave of tightening on foreign investment screening. For example, on 25 March 2020, the European Commission issued

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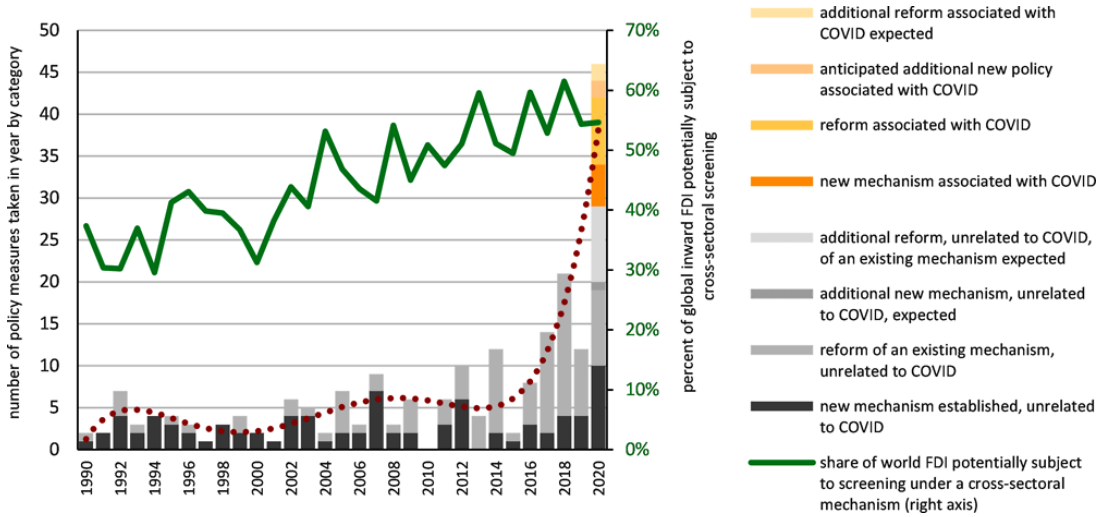
[9] For more details, please see "Investment screening in times of COVID-19 and beyond" by the Secretary-General of the OECD (July 2020) at http://www.oecd.org/coronavirus/policy-responses/investment-screening-in-times-of-covid-19-and-beyond-aa60af47/, accessed 13 January 2021.

[10] For more details, please refer to https://www.congress.gov/bill/115th-congress/house-bill/5841/text, http://trade.ec.europa.eu/doclib/press/index.cfm?id=2006, https://investmentpolicy.unctad.org/investment-laws/laws/269/germany-foreign-trade-and-payments-ordinance, https://www.internationallawoffice.com/Newsletters/Banking-Financial-Services/Japan/Nagashima-Ohno-Tsunematsu/Recent-amendments-to-Foreign-Exchange-and-Foreign-Trade-Act#2019%20Amendments, https://www.legislation.gov.au/Details/F2020L01568 and https://services.parliament.uk/bills/2019-21/nationalsecurityandinvestment.html, all accessed 13 January 2021.

Guidelines to ensure a strong EU-wide approach to foreign investment screening at a time of public health crisis and related economic vulnerability.[11]

FIGURE 1 WORLD TRENDS TO ACQUISITION- AND OWNERSHIP-RELATED POLICIES TO SAFEGUARD ESSENTIAL SECURITY INTERESTS (1990 to 2020)



Note: Data covers the 62 economies that participate in the OECD-hosted Freedom of Investment Roundtable.
Source: "Investment screening in times of COVID-19 and beyond" by OECD (July 2020).

On the other hand, the release of China's *2020 NSR Measures* does not seem to be directly related to the pandemic as China has adopted a gradual process to establishing its national security risks management system for inbound foreign investment since 1995. However, China's new regulation is not unique and does share some common features[12] with that of the recent global trend. First, the reviewing scope has expanded from national defence-related activities to critical infrastructure, advanced technology and digital content such as personal data. Second, the types of transactions covered have been extended to include non-ownership transactions such as lease, trust and international research cooperation. Third, the review mechanisms are geared towards routine implementation.

What is missing from China's new regulation are two important global trends: (i) continuous risk-management as complementary process to the one-time review before the transaction and (ii) regulations on foreign state-controlled investment as a means to manage risk. For the former, China may incorporate it into the future version of its regulations. For the latter, Chinese state-owned or controlled investment have been the targets of regulation abroad. Therefore, this is a sensitive area for China in its negotiation of international agreements as well as domestic policymaking.

[11] For more details, please refer to https://trade.ec.europa.eu/doclib/press/index.cfm?id=2124, accessed 13 January 2021.

[12] For more details of the current and emerging global trends of NSR, please refer to Research note by the OECD Secretariat (May 2020), "Acquisition- and ownership-related policies to safeguard essential security interests - Current and emerging trends, observed designs, and policy practice in 62 economies". Available at http://www.oecd.org/Investment/OECD-Acquisition-ownership-policies-security-May2020.pdf, accessed 14 January 2021.

