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# BALANCING SECURITY AND GROWTH: DEFINING NATIONAL SECURITY REVIEW OF FOREIGN INVESTMENT IN CHINA

Eric Jensen<sup>†</sup>

*Abstract:* One of the most recent steps in China's slow march towards liberalization of foreign investment is the introduction of the 2006 Provisions on Acquisition of Domestic Enterprises by Foreign Investors ("2006 M&A Provisions"). Article 12 of this law provides new procedures for review and approval of foreign investment in China. China's national security review of foreign direct investment has the same motivations as the United States' Committee on Foreign Investment in the United States (CFIUS) review, but it is much murkier and less efficient. CFIUS is governed by numerous statutory and regulatory guidelines. China should integrate some of the CFIUS statutes and regulations, which allow the United States to address new threats to national security without unreasonably burdening foreign investment, into its national security review process. China should also draw on standards contained in other parts of the 2006 M&A Provisions to improve the workability of national security review under Article 12. These changes would help ensure that foreign investors will be willing to continue providing the capital that has helped drive China's economic transformation, while safeguarding China's essential national security interests.

## I. INTRODUCTION

A steep decline in foreign investment in developing economies was one of the major consequences of the 2008-2009 financial crisis.<sup>1</sup> Projections indicate that global investment in emerging markets will decline 31 percent in 2009.<sup>2</sup> China has not been exempted from this decline in foreign investment. The decline in foreign investment in China combined with the other effects of the global economic slowdown caused the closing of tens of thousands of factories in China.<sup>3</sup> As a result, labor protests broke out, leading to a number of clashes between workers and riot police.<sup>4</sup> Plant closings and labor unrest have been most prevalent in the coastal regions of

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<sup>1</sup> Patricia Lui, *Emerging Markets Face \$180 Billion Investment Decline*, BLOOMBERG.COM, Jan. 20, 2009, [http://www.bloomberg.com/apps/news?pid=20601086&sid=apJ57WoinRr8&refer=latin\\_america](http://www.bloomberg.com/apps/news?pid=20601086&sid=apJ57WoinRr8&refer=latin_america).

<sup>2</sup> *Id.*

<sup>3</sup> Edward Wong, *Factories Shut, China Workers Are Suffering*, N.Y. TIMES, Nov. 14, 2008 at A1, available at <http://www.nytimes.com/2008/11/14/world/asia/14china.html>.

<sup>4</sup> *Id.*

China.<sup>5</sup> Previously, these areas had seen the bulk of foreign investment in China due to tax and regulatory advantages.<sup>6</sup>

Since 1978, Chinese foreign direct investment policies have been gradually liberalized.<sup>7</sup> However, investors fear that developing economies, including China, are “becom[ing] increasingly protectionist under the guise of a national security review.”<sup>8</sup> Article 12 of China’s 2006 Provisions on Acquisition of Domestic Enterprises by Foreign Investors (“2006 M&A Provisions”)<sup>9</sup> allows such review. Under Article 12, China’s Ministry of Commerce has the authority to subject foreign investment to a national security screening that, because of its vague and as-yet-undefined process and lack of investor protections, may drive foreign investment away from China.

The United States also screens foreign investment for national security concerns. In the United States, the interagency Committee on Foreign Investment in the United States (“CFIUS”) performs national security reviews of foreign investments.<sup>10</sup> The Chinese and American systems share the common goal of protecting national security without acting as an unnecessary barrier to foreign investment. China’s 2006 M&A Provisions were enacted in part because of a belief that China needed a national security review process similar to the United States.<sup>11</sup> However, the systems are in different stages of procedural development. CFIUS has existed since 1975<sup>12</sup> and its review is governed by clear statutory and regulatory rules including timelines, express review criteria, and “safe harbor” protections for investors.<sup>13</sup> China’s 2006 M&A Provisions lack any such provisions.

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<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> ZULIU HU & MOHSIN S. KHAN, INT’L MONETARY FUND, WHY IS CHINA GROWING SO FAST, 8 ECONOMIC ISSUES 1 (1997) available at <http://www.imf.org/EXTERNAL/PUBS/FT/ISSUES8/INDEX.HTM>. For the purposes of this comment, “liberal” trade policies are defined as “policies that allow the unrestricted flow of goods and services.” World Trade Organization, *Understanding the WTO: The Case for Open Trade*, [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact3\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm) (last visited Sept. 23, 2009).

<sup>8</sup> Jessica Holzer, *National Security Chill on Takeovers*, FORBES.COM, Dec. 6, 2006, [http://www.forbes.com/2006/12/21/cfius-outlook-washington-biz-wash-cx\\_jh\\_1222cfius.html](http://www.forbes.com/2006/12/21/cfius-outlook-washington-biz-wash-cx_jh_1222cfius.html) (internal quotations omitted) (last visited Nov. 20, 2009).

<sup>9</sup> Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (promulgated by the Ministry of Commerce, Aug. 8, 2006, effective Sept. 8, 2006), art. 12, translated in <http://english.mofcom.gov.cn/aarticle/policyrelease/domesticpolicy/200610/20061003434565.html> (P.R.C.) (last visited Nov. 20, 2009) [hereinafter 2006 M&A Provisions].

<sup>10</sup> See 50 U.S.C. App. § 2170 (2007).

<sup>11</sup> See Destiny Duron Deas, *The Costs of Perceived Hypocrisy: The Impact of U.S. Treatment of Foreign Acquisitions of Domestic Enterprises*, 57 DUKE L.J. 1795, 1795 (2008).

<sup>12</sup> See Exec. Order No. 11,858, 3 C.F.R. 990 (1975).

<sup>13</sup> 50 U.S.C. App. § 2170.

Because China has the same dual goals of encouraging foreign investment and protecting national security, the provisions guiding CFIUS should serve as a blueprint for China in making changes to its review procedures.

In addition to the United States CFIUS rules, China should also look to other articles in the 2006 M&A Provisions for guidance in reforming Article 12. The 2006 M&A Provisions provide rules for normal “non-national-security” review, including rules governing which transactions must be submitted for review to Chinese officials<sup>14</sup> and explicit timelines for review.<sup>15</sup> Because the rules for “non-national-security” review provide increased investor confidence and protection, they should also be integrated into China’s national security review regime.

This Comment examines the history and structure of national security review in the United States and China and suggests changes to China’s national security review process to clarify its scope, procedures, and effects. Part II reviews the history and structure of foreign direct investment in China and the history of national security review of foreign direct investment in the United States. Part III examines some of the shortfalls of national security review under Article 12. Part IV recommends changes and additions to China’s national security review of foreign direct investment.

## II. ECONOMIC DEVELOPMENT AND EVOLVING NATIONAL SECURITY CONCERNS IN CHINA AND THE UNITED STATES HAVE PROMPTED THE NEED FOR REGULATION OF FOREIGN DIRECT INVESTMENT

The respective approaches to national security review of foreign investment in the United States and China have been greatly shaped by their historical attitudes towards and experience with such investment. China’s only recent embrace of foreign direct investment as well as lingering mistrust of foreign investors has informed its recent adoption of opaque national security review procedures. The United States, in contrast, has a longer history of allowing foreign investment and more experience with national security screening. This experience has shaped the United States’ CFIUS procedures while placing emphasis not strictly on national security, but also on maintaining an open investment policy.

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<sup>14</sup> 2006 M&A Provisions, *supra* note 9, art. 21, 22, 23, 32, 42, 44.

