China’s opportunity

A proposed national security regime shares similarities with the US regime. Will it create tension with broader moves to liberalise investment?

China has taken positive steps to formalise its national security review process in its draft Foreign Investment Law (FIL). As it moves towards liberalising investment through a series of reforms and negotiates a bilateral investment treaty (BIT) with the US, China has an opportunity to reinforce its commitment to foreign investment. It can do this by more narrowly tailoring its definition of ‘national security’ and addressing other aspects of the FIL’s proposed national security review process.

China’s Ministry of Commerce (MoCom) unveiled the draft FIL on January 19, 2015. It seeks to consolidate existing foreign investment laws governing equity joint ventures, non-equity joint ventures, and wholly foreign-owned enterprises into one law creating a new foreign investment regime. As part of its reforms, the FIL proposes a ‘negative list’ system, whereby foreign investments falling outside defined sectors will no longer require market access approval (subject to certain registration requirements and industry-specific licensing regimes). A negative list system is already in effect in China’s free trade zones. On October 19, 2015, the State Council released its Opinions on Implementing the Negative List for Market Entry, which further elaborates on the negative list system for market access. It also sets the formal implementation of the negative list for the entire country in 2018, following application in select regions on a trial basis from 2015 to 2017.

In addition to amending market access requirements, and thereby ostensibly improving the climate for foreign investment in China, the FIL establishes a formal national security framework that approximates the US national security review process administered by the Committee on Foreign Investment in the United States (Cfius). Businesses and other stakeholders have expressed concerns that the potential breadth of China’s national security review powers, as contemplated in the FIL, could undercut its larger investment reforms and liberalisation efforts. Some key similarities and differences exist between the FIL and Cfius process, and larger geopolitical and economic trends related to China’s negotiation of a BIT with the US – plus a spate of other national security legislation under consideration – may ultimately influence the final language of the FIL.

National security review comparison

Separate from its negative list approach, which essentially accords national treatment to foreign investors (except in certain prohibited or restricted sectors), the FIL provides the basis for a more formal and extensive national security review for foreign investment than exists today. In many ways, the framework established by the FIL parallels the Cfius process – under which Chinese investors have not always fared well in the past. Among its similarities, the FIL establishes an inter-ministerial body, the Foreign Investment National Security Review Joint Ministerial Conference (Joint Conference), to review foreign investments for national security concerns in a staged process, in coordination with relevant departments within the State Council. Like Cfius, the Joint Conference (in coordination with the State Council) has broad discretion to review, block, and even unwind a particular transaction post-closing.

Both the FIL and Cfius regimes provide broad jurisdiction to subject transactions to the national security review process. While the jurisdictional reach of the FIL is, in some ways, broader than Cfius, the FIL uses Cfius’s approach of ‘control’, rather than exclusively ownership, as a determining factor (among others) to trigger jurisdiction. Both the FIL and regulations governing the Cfius process define ‘control’ functionally as the ability of the foreign investor to exert a certain level of influence over the target company, for example, ‘to exert a decisive influence’ under the FIL, and ‘to determine, direct, or decide important matters’ under the Cfius regime. Moreover, the FIL’s ‘factors subject to national security review’ encompass ‘critical infrastructure’ and ‘foreign government-controlled transactions’ in the Cfius context, in which they presumptively implicate national security concerns. Similar to the Cfius regime, the FIL also provides the potential for companies to mitigate national security risk in particular transactions. In addition, as with US Presidential determinations, the Joint Conference’s national security determinations are not subject to administrative or judicial review. Finally, like Cfius, the State Council is required to publish annual reports related to the national security review process.

Conversely, the FIL includes ‘factors subject to national security review’ that are beyond the scope of Cfius review and not part of what the US government considers traditional national security concerns. These include ‘social public interests’ and ‘public order’, as well as the ‘stable operation of the Chinese economy’. Unlike the US regime, the FIL does not exclude from the scope of review greenfield investments or certain other types of transactions (such as obtaining the right to use land or real estate without other corresponding assets or interests). Another of the FIL’s distinguishing characteristics is a mechanism for competitors, industry associations, enterprises in the same industry, and other concerned parties to recommend that the Joint Conference review a particular transaction. Moreover, unlike the Cfius review process, the FIL does not allow parties to withdraw their application for national security review without consent from the State Council, nor does it explicitly provide for the confidentiality of the national security review process. Finally, whereas the US has one national security review regime, the FIL anticipates a separate national security review process for investments in the financial sector.

Investment liberalisation efforts

From a US perspective, the expansiveness of Chinese national security review could compromise some positive effects of its proposed negative list approach to foreign investment, and its larger investment liberalisation efforts undertaken as part of the BIT negotiations. Amid a slowing economy and weakening business confidence in the local market, China has an opportunity to refine its national security review process and narrowly tailor the definition of ‘national security’, as well as the scope of transactions subject to jurisdiction, before implementing the FIL. In doing so, China would demonstrate its commitment to encouraging foreign investment, rather than using purported national security concerns as a way to block foreign investors and advance protectionist ends.

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