NEWS

China's National Security Review: A Case Study of a Supermarket Chain

China's national security review regime has largely flown under the radar since it was introduced in 2011. But a recent case involving a foreign-invested supermarket chain, the first since a revamp of the regime's regulatory structure elevated the role of China's powerful central planning agency, has put national security in the spotlight once again.

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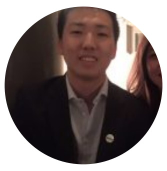

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National security is in vogue. As the United States and its allies continue to dominate headlines with their blacklisting of Huawei and increasingly hostile treatment of Chinese investments, China is now pressing on with its own efforts to bolster national security oversight of foreign investment – and its definition of national security goes far beyond defense.

China introduced a national security review (NSR) regime in 2011 but it has received relatively little attention and has seen only a few cases. That is about to change as the National Development and Reform Commission (NDRC) took over earlier this year as the leading agency for the NSR process and will likely ramp up enforcement.

"Considering the global economic challenges, we expect Chinese authorities will tighten national security review for foreign investment," said Barbara Li, a Beijing-based partner at Norton Rose Fulbright, adding that NSRs have more strategic implications from the national interests and security perspectives than other regulatory clearance requirements.

The revamped NSR regime has already seen its first publicly reported case. On August 23, Yonghui Superstores announced that it had received a letter from the NDRC requesting that it submit for NSR its proposed increase in stake in Zhongbai Holdings, a regional supermarket chain. This came just two days after Yonghui said it had received approval for the transaction from the state antitrust regulator, the State Administration for Market Regulation. On September 24, the NDRC confirmed that the deal involves national security and that a review is underway.

Until April this year, China's NSR regime was overseen by the Ministry of Commerce (MOFCOM). However, MOFCOM has largely functioned as a recipient for NSR documents and coordinator of NSRs, according to Lester Ross, Wilmer Cutler Pickering Hale and Dorr's partner-in-charge in Beijing. "It has very modest internal capability to conduct NSRs," he said.

The NDRC, China's leading macro-planning body with sweeping powers in different areas including anti-monopoly and foreign investment, has always been involved in the process. In April, as MOFCOM officially ceded its responsibilities, the NDRC, with greater manpower, became the sole overseer of the NSR regime.

"As national security has risen in importance with respect to both foreign direct investments and technology trade, transfer of such responsibility to an agency with greater capability to coordinate such matters is not surprising," said Ross.

Expanding scope

China's NSR regime outlined two categories of transactions subject to NSRs: foreign investment in domestic entities involving defense security, and foreign investment in Chinese entities related to "key industries".

The defense-related category will flag any transactions involving military products or entities near sensitive military facilities. But the second category is less straightforward: a broad category that brings to the fore the notion of national economic security by including in the NSR remit important agricultural, energy, transport and technology sectors not explicitly related to military or defense matters.

There is an effective control threshold under this category. Only those proposed transactions that would give foreign investors effective control over domestic entities in these key industries would require an NSR. For example, owning more than 50% of shares in a domestic company would be sufficient but not necessary for meeting the threshold. What matters is de facto control of management decisions and technologies of the domestic company.

The authorities have not published an exhaustive list of all the industries that fall under this category. However, companies can get a general picture of what these might be by looking at existing government documents. One indicator is the 'Negative List', which sets out industries where foreign investment is limited or prohibited, said Fay Zhou, a Beijing-based partner at Linklaters and a former MOFCOM official.

For example, the authorities clearly view telecommunications and cybersecurity as sensitive areas. The most recent version of the Negative List issued in June contains 40 sectors, including internet news, audio and video services related to telecom and cybersecurity. In 2017, the Cyberspace Administration of China labelled these as "critical information infrastructure", a term that features throughout the 2016 Cybersecurity Law (CSL) (中华人民共和国网络安全法), subject to protection due to their potential to "seriously jeopardise" national security in a draft regulation clarifying elements of the CSL.

The CSL is another important document for understanding the sectors that fall under the scope of national security, as White & Case's China practice head Alex Zhang wrote in a client note. It lays out national security review standards and requirements for network and data companies seeking to operate in the critical information infrastructure sectors, he said.

Nevertheless, the authorities' scope is very broad; the NSR regime is designed with a 'catch-all' provision that gives the overseeing agency more discretion when it comes to deciding whether a transaction is subject to NSR. The new Foreign Investment Law (中华人民共和国外商投资法), which will take effect on January 1, 2020, provides that an NSR should be undertaken for "any foreign investment that affects or may affect national security".

"What will trigger an NSR is not clear as there is no exhaustive list of sensitive sectors," said Scott Yu, a Beijing-based partner at Zhong Lun, which has advised on several NSR cases.

When the NDRC confirms that a transaction falls within the scope of an NSR, an ad hoc inter-ministerial joint committee (IJC) is established to review the deal. The makeup of the IJC varies from case to case, depending on the substance of the transaction in question and can involve any relevant government departments or agencies. For example, a case involving agricultural products might tie in the Ministry of Agriculture and various farming agencies.

"There is no obligation [on the authorities] to disclose what concerns they have or which ministries they will call on to be part of the IJC," Yu said. "Lawyers need more knowledge about what could trigger an NSR and put more work into assessing what legal barriers might arise before starting a transaction."