<sup>15</sup> *Id.* art. 25.

A. *Article 12 of the 2006 M&A Provisions Bucks China's Trend of Market Liberalization*

China's embrace of foreign investment and trade has helped drive its transformation into a global economic powerhouse. "Over the past quarter-century no country has gained more from globalization than China."<sup>16</sup> Cumulative foreign direct investment in China, negligible before 1978, reached nearly \$100 billion in 1994.<sup>17</sup> Similarly, annual inflows of foreign investment increased from less than one percent of total fixed investment<sup>18</sup> in 1979 to eighteen percent in 1994.<sup>19</sup> In 2008 alone, China took in \$92.4 billion in foreign investment.<sup>20</sup>

This foreign money has helped build factories, create jobs, link China to international markets, and has led to important transfers of technology.<sup>21</sup> This new advanced technology has been a boon not just for China's economic growth, but also its military and intelligence communities and, as a result, national security.<sup>22</sup> In addition to fueling macro-economic development, China's economic growth has also allowed hundreds of millions of Chinese to move from subsistence living to the middle class.<sup>23</sup> These trends are especially apparent in coastal areas where foreign investors are given tax advantages.<sup>24</sup> In addition, economic liberalization has boosted exports, which rose 19 percent a year from 1981 to 1994. Strong export growth, in turn, appears to have fueled productivity growth in domestic industries.<sup>25</sup> China's move towards embracing foreign investment has not, however, been without some difficulty. China's past resistance to foreign investment has helped shape its national security review procedure under Article 12.

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<sup>16</sup> *How China Sees the World*, THE ECONOMIST, March 21, 2009, at 13.

<sup>17</sup> HU & KHAN. *supra* note 7, at 5.

<sup>18</sup> Fixed investment is investment in tangible capital goods (physical assets like machinery, land, buildings, vehicles, etc.) or in the replacement of depreciated capital goods. See generally Robert S. Chirinko, *Business Fixed Investment Spending: Modeling Strategies, Empirical Results, and Policy Implications*, 31 J. OF ECON. LIT. 1875 (1993).

<sup>19</sup> HU & KHAN. *supra* note 7, at 5.

<sup>20</sup> *China's FDI Up 23.6%*, XINHAU, Jan. 1, 2009, available at [http://news.xinhuanet.com/english/2009-01/15/content\\_10662757.htm](http://news.xinhuanet.com/english/2009-01/15/content_10662757.htm).

<sup>21</sup> HU & KHAN. *supra* note 7, at 5.

<sup>22</sup> Jordan Brandt, *Comparing Foreign Investment in China, Post-WTO Accession, With Foreign Investment in the United States, Post-9/11*, 16 PAC. RIM. L. & POL'Y. J. 285, 288 (2006).

<sup>23</sup> *How China Sees the World*, *supra* note 16, at 13.

<sup>24</sup> HU & KHAN. *supra* note 7, at 5.

<sup>25</sup> *Id.*

1. *China's Economic Growth Will Likely Stall if Foreign Direct Investment is Thwarted.*

China retained some problematic regulatory barriers to foreign investment. Regulations that unnecessarily confuse or discourage foreign investors may deter continued foreign investment in China.<sup>26</sup> Today's economic climate has exacerbated concerns about the effect of discouraging foreign investment. China has already suffered a 32.67 percent decline in foreign investment in the first few months of 2009.<sup>27</sup>

Under these conditions, maintaining a confusing foreign investment regulatory scheme could delay China's economic recovery. The slowdown in global investment, as well as the advantages that China has previously gleaned from foreign investment, provide ample incentives for China to formulate a national security review regime that promotes foreign investment in China.

2. *Regulation of Foreign Investment in China Has Been Gradually Liberalized, But Not Without Some Political Backlash*

The modern history of foreign direct investment in China is brief. Before 1983, Chinese law prohibited foreign investors from acquiring a stake in Chinese companies.<sup>28</sup> In the wake of the liberalization of the Chinese economy that started in 1978, the Chinese government began to relax regulation of both domestic and foreign capital investment.<sup>29</sup> From 1983 to 2003, the central government dealt with acquisitions of domestic companies by foreign entities on an ad hoc basis.<sup>30</sup> In April 2003, the Chinese government promulgated the Interim Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors ("Interim Regulations").<sup>31</sup> The Interim Regulations provided little more than a vague

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<sup>26</sup> For example, lower foreign investment and reduced exports has led to the closing of tens of thousands of factories and labor riots in some areas of China. Wong, *supra* note 3.

<sup>27</sup> *Foreign Investment in China Plunges in January*, CHINA DAILY, Feb. 16, 2009, [http://www.chinadaily.com.cn/china/2009-02/16/content\\_7480346.htm](http://www.chinadaily.com.cn/china/2009-02/16/content_7480346.htm). (last visited Nov. 20, 2009)

<sup>28</sup> Ken Davies, Senior Economist, OECD, *China's FDI Policies: The OECD's Policy Review and Possible Next Step*, 8 (Dec. 2, 2003), [http://www.oecdwash.org/PDFILES/china\\_fdi\\_update.pdf](http://www.oecdwash.org/PDFILES/china_fdi_update.pdf) (last visited Nov. 17, 2009).

<sup>29</sup> HU & KHAN. *supra* note 7, at 5.

<sup>30</sup> Davies, *supra* note 28, at 8.

<sup>31</sup> Waiguo touzi zhibing goujing nei qiye zhixing guiding [Interim Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors] (promulgated by the Ministry of Commerce, Mar. 7, 2003, effective Apr. 12, 2003) *translated in* [http://www.chinadaily.com.cn/bizchina/2006-04/17/content\\_569271.htm](http://www.chinadaily.com.cn/bizchina/2006-04/17/content_569271.htm) (P.R.C) (last visited Nov. 20, 2009) [hereinafter Interim Regulations].

outline of the process for foreign corporations to acquire controlling stakes in domestic Chinese enterprises.<sup>32</sup>

The Chinese government, motivated by a desire for international capital and an exponentially growing economy, has welcomed foreign investors by giving them more and more access to larger shares of Chinese companies.<sup>33</sup> However, in the past 15 years, the Chinese business community has grown increasingly concerned about foreign investment.<sup>34</sup> Many worry foreign enterprises were being given too many advantages in the emerging market and were thus gaining “capacity and market share in China, without adequate oversight by the central government.”<sup>35</sup>

The public battle between the Chinese Sany Corporation (“Sany”) and American Carlyle Group (“Carlyle Group”) catalyzed this sentiment. Both companies wished to take over China’s largest construction machinery manufacturer, Shanghai-based Xugong Construction Machinery Group (“XCMG”).<sup>36</sup> The Carlyle Group was the first to enter into an agreement with XCMG on the takeover.<sup>37</sup> After its own takeover bid was dismissed, however, Sany launched a popular opinion protest against the proposed Carlyle Group acquisition.<sup>38</sup> In the face of growing public discontent, the Ministry of Commerce suspended review of the acquisition, placing it in bureaucratic limbo for over a year until the Carlyle Group decided to scale back its initial investment from 85 percent to 50 percent.<sup>39</sup> The Carlyle Group changed its majority ownership position to secure central government approval of the deal, something that had become less and less likely as time dragged on.<sup>40</sup> The Ministry of Commerce had effectively used its review discretion to quash a politically sensitive takeover bid. This tension between liberalizing economic policies, reacting to political pressure, and safeguarding national security has been at the heart of China’s recent adoption of new rules that provide for national security review of foreign investment.