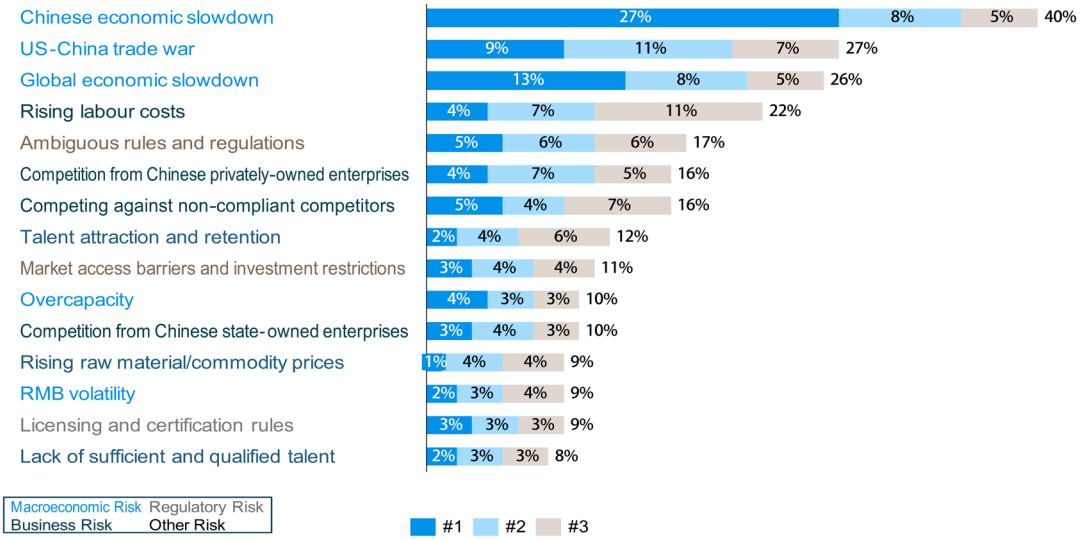
WHY DO THE *2020 NSR MEASURES* MATER?

China has continued to promote enhanced market access and shortened the negative list of foreign investment. China's NDRC and MOFCOM jointly issued two "negative lists" which included the *Special Administrative Measures on Access to Foreign Investment* (2020 edition) and the *Free Trade Zone Special Administrative Measures on Access to Foreign Investment* (2020 edition) in June 2020. The number of restrictive measures for foreign investment has been cut from 63/95 in 2017 to 33/30 in both of national and free trade zone versions. For example, it has abolished prohibitions on foreign investment in internet services, movie theatres and performance brokerage agencies, and allowed foreign-funded enterprises to engage in the production and sales of game equipment; in the financial field, foreign shareholding restrictions on investment in bank securities, funds, futures and personal insurance have also been lifted.

While the *2020 NSR Measures* are not exceptional, it is a significant measure towards building a comprehensively regulated regime. China promulgated the *National Security Law* on 1 July 2015 and the *Foreign Investment Law* on 1 January 2020. In the past, there was only one generic clause in the *Foreign Investment Law* to review foreign investment that could impact China's national security. With the promulgation of the *2020 NSR Measures* that act as a supplement to the Law, foreign investors can look forward to an improvement to the transparency and fairness of the regulatory environment.

Even though China's regulatory environment for inward foreign investment has made tremendous improvement, unfair treatment is still a persistent complaint.[13] Apart from major macroeconomic risks (Chinese economic slowdown, US-China trade war and global economic slowdown), rising labour cost and ambiguous rules and regulations are the most significant challenges for EU companies doing business in China (Figure 2). Market access barriers and investment restriction are the second significant challenge among other regulatory risks for EU investors in China.

FIGURE 2 TOP THREE CHALLENGES FOR EUROPEAN COMPANIES DOING BUSINESS IN CHINA



Source: European Chamber, European Business in China-Business Confidence Survey 2020.

[13] https://www.china-briefing.com/news/what-eu-investors-seek-from-china-market-access-transparency-level-playing-field/, (accessed 12 January 2021).

The 2020 *China Business Climate Survey Report* published regularly by the America Chamber of China highlighted the significant role of the regulatory environment which impacts the investment level of US companies in China. Amidst the US-China trade friction, intellectual property protection, unequal industrial policies and technology transfer are some of the concerns of US companies in China. However, a huge 41% of respondents, the highest rate in the survey, have indicated that if China increases the transparency, predictability and fairness of its regulatory environment, they are prepared to enlarge their investment scale (Figure 3).

FIGURE 3 IMPACT OF A CHANGE IN POLICY ENVIRONMENT ON INVESTMENT LEVEL IN CHINA

Source: AmCham China, 2020 China Business Climate Survey Report.

The *2020 NSR Measures* are a significant step towards building a rule-based foreign investment system; its investment regulation has moved from a positive-list regime to a negative-list one. As the new rules have kicked in since 18 January 2021, monitoring views and investments of foreign firms as well as the effects of the United States' stricter investment review of Chinese companies, the signing of China-EU investment agreement and the on-going COVID-19 pandemic are critical for a better gauge of foreign investment trends in China.

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