The IJC has 90 working days to come to a decision and there are four possible outcomes. If it determines that there will be no impact on national security, the transaction will be given the go-ahead. However, if there will likely be national security impact, the NDRC will suspend the transaction or request changes in the transaction structure before resubmitting it for another review, such as a reduction in the level of shares being purchased so that the effective control threshold is not met.

If the impact is likely to be "substantial" or if there has already been impact because a transaction was completed prior to NSR approval, the regulations state that the NDRC and other authorities will terminate the transaction and could even force the buyer to divest the acquired assets. Lastly, if the IJC fails to reach a consensus, the case is forwarded to the State Council, which has no time limit to make a decision. As such, transactions could be delayed indefinitely if an NSR reaches this stage.

Yonghui case

The reason why Yonghui's deal has been flagged for NSR has not been disclosed. The Shanghai-listed company's largest shareholder is Dairy Farm International, the Asian retail arm of the Hong Kong-headquartered British conglomerate Jardine Matheson, which purchased an almost 20% stake in Yonghui for $925 million in 2014. Ben Keswick, the executive chairman of Jardine Matheson, also became chairman of Yonghui in December 2018.

However, Dairy Farm International is neither Yonghui's controlling shareholder nor actual controller. According to a company statement on December 5, 2018, the company does not have a controlling shareholder or actual controller as no single party enjoys an "absolute shareholding advantage" nor actual control over the company's board. Just two of the company's 11 board members are representatives of Dairy Farm.

Yonghui is offering to raise its stake in Zhongbai from 30% to 40%, according to a company statement in April. The move would make it Zhongbai's biggest shareholder, surpassing its current controlling shareholder, the Wuhan municipal government, which owns 34%. Although Yonghui said it is not seeking control of the Wuhan-based supermarket chain, it did not rule out further increasing its stake in the next year. Zhongbai itself said the move might change who the actual controller of the company is.

If the authorities deem Yonghui a foreign-controlled company seeking to take control of Zhongbai, this would meet the effective control threshold and trigger an NSR. A purported leak of MOFCOM's internal list consisting of 57 sensitive sectors for NSR has circulated around the internet for years and includes retail. Although the leaked list has never been acknowledged by any Chinese regulator or official, several lawyers have highlighted it as a credible point of reference for foreign investors conducting risk assessments for a proposed transaction.

On the other hand, effective control might be a moot point if the authorities deem the transaction as having direct military and defense implications. Under this category, an NSR is required for every transaction regardless of whether the foreign investor is seeking effective control of the target domestic company.

In Yonghui's case, the location factor could be key. China's NSR regime states that foreign investors' acquisition of "enterprises located adjacent to key or sensitive military facilities" would be subject to NSR. Zhongbai currently operates 1,255 establishments around the country including supermarkets, food markets and wholesale centres. The proximity of some of these to sensitive military and defense facilities might be grounds for the review to be conducted, according to a lawyer who wished to stay anonymous. However, the real reason for Yonghui's NSR is unlikely to be disclosed even after the review is concluded. Unlike merger filings, the NSR process is not transparent given its sensitive nature and there is no official record of reviews that have taken place.

Engaging regulators

There are two ways that the NSR process can be initiated: the self-reporting of parties involved in a transaction, or a complaint to the NDRC from a third party such as relevant State Council departments, industry associations and other companies in the same industry. The latter category is where a lot of uncertainty and risk can arise, said Linklaters' Fay Zhou, who advises her clients conduct "stakeholder mapping" to identify who might launch a complaint about a transaction to the authorities.

"This is useful for other regulatory approval processes too, such as antitrust, but it is especially helpful for NSRs as the client can then develop a stakeholder engagement strategy," she said. "For example, a client may choose to inform the industry regulators about why the transaction is beneficial to China, instead of waiting for the authorities to approach them." She recommends approaching industry regulators such as the Ministry of Agriculture because they are more familiar with issues in their sector than MOFCOM or the NDRC.

In cases where a proposed transaction is likely to trigger an NSR, she recommends the parties engage the NDRC directly. Rather than take the high risk of an NSR being initiated by a third party down the line, companies can submit an NSR application voluntarily. "Early engagement is helpful for clarity," she said. However, this approach is not recommended for deals without clear national security implications, as it might trigger an NSR that otherwise would not have been.

Frank Jiang, a Beijing-based partner at Zhong Lun, agrees that companies should be proactive but careful in their approach. "We would be cautious in putting too much time and effort into consulting with relevant third-party stakeholders as such a move might instead trigger an unintended NSR recommendation," he said.

"But if there is likely to be an NSR or if the NDRC has already started one, it would be advisable to have a proactive and comprehensive plan of outreach to third-party stakeholders, including regulators and trade associations," Jiang added.

The difficulty lies in weighing up the respective risks and uncertainties of being proactive or not, especially for listed companies with public disclosure obligations. As every case is unique, it is crucial that a proper risk assessment is conducted along with stakeholder mapping in order to determine what the best course of action is, Zhou said, adding that the current political climate makes the input of experienced lawyers even more crucial.

Volatile geopolitical tensions and the growing influence of social media have made doing business increasingly difficult for multinationals in China in recent months. For foreign companies, particularly those with ties to Taiwan and Hong Kong, their positions on certain contentious issues must be factored into any risk assessment they do.

"Big foreign-owned Hong Kong companies like Swire [and Jardine Matheson] are not very popular in the mainland these days," Wilmer's Ross noted.