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<sup>32</sup> *Id.*

<sup>33</sup> Peter A. Neumann & Tony Zhang, *China’s New Foreign-Funded M&A Provisions: Greater Legal Protection or Legalized Protectionism?*, 20 CHINA LAW & PRAC. 21, 21 (2006).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *War of Words in Company Takeover Battle*, PEOPLE’S DAILY ONLINE, June 16, 2006, [http://english.peopledaily.com.cn/200606/16/eng20060616\\_274537.html](http://english.peopledaily.com.cn/200606/16/eng20060616_274537.html) (last visited October 29, 2009).

<sup>37</sup> *Id.*

<sup>38</sup> Russell Flannery, *A China That Can Say No*, FORBES.COM, Sept. 18, 2006, <http://www.forbes.com/global/2006/0918/096.html> (last visited Nov. 17, 2009).

<sup>39</sup> *Largest Machine Tool Manufacturer to Sell Shares*, XINHUA, Nov. 29, 2006, [http://news.xinhuanet.com/english/2006-11/29/content\\_5406343.htm](http://news.xinhuanet.com/english/2006-11/29/content_5406343.htm) (last visited October 29, 2009).

<sup>40</sup> *Id.*

3. *China Adopts the 2006 M&A Provisions to Revise and Expand its Review of Foreign Direct Investment*

The same year the Carlyle Group's takeover was thwarted, the Ministry of Commerce promulgated and adopted the revised 2006 M&A Provisions.<sup>41</sup> One scholar has suggested that the new provisions were enacted in response to the Carlyle Group's takeover bid and perceived hypocrisy in the United States' treatment of foreign investment.<sup>42</sup>

China may also have been motivated to adopt the 2006 M&A Provisions due to its recent frustrations with the United States' direct foreign investment regulations. In 1990, President George H.W. Bush ordered the first, and only, formal divestment.<sup>43</sup> President George H.W. Bush ordered a Chinese company, China National Aero-Technology Import and Export Corporation ("CATIC"), to divest any interest in MAMCO Manufacturing, Inc. ("MAMCO"), a Seattle-based commercial aircraft manufacturer.<sup>44</sup> "The American public thought that CFIUS was not doing enough to thwart attempts by foreign governments to take control of major U.S. industries."<sup>45</sup> CFIUS had been "closely monitor[ing] recent investment attempts in the United States by the People's Republic of China since it [was] the last remaining communist threat."<sup>46</sup> CFIUS was especially suspicious of CATIC, which "had a reputation for disregarding foreign-export-control laws in order to obtain sensitive Western technology."<sup>47</sup> This transaction led to the Byrd Amendment, which was enacted to "tighten[] . . . the CFIUS review process."<sup>48</sup>

In 2005, the United States again stepped in to block a takeover by a Chinese company. Congress intervened to prevent China National Offshore Oil Company ("CNOOC") from acquiring California-based Unocal.<sup>49</sup> This

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<sup>41</sup> 2006 M&A Provisions, *supra* note 9.

<sup>42</sup> *See* Deas, *supra* note 11.

<sup>43</sup> Jose E. Alvarez, *Political Protectionism and United States International Investments Obligations in Conflict: The Hazards of Exon-Florio*, 30 VA. J. INT'L L. 1, 96 (1989).

<sup>44</sup> *Id.*

<sup>45</sup> Jason Cox, *Regulation of Foreign Direct Investment After the Dubai Ports Controversy: Has the U.S. Government Finally Figured Out How to Balance Foreign Threats to National Security Without Alienating Foreign Companies?*, 34 J. OF CORP. L. 293, 299 (2008).

<sup>46</sup> *Id.*

<sup>47</sup> Jim Mendenhall, *United States: Executive Authority to Divest Acquisitions Under the Exon-Florio Amendment--The MAMCO Divestiture*, 32 HARV. INT'L L.J. 286, 290 (1991).

<sup>48</sup> Matthew R. Byrne, *Protecting National Security and Promoting Foreign Investment: Maintaining the Exon-Florio Balance*, 67 OHIO ST. L.J. 849, 868 (2006).

<sup>49</sup> H.R. Res. 344, 109th Cong. (2005).



intervention was seen as necessary in the United States,<sup>50</sup> but was decried in China.<sup>51</sup>

As the acquisition of Unocal by CNOOC progressed, it was met by increased political opposition.<sup>52</sup> Members of the U.S. Congress voiced their objections, stating “CNOOC's proposal should be rejected on security grounds.”<sup>53</sup> The Unocal debate culminated with the House of Representatives approving a non-binding resolution which stated that the takeover would “threaten to impair the national security of the United States” and urging President Bush to block the deal.<sup>54</sup> On August 1, Unocal's board of directors recommended that shareholders accept Chevron's offer because the CNOOC bid did not “compensate Unocal shareholders for the ‘higher risk of the CNOOC transaction.’”<sup>55</sup> CNOOC subsequently withdrew of its offer and Unocal shareholders voted to approve Chevron's offer.<sup>56</sup> Soon after this incident, China enacted its own version of national security review in Article 12.<sup>57</sup>

China's revised law now consists of sixty-one provisions, a substantial expansion of the twenty-six provisions in the interim rules.<sup>58</sup> Most of the additional provisions extend and clarify previous versions of the vague interim rules.<sup>59</sup> There are some pronounced differences, however.<sup>60</sup> Some of the revised rules are likely to smooth the way for foreign investors who

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<sup>50</sup> Emad Mekay, *China Oil Bid Tests US Free Market Rhetoric*, ASIA TIMES ONLINE, July 15, 2005, <http://www.atimes.com/atimes/China/GG15Ad01.html> (last visited Nov. 17, 2009) (citing a poll stating that 73% of those polled disapproved of the prospective merger).

<sup>51</sup> See, e.g., Peter S. Goodman, *China Tells Congress to Back off Businesses*, WASH. POST FOREIGN SERVICE, July 5, 2005, <http://www.washingtonpost.com/wp-dyn/content/article/2005/07/04/AR2005070400551.html> (last visited Nov. 17, 2009).

<sup>52</sup> Ben White & Justin Blum, *Chinese Consider Assurances to Unocal*, WASH. POST, July 14, 2005, at D3.

<sup>53</sup> *Id.* (Reasoning that “China's purchase of Unocal would dramatically increase its leverage over critical players and key U.S. allies in the global war on terror and therefore its leverage over U.S. interests in those regions.”).

<sup>54</sup> H.R. Res. 344, 109th Cong. (2005).

<sup>55</sup> *CNOOC Withdrawal Clears Way for Chevron Merger*, EAST BAY BUS. TIMES, Aug. 2, 2005, <http://sanfrancisco.bizjournals.com/eastbay/stories/2005/08/01/daily11.html> (last visited Nov. 17, 2009).

<sup>56</sup> Justin Blum, *Shareholders Vote in Favor Of Unocal Acquisition.*, WASH. POST, Aug. 11, 2005 at D1.

<sup>57</sup> See Deas, *supra* note 11, at 1802-03.

<sup>58</sup> Compare 2006 M&A Provisions, *supra* note 9 (providing more detailed rules for the regulation of foreign investment), with Interim Regulations, *supra* note 31 (providing only a basic outline for the regulation of foreign investment).

<sup>59</sup> *Id.*

<sup>60</sup> See, e.g., BAKER & MCKENZIE, CLIENT ALERT: CHINA AMENDS FOREIGN M&A REGULATIONS 1 (2006), <http://www.bakernet.com/NR/rdonlyres/CDDDA47C-B52E-40AC-9325-95DB28803733/40679/ChinaAlertMASep061.pdf> (last visited Nov. 22, 2009). (“The key changes introduced by the Acquisition Regulations relate to the reporting procedures to, and approval by, MOFCOM.”).

would otherwise be unable to acquire ownership in Chinese companies.<sup>61</sup> However, other articles, such as Article 12, which provides an opaque blueprint for national security review of foreign investments, have caused a great deal of concern among foreign investors.<sup>62</sup>

*B. The Statutes and Regulations Providing for National Security Review of Foreign Investment in the United States Have Been Adjusted Over Time to Provide Balance Between Security and Efficiency of Review*

In comparison to the relatively new and as yet undefined system for national security review under Article 12, the United States' CFIUS procedures are relatively clear, largely as a result of constant tweaking throughout the last 35 years. The original grant of authority to the President to review and regulate foreign investment has been altered due to changing national security and foreign investment needs. This tweaking has left the United States with a system for reviewing foreign investment that strikes a balance between encouraging investment and protecting national security.

*1. The United States Has Historically Regulated Foreign Investment as a Means of Addressing National Security Concerns*

The modern era of regulation of foreign direct investment in the United States began in the 1970s when Congress began investigating the large inflow of foreign direct investment.<sup>63</sup> As a result of these investigations, Congress passed the Foreign Investment Study Act of 1974 and the International Investment Survey Act of 1976.<sup>64</sup> These Acts allowed the President to collect information on international investment and provide information to Congress.<sup>65</sup> Governmental investigation under the Foreign Investment Study Act of 1974 led Congress to conclude that “the United

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<sup>61</sup> See, e.g., 2006 M&A Provisions, *supra* note 9, arts. 27-29 (allowing acquisitions of domestic enterprises by foreign investors through the “payment of equity interests”). Before these rules, this method of payment was not allowed. See Interim Regulations, *supra* note 31 (not allowing the use of equity interests as a form of payment in an acquisition).

<sup>62</sup> See, e.g., BAKER & MCKENZIE, *supra* note 60, at 1. (“[T]hese new provisions have sparked concerns among foreign investors that future acquisitions will be subject to much tighter control and further scrutiny by the Chinese government.”).

<sup>63</sup> See SARA L. GORDON & FRANCIS A. LEES, FOREIGN MULTINATIONAL INVESTMENT IN THE UNITED STATES 230-31 (1986).

<sup>64</sup> *Id.* at 231.

<sup>65</sup> *Id.* Congress, under the Defense Production Act of 1950, originally granted the power to the President to investigate and monitor industries that could fill a role in the national defense of the United States. Defense Production Act, 50 U.S.C. App. §§ 2161-70 (1950).

States lacked a coherent mechanism to monitor foreign investment.”<sup>66</sup> President Ford decided that there was a “responsibility within the Executive Branch for monitoring the impact of foreign investment in the United States . . . and for coordinating the implementation of the United States policy on such investment” and delegated that responsibility to CFIUS.<sup>67</sup>

But the United States quickly determined that these laws alone were not enough. Over the next thirty years, additional laws were passed which today regulate national security review of foreign investment. These include the Exon-Florio Amendment, the Byrd Amendment, and the Foreign Investment and National Security Act of 2007 (“FINSA”).

## 2. *The Exon-Florio Amendment*

During the 1980s, increased foreign direct investment heightened public concerns that some foreign firms’ acquisitions of, and mergers with, U.S. businesses might be undermining national security.<sup>68</sup> Complaints escalated in 1987 when Fujitsu, a Japanese electronics company, proposed to acquire Fairchild Semiconductor Corporation.<sup>69</sup> Fairchild was widely seen as the “mother company” of Silicon Valley, and many viewed the semiconductor industry as critical to the development of high-technology weaponry.<sup>70</sup> In addition, some observers argued that permitting Fujitsu to acquire Fairchild would further encourage anticompetitive practices by Japanese businesses and foster U.S. dependence on Japanese suppliers in the dual-use technology market.<sup>71</sup> Congressional committees held hearings on whether and how the U.S. government should block the Fujitsu/Fairchild transaction.<sup>72</sup> Members of Congress concluded that additional statutory authority was needed to authorize the blocking of foreign direct investment<sup>73</sup> and proposed the Foreign Investment, National Security, and Essential Commerce Amendment (“Exon-Florio Amendment”) to the Technology

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<sup>66</sup> Deborah M. Mostaghel, *Dubai Ports World Under Exon-Florio: A Threat to National Security or a Tempest in a Seaport?*, 70 ALB. L. REV. 583, 589 (2007).

<sup>67</sup> Exec. Order No. 11,858, 3 C.F.R. 990 (1975).

<sup>68</sup> Alvarez, *supra* note 43, at 56-63

<sup>69</sup> *Id.* at 57.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 58.

<sup>72</sup> See, e.g. *Acquisitions by Foreign Companies: Hearing Before the Senate Committee on Commerce, Science, and Transportation*, 100th Cong., 1st Sess. 17 (1987) (statement of Commerce Secretary Baldrige) [hereinafter June 10, 1987 Hearings].

<sup>73</sup> ABA Section of International Law Report on Exon-Florio Amendments 2007, <http://meetings.abanet.org/webupload/commupload/IC752000/newsletterpubs/Section%27sReportwithRecommendationsonExon-FlorioProcess.doc> (last visited October 29, 2009) [hereinafter ABA Report].

Competitiveness Act.<sup>74</sup> The original Exon-Florio Amendment would have authorized the President to disrupt any foreign takeover, merger, acquisition, joint venture or licensing agreement that threatened either the U.S. national security or “essential commerce.”<sup>75</sup>

This proposal encountered strong opposition among many members of Congress who were concerned that the inclusion of the “essential commerce” language would chill foreign investment to the detriment of the U.S. economy and invite retaliation against U.S. investors abroad.<sup>76</sup> As a result, the Senate Commerce Committee proposed to limit the “essential commerce” criterion to “essential commerce which affects national security.”<sup>77</sup> However, this improvement was deemed inadequate and after much debate, the legislation was adopted without any reference to “essential commerce.”<sup>78</sup>

Furthermore, the 1988 Trade Act Conference Report specified that Congress expected the Exon-Florio Amendment to be implemented in a manner consistent with U.S. international obligations, which include many open-investment commitments.<sup>79</sup> Congress made clear that it expected that the Exon-Florio Amendment would not be used as a protectionist tool to block international competition.<sup>80</sup> The revised provision was adopted with the rest of the 1988 Trade Act on August 23, 1988, as an amendment to the Defense Production Act.<sup>81</sup>

### 3. *The Byrd Amendment*

In response to perceived threats to national security, the Exon-Florio Amendment has undergone major reforms in an attempt to clarify CFIUS

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<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> Alvarez, *supra* note 43, at 63. See June 10, 1987 Hearings, *supra* note 72, at 65-76. Senator Exon recognized this concern and stated in his initial proposal that he “in no way intended to ‘chill’ foreign investment.” Alvarez, *supra* note 43, at 63. Thus, from its inception, the Exon-Florio Amendment was characterized as not intended to block foreign investment, but rather to provide the authority needed in extraordinary circumstances to protect national security. The debate over the Exon-Florio Amendment’s “essential commerce” provision further illustrates the strong sentiment against impeding foreign investment on economic grounds. On behalf of the Reagan Administration, Secretary of Commerce Malcolm Baldrige opposed consideration of any factors not directly related to national security, including the “essential commerce” provision. June 10, 1987 Hearings, *supra* note 72. Other opponents of the original proposal echoed these views. *Id.*

<sup>77</sup> S. Rep. No. 100-80, at 25 (1987).

<sup>78</sup> 50 U.S.C. App. § 2170.

<sup>79</sup> H.R. REP. NO. 100-576, at 523 (1988), *reprinted in* 1988 U.S.C.C.A.N. 1547, 1556, 1988 WL 170253. See, e.g., Agreement Between the United States of America and Japan Regarding the Guaranty of Investments, U.S.-Japan, Mar. 8, 1954, 5 U.S.T. 791.

<sup>80</sup> H.R. REP. NO. 100-576, at 523 (1988).

<sup>81</sup> 50 U.S.C. App. § 2170.

procedures.<sup>82</sup> In 1993, Congress amended the Exon-Florio Amendment through part of the National Defense Authorization Act for Fiscal Year 1993, commonly known as the Byrd Amendment.<sup>83</sup> The Amendment created a mandatory review of any foreign company that was “controlled by or acting on behalf of a foreign government” and seeking to merge or take over a U.S. company.<sup>84</sup> Before the Byrd Amendment, all CFIUS reviews were discretionary.<sup>85</sup> By making review obligatory in certain cases, the Byrd Amendment enhanced scrutiny of acquisition by businesses owned by foreign governments.<sup>86</sup>

#### 4. *The Foreign Investment and National Security Act of 2007 (“FINSA”)*

Congress passed FINSA<sup>87</sup> in direct response to Dubai Ports World's (“DP World”) attempt to acquire operations of American ports.<sup>88</sup> The Dubai Ports scandal occurred in February 2006, when DP World attempted to purchase Peninsular and Oriental Steam Navigation Company (“P&O”), a British company that operated five U.S. ports.<sup>89</sup> DP World is a company owned in large part by the government of the United Arab Emirates (“UAE”) through a holding company.<sup>90</sup> DP World voluntarily approached CFIUS about a review to approve the buyout.<sup>91</sup> CFIUS signed off within thirty days, as opposed to the forty-five day period required by the Byrd Amendment for foreign-government-owned businesses.<sup>92</sup>

When the story first broke, the American public and many members of Congress were openly critical of what they considered a “rubber-stamping” by CFIUS.<sup>93</sup> “This transaction apparently did not come to the attention of Congress until after it had been approved by CFIUS, prompting a wave of protests by U.S. politicians . . . .”<sup>94</sup> Critics believed DP World created a

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<sup>82</sup> See Mostaghel, *supra* note 66, at 591-603.

<sup>83</sup> *Id.* at 600-01.

<sup>84</sup> 50 U.S.C. App. § 2170(b).

<sup>85</sup> Mostaghel, *supra* note 66, at 601-03.

<sup>86</sup> *Id.* at 603.

<sup>87</sup> Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007) (amending 50 U.S.C. App. § 2170).

<sup>88</sup> Cox, *supra* note 45, at 300.

<sup>89</sup> EDWARD M. GRAHAM & DAVID M. MARCHICK, INST. FOR INT'L ECON., US NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT 139 (2006), at 139.

<sup>90</sup> Mostaghel, *supra* note 66, at 606-07.

<sup>91</sup> *Id.* at 606.

<sup>92</sup> *Id.*

<sup>93</sup> GRAHAM & MARCHICK, *supra* note 89, at 136-39.

<sup>94</sup> ABA Report, *supra* note 73, at 10. The politicians speaking out against the proposed merger included “Robert Ehrlich, the Republican governor of Maryland and Jon Corzine, his Democratic peer in New Jersey; Charles Schumer and Hillary Clinton, democratic senators of New York; Pete King, the

national security risk because of “the UAE's history as an operational and financial base for the hijackers who carried out the attacks of Sept[ember] 11, 2001.”<sup>95</sup> Amid backlash from Congress and the American public, DP World voluntarily divested its ownership in P&O.<sup>96</sup> Congress responded by approving FINSA,<sup>97</sup> created by Senators Chris Dodd and Richard Shelby to “overhaul how the government reviews foreign takeovers of U.S. companies.”<sup>98</sup>

Signed into law by President George W. Bush on July 26, 2007,<sup>99</sup> FINSA purports to clarify the scope of national security review in the Exon-Florio Amendment.<sup>100</sup> It also enhances the reporting requirements for CFIUS by adding to the transparency of CFIUS reviews.<sup>101</sup> On December 22, 2008, a new set of regulations seeking to clarify and improve the CFIUS review process also went into effect (“CFIUS regulations”).<sup>102</sup> In drafting FINSA and the new regulations a number of proposals to insert the type of “essential commerce” language originally included in Senator Exon’s amendment were rejected.<sup>103</sup> Thus, over the years, Congress and various administrations have succeeded in resisting efforts to make CFIUS review a tool for economic protectionism, while still allowing for the legislative changes that leave FINSA in its current regulatory state. This history of specific statutory and regulatory controls on the powers of CFIUS is in

Republican chairman of the House Homeland Security Committee; and Bill Frist, the Senate majority leader.” *Id.*

<sup>95</sup> Sean Alfano, *Dems. Attack Port Takeover By Arabs*, CBS NEWS, Feb. 20, 2006, <http://www.cbsnews.com/stories/2006/02/19/national/main1330431.shtml> (last visited Nov. 17, 2009).

<sup>96</sup> Shakir Husain, *DP World Completes P&O Unit Sale to AIG*, GULFNEWS, Mar. 17, 2007, [http://archive.gulfnews.com/indepth/pando/more\\_stories/10111732.html](http://archive.gulfnews.com/indepth/pando/more_stories/10111732.html) (last visited Nov. 17, 2009). DP World sold its complete ownership in P&O to the American company AIG Global Investment Group.

<sup>97</sup> Foreign Investment and National Security Act 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007) (amending 50 U.S.C. App. § 2170).

<sup>98</sup> Peter Kaplan, *Senators Plan New Bill on Foreign Takeover Reviews*, REUTERS, May 10, 2007, <http://www.reuters.com/article/mergersNews/idUSN1028906020070510> (last visited Nov. 17, 2009).

<sup>99</sup> Memorandum from Paul, Weiss, Rifkind, Wharton & Garrison LLP, President Bush Signs Exon-Florio Reform Legislation, 1 (July 31, 2007) <http://www.paulweiss.com/files/Publication/f17d8d40-43ba-4ac2-9f0e-0188c4f05605/Presentation/PublicationAttachment/c04e8271-9fb6-4ca9-9886-0860a397771e/31Jul07Memo.pdf> (last visited Nov. 17, 2009).

<sup>100</sup> Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons; Final Rule, 73 Fed. Reg. 226, 70702 (Dep’t of the Treasury Nov. 21, 2008), *available at* <http://www.treas.gov/offices/international-affairs/cfius/docs/CFIUS-Final-Regulations-new.pdf>.

<sup>101</sup> *Id.*

<sup>102</sup> Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. § 800.210 (2008).

<sup>103</sup> *E.g., compare*, H.R. 4881, 109th Cong. § 2(d)(3) (2005), at § 2(d)(3) (proposing a definition of “Critical Infrastructure” that included a “system or asset. . . vital to . . . national *economic* security. . .”) (emphasis added), *with*, 50 U.S.C. App. § 2170(a)(67) (defining “Critical Infrastructure” as “systems and assets. . . vital to . . . national security”), *and*, 31 C.F.R. § 800.208 (both defining “Critical Infrastructure” as a “systems and or assets. . . vital to . . . national security.”).

contrast to Article Twelve, which provides few details or controls on its implementation.

### III. CHINA'S VERSION OF NATIONAL SECURITY REVIEW IS OVERBROAD AND VAGUELY DEFINED, AND COULD DETER FUTURE FOREIGN INVESTMENT AND NEGATIVELY AFFECT EFFICIENT AND EFFECTIVE REVIEW

Article Twelve of the 2006 M&A Provisions provides little guidance on the nature of China's national security review for either Chinese authorities charged with the task or foreign investors considering an acquisition. Article Twelve allows the Ministry of Commerce to conduct a review of any investment that results in actual foreign investor control over an enterprise that: 1) "involves [a] major industry," 2) "has or may have ... influence on ... state security," 3) involves a "famous [Chinese] trademark," or 4) is a business with a "name of long history . . . ."<sup>104</sup> This system for national security review of foreign investment is underdeveloped to the point of creating uncertainties for foreign investors and governmental authorities alike. Article Twelve is also flawed in that it fails to provide procedural safeguards. Specifically, Article Twelve fails to: 1) define which transactions are subject to national security review, 2) provide the procedural requirements and criteria for national review, and 3) provide protections to parties after the approval and completion of a transaction.

#### A. *The 2006 M&A Provisions Fail to Define Which Transactions Are Subject to National Security Review*

The lack of specificity in defining which transactions are covered by Article Twelve makes it difficult to predict which transactions will be subjected to review, and on what basis. Depending on the interpretation of terms like "national security," "state security," "major industry," and "famous trademark or having a name of long history" either a small sector of the Chinese economy or practically its entirety could be subject to the mandatory reporting requirements of Article Twelve. While "state security" and "national security" are undefined in Article Twelve, there is some evidence that Chinese authorities intend to read them quite broadly.<sup>105</sup> For

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<sup>104</sup> 2006 M&A Provisions, *supra* note 9, art. 12.

<sup>105</sup> See, e.g., Thomas R. Howell et al., *China's New Anti-Monopoly Law: A Perspective from the United States*, 18 PAC. RIM L. & POL'Y J. 53, 92 (2008) (discussing plans to use the national security provisions contained in the M&A Rules and the Anti-Monopoly Law to protect the Chinese soy bean industry from foreign investment). China has heightened these fears of protectionist use of merger review by rejecting the proposed merger between Coca-Cola and China Huiyuan Juice Group. Michael Orey, *M&A: Behind the Heat on Global Deals*, BUS. WEEK, April 6, 2009, at 73. The move was characterized by

example, China has recently delayed or rejected investments in a cookware company,<sup>106</sup> a paper producer,<sup>107</sup> retailers, soybean producers, automakers, cement producers, and steel manufacturers<sup>108</sup> for “national security” reasons. The lack of definitions of key terms in Article Twelve contributes to fears that China’s national security review will be applied broadly and used in a protectionist manner.

Additionally, Article Twelve restricts the Ministry of Commerce’s authority to review investments that would grant a foreign entity the “right to control,”<sup>109</sup> but “right to control” is not defined. Whether “the right to control” extends only to majority shareholders and dominant minority shareholders or to any stakeholder is unknown. Given the vast number of ways in which an investor can gain even some miniscule degree of control over business entities, the phrase “control,” as left undefined by Article Twelve, is extremely ambiguous. This leaves open the possibility that investment by silent minority shareholders or contractual partners, who may exercise some limited degree of influence on limited matters, may be subjected to advanced “national security” screening. Such a potential screening requirement would unreasonably force stakeholders in Chinese enterprises to examine nearly every transaction that the enterprise might make for as-yet-undefined “national security” concerns, as even minor contractual obligations could trigger the control provision of Article Twelve.

*B. The 2006 M&A Provisions Fail to Provide Procedural Requirements and Criteria for National Security Review*

A second major defect of Article Twelve is its failure to specify the contents of reports that must be submitted to the Ministry of Commerce. Article Twelve states that:

If a foreign investor merges or acquires a domestic enterprise and obtains the actual right to control it, and it involves major industry, has or may have the influence on the state security or caused the transference of the actual right of the domestic

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George L. Paul, an antitrust lawyer of the law firm White & Case, as “nothing less than a frontal assault on foreign investment disguised as merger review . . .” *Id.*

<sup>106</sup> Keith Bradsher, *China Casts Wary Eye on Foreign Takeovers*, N.Y. TIMES, Aug. 27, 2007, [http://www.nytimes.com/2007/08/27/business/worldbusiness/27iht-monopoly.4.7275218.html?\\_r=1](http://www.nytimes.com/2007/08/27/business/worldbusiness/27iht-monopoly.4.7275218.html?_r=1) (last visited Nov. 17, 2009).

<sup>107</sup> Eileen Francis Schneider, Note, *Be Careful What You Wish For: China's Protectionist Regulations of Foreign Direct Investment Implemented in the Months Before Completing WTO Accession*, 2 BROOK. J. CORP. FIN. & COM. L. 267, 270 (2007).

<sup>108</sup> *Id.* at 274.

<sup>109</sup> 2006 M&A Provisions, *supra* note 9, art. 12



enterprise owning famous trademark or having a name of long history, the person concerned *shall submit a report* on it to the Ministry of Commerce.<sup>110</sup>

If the parties to the transaction fail to submit what the Ministry of Commerce feels is an adequate report and the Ministry of Commerce determines that the “merger or acquisition does cause or may cause serious influence on the state economic security,” the Ministry of Commerce and other departments may stop the proposed transaction or, if the transaction has already occurred, force a divestment of ownership and assets.<sup>111</sup>

Article Twelve also grants the Ministry of Commerce blanket authority to take any other measures necessary “to eliminate the influence of the merger or acquisition on the state security.”<sup>112</sup> The mandatory reporting language of Article Twelve<sup>113</sup> and the seriousness with which China enforces its foreign investment rules<sup>114</sup> may draw transactions that would normally be considered far afield of “national security” concerns into Article Twelve review. This is especially true when viewed in combination with the vague language about what constitutes a transaction covered by Article Twelve.<sup>115</sup> Given the fact that underreporting can cause the Ministry of Commerce and other affiliated agencies to take the drastic and damaging step of forcing a divestment, parties are likely to over-report, which wastes the time and energy of the party submitting the report, and burdens the administrative body charged with reviewing it.

The 2006 M&A Provisions provide no timelines for national security reviews. Obviously, having a timeline to plan around is important for parties to review transactions. Predictability of the regulatory process influences where investors decide to invest their capital and valuation of assets.<sup>116</sup> The addition of timelines “helps to speed up the review process of the law enforcement authorities, increases review efficiency, lowers law enforcement costs to a certain extent, and protects the interests of the

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<sup>110</sup> 2006 M&A Provisions, *supra* note 9, art. 12 (emphasis added).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> Steve Dickinson, *Foreign Direct Investment In China: It All Just Changed*, CHINA LAW BLOG, March 6, 2008, [http://www.chinalawblog.com/2008/03/foreign\\_direct\\_investment\\_in\\_c.html](http://www.chinalawblog.com/2008/03/foreign_direct_investment_in_c.html) (last visited Oct. 21, 2009).

<sup>115</sup> See 2006 M&A Provisions, *supra* note 9, art. 12.

<sup>116</sup> See Alvarez, *supra* note 43, at 80. During the immediate aftermath of the establishment of CFIUS, investors “started cutting the price tags of companies whose sale to foreign bidders could raise a national security question.” *Id.* Defense firms, particularly, struggled to find investors, despite the fact that such firms were being undervalued by up to 25%. *Id.* at 80 n.434.

parties . . . .”<sup>117</sup> Unfortunately, Article Twelve fails to provide timelines that would yield these advantages. This is of particular concern when investors consider that, in the past, Chinese authorities have allowed review of transactions to stretch on for years.<sup>118</sup>

The 2006 M&A Provisions are also silent as to what factors will be considered when conducting a “state security” or “national security” review. There is value both to parties and to governmental actors in “putting policy on the record [which] . . . temper[s] the arbitrary character of approvals and disapprovals and preclude[s] . . . stalemates over technicalities.”<sup>119</sup> When this ambiguity is combined with the lack of a definition of the terms “state security” and “national security” and the lack of any guidance on what should be contained in the “national security report,” the Article Twelve review process becomes a guessing game for the parties involved.

*C. The 2006 M&A Provisions Fail to Provide Protection to Parties to Previously Approved Transactions*

Finally, the 2006 M&A Provisions do not contain a “safe harbor” provision for approved transactions. Under Article Twelve, the Ministry of Commerce is not prohibited from reopening previously approved transactions, without cause. The failure to provide a “safe harbor” provision causes additional uncertainty to foreign investors and may dissuade them from pursuing national security related transactions even if the transactions are initially approved by the Ministry of Commerce. Even if China is concerned about having the chance to later review transactions that may have been approved based upon fraud or misrepresentation, a presumptive “safe harbor” absent such a showing would reassure investors and serve governmental purposes. For these reasons the national security review provided for by the 2006 M&A Provisions leaves much to be desired, and should be amended.

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<sup>117</sup> Zhenguo Wu, *Perspectives on the Chinese Anti-Monopoly Law*, 75 ANTITRUST L. J. 73, 91 (2008).

<sup>118</sup> See, e.g., *supra* Part II.A.2. (discussing the quashed takeover of XCMG by the Carlyle Group).

<sup>119</sup> DANIEL H. ROSEN, INST. FOR INT’L ECON., BEHIND THE OPEN DOOR: FOREIGN ENTERPRISES IN THE CHINESE MARKETPLACE 23 (1999).

IV. ARTICLE TWELVE OF THE 2006 M&A PROVISIONS SHOULD BE AMENDED TO PROVIDE MORE TRANSPARENCY AND PREDICTABILITY TO NATIONAL SECURITY REVIEW

The lack of clarity in Article Twelve may have the unintended consequence of discouraging beneficial foreign direct investment in China. “[U]ncertainty about the rule’s content can cause individuals to protect themselves by overcomplying, that is, foregoing behavior in which they have a right to engage.”<sup>120</sup> Here, the discouraged behavior is investing in China.

Withholding approval from foreign acquisitions without standards for doing so, and the uncertainty that follows, has resulted in a decline in foreign investment in China in the past.<sup>121</sup> Between January and August 2006, after beginning to apply increased scrutiny to foreign investments without a regulatory structure in place, China experienced a 2.1% decrease in foreign investment compared to the same months in 2005, and the pace continued to slow as the 2006 M&A Regulations were announced.<sup>122</sup> Indeed, in August 2006 China received 8.5% less foreign investment than August 2005.<sup>123</sup>

China can solve a number of the problems posed by the lack of clarity in Article Twelve by revising it to remove ambiguity in ways that reflect the advantages of the U.S. review process, which, while imposing somewhat flexible “standards” instead of hard and fast “rules,”<sup>124</sup> provides guidance to both foreign investors and regulators. These include: 1) defining the terms “national security,” “state security,” and “major industry;” 2) defining “famous trademark or having a name of long history;” 3) clarifying “right to control;” 4) creating additional procedural guidelines; 5) creating timetables for action or inaction by the Ministry of Commerce; and 6) creating a “safe harbor” guarantee.

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<sup>120</sup> Gillian K. Hadfield, *Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law*, 82 CAL. L. REV. 541, 544 (1994).

<sup>121</sup> Clay Chandler, *China Takes a Break*, FORTUNE, Oct. 16, 2006, at 37.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> For examinations of the difference between rules and standards, see Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 71-79 (1983); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 571-86 (1992); Eric A. Posner, *Standards, Rules, and Social Norms*, 21 HARV. J.L. & PUB. POL’Y 101, 107-16 (1997).

A. *China Should Define “National Security,” “State Security,” and “Major Industry,” To Remove Ambiguity as to Which Transactions Are Subject to National Security Review*

Defining the terms “national security,” “state security,” and “major industry,” and supplying factors for the Ministry of Commerce to apply in conducting national security reviews would go a long way in assuaging fears that Article Twelve will be used as a protectionist tool. In addition, these changes would streamline review of transactions and help ensure a greater degree of predictability and uniformity in the outcome of the reviews.

China should look to the CFIUS regulations<sup>125</sup> in crafting the factors to be considered in determining whether a transaction is covered under Article Twelve’s definitions of “national security,” “state security,” and “major industry.”<sup>126</sup> The CFIUS regulations list eleven factors and numerous sub-factors to be considered by CFIUS and the President when reviewing the national security implications of foreign investments.<sup>127</sup>

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<sup>125</sup> See 50 U.S.C. App. § 2170.

<sup>126</sup> 50 U.S.C. App. § 2170(f).

<sup>127</sup> *Id.* The full list of factors to be considered is “(1) domestic production needed for projected national defense requirements, (2) the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services, (3) the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet the requirements of national security, (4) the potential effects of the proposed or pending transaction on sales of military goods, equipment, or technology to any country-- (A) identified by the Secretary of State-- (i) under section 6(j) of the Export Administration Act of 1979 [section 2405(j) of this Appendix], as a country that supports terrorism; (ii) under section 6(l) of the Export Administration Act of 1979 [section 2405(l) of this Appendix], as a country of concern regarding missile proliferation; or (iii) under section 6(m) of the Export Administration Act of 1979 [section 2405(m) of this Appendix], as a country of concern regarding the proliferation of chemical and biological weapons; (B) identified by the Secretary of Defense as posing a potential regional military threat to the interests of the United States; or (C) listed under section 309(c) of the Nuclear Non-Proliferation Act of 1978 on the ‘Nuclear Non-Proliferation-Special Country List’ (15 C.F.R. Part 778, Supplement No. 4) or any successor list; (5) the potential effects of the proposed or pending transaction on United States international technological leadership in areas affecting United States national security; (6) the potential national security-related effects on United States critical infrastructure, including major energy assets; (7) the potential national security-related effects on United States critical technologies; (8) whether the covered transaction is a foreign government-controlled transaction, as determined under subsection (b)(1)(B) of this section; (9) as appropriate, and particularly with respect to transactions requiring an investigation under subsection (b)(1)(B) of this section, a review of the current assessment of-- (A) the adherence of the subject country to nonproliferation control regimes, including treaties and multilateral supply guidelines, which shall draw on, but not be limited to, the annual report on ‘Adherence to and Compliance with Arms Control, Nonproliferation and Disarmament Agreements and Commitments’ required by section 2593a of Title 22; (B) the relationship of such country with the United States, specifically on its record on cooperating in counter-terrorism efforts, which shall draw on, but not be limited to, the report of the President to Congress under section 7120 of the Intelligence Reform and Terrorism Prevention Act of 2004; and (C) the potential for transshipment or diversion of technologies with military applications, including an analysis of national export control laws and regulations; (10) the long-term projection of United States requirements for sources of energy and other critical resources and

These factors include domestic production needs,<sup>128</sup> effects on critical infrastructure,<sup>129</sup> and long term material and energy needs.<sup>130</sup> However, the Chinese version need not be as exhaustive. A short list of five or six important factors would provide guidance to foreign investors, both when considering investments and preparing for review.

China's Anti-Monopoly Law provides six factors to be considered during anti-competition review, including a catchall factor allowing for flexibility.<sup>131</sup> The listed factors are:

1. The involved business operators' market share in the relevant market and their controlling power over that market;
2. The degree of market concentration in the relevant market;
3. The impact of the concentration of business operators on the market access and technological advancements;
4. The impact of the concentration of business operators on the consumers and other business operators;
5. The impact of the concentration of business operators on the national economic development; and
6. Other factors that may affect the market competition and shall be considered as deemed by the Anti-monopoly Law Enforcement Agency under the State Council.<sup>132</sup>

This list could also serve as a model for China in crafting its factors for national security review.

*B. China Should Publicize What Constitutes a "Famous Trademark or Having a Name of Long History"*

In defining "famous trademark or having a name of long history," China should seek to publicize as much information about which brands are covered as possible. Currently, "famous trademarks" can be certified by a People's Court and Chinese administrative agencies.<sup>133</sup> But, because People's Court certifications are not listed publicly, it is difficult for foreign

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material; and (11) such other factors as the President or the Committee may determine to be appropriate, generally or in connection with a specific review or investigation."

<sup>128</sup> 50 U.S.C. App. § 2170(f)(1).

<sup>129</sup> 50 U.S.C. App. § 2170(f)(6).

<sup>130</sup> 50 U.S.C. App. § 2170(f)(10).

<sup>131</sup> Anti-Monopoly Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 30, 2007, effective Aug. 1, 2008), art. 27, LAWINFOCHINA (P.R.C.) (last visited Nov. 22, 2009) [hereinafter Anti-Monopoly Law].

<sup>132</sup> *Id.*

<sup>133</sup> OECD, RECENT DEVELOPMENTS IN CHINA'S POLICIES TOWARDS CROSS-BORDER MERGERS AND ACQUISITIONS 3 (2006), <http://www.oecd.org/dataoecd/1/26/37808943.pdf> (last visited Nov. 17, 2009).

investors to ascertain if a trademark qualifies as a “famous trademark.”<sup>134</sup> Publication of People’s Court certifications, along with the creation of a central database of “famous trademarks and brands,” would allow investors to make informed decisions as to which brands would be subject to increased national security scrutiny.

*C. China Should Create a Statutory Definition of “Right to Control” to Provide Clarity to Both Investors and Regulators*

China should also clarify what it means by the “right to control” a Chinese entity. The CFIUS regulations provide a detailed definition of what constitutes a foreign interest exercising control over a domestic entity<sup>135</sup> and offer a good blueprint for China’s statutory definition. According to the CFIUS regulations:

The term control means the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity . . . .<sup>136</sup>

“Important matters” include the sale and lease of principle assets,<sup>137</sup> reorganization, merger, or dissolution,<sup>138</sup> entry into or termination of significant contracts,<sup>139</sup> appointment or dismissal of officers and senior managers<sup>140</sup> or employees with access to sensitive or classified information,<sup>141</sup> and selection of new ventures<sup>142</sup> and major expenditures.<sup>143</sup> In addition, only certain types of transactions are defined as conferring control and subject to CFIUS review. These transactions include:

[A] proposed or completed merger, acquisition or takeover . . . includ[ing] . . . (a) The acquisition of an ownership

<sup>134</sup> *Id.*

<sup>135</sup> Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. § 800.204 (2008).

<sup>136</sup> 31 C.F.R. § 800.204(a).

<sup>137</sup> 31 C.F.R. § 800.204(a)(1).

<sup>138</sup> 31 C.F.R. § 800.204(a)(2).

<sup>139</sup> 31 C.F.R. § 800.204(a)(6).

<sup>140</sup> 31 C.F.R. § 800.204(a)(8).

<sup>141</sup> 31 C.F.R. § 800.204(a)(9).

<sup>142</sup> 31 C.F.R. § 800.204(a)(5).

<sup>143</sup> 31 C.F.R. § 800.204(a)(4).

interest in an entity. (b) The acquisition or conversion of convertible voting instruments of an entity. (c) The acquisition of proxies from holders of a voting interest in an entity. (d) A merger or consolidation. (e) The formation of a joint venture. (f) A long-term lease under which a lessee makes substantially all business decisions concerning the operation of a leased entity, as if it were the owner.<sup>144</sup>

The CFIUS regulations also provide a list of examples of covered transactions<sup>145</sup> and non-covered transactions.<sup>146</sup>

Using the CFIUS definition of control being the “power . . . to determine, direct, or decide important matters affecting an entity . . .”<sup>147</sup> and providing a list of what constitutes important matters<sup>148</sup> would help businesses and the Ministry of Commerce make principled decisions as to which deals confer control to foreign interests.<sup>149</sup>

*D. China Should Provide Additional Procedural Guidelines to Protect Investors and Promote Foreign Investment in China*

In addition to these clarifications of important statutory terms, the creation of additional procedural guidelines would help ensure both efficiency and efficacy of review. The creation of guidelines that govern what must be included in the national security reports mandated by Article 12 would help ensure that parties provide the Ministry of Commerce with the necessary information to conduct a full national security review without

<sup>144</sup> 31 C.F.R. § 800.224; *see also* 31 C.F.R. § 800.204

<sup>145</sup> 31 C.F.R. § 800.301. E.g. “Corporation A, a foreign person, proposes to purchase all of the shares of Corporation X, which is a U.S. business. As the sole owner, Corporation A will have the right to elect directors and appoint other primary officers of Corporation X, and those directors will have the right to make decisions about the closing and relocation of particular production facilities and the termination of significant contracts. The directors also will have the right to propose to Corporation A, the sole shareholder, the dissolution of Corporation X and the sale of its principal assets. The proposed transaction is a covered transaction.” *Id.*

<sup>146</sup> 31 C.F.R. § 800.302. E.g. “Corporation A, a foreign person, holds 10,000 shares of Corporation B, a U.S. business, constituting ten percent of the stock of Corporation B. Corporation B pays a 2-for-1 stock dividend. As a result of this stock split, Corporation A holds 20,000 shares of Corporation B, still constituting ten percent of the stock of Corporation B. Assuming no other relevant facts, the acquisition of additional shares is not a covered transaction.” *Id.*

<sup>147</sup> 31 C.F.R. § 800.204(a).

<sup>148</sup> *Id.*

<sup>149</sup> Anti-Monopoly Law, *supra* note 131, arts. 20, 22. Articles 20 and 22 of China’s Anti-Monopoly Law could also be a good model from which to start crafting a definition of “control.” These articles generally provide which transactions need to be reviewed, art. 20, and which ones do may not, art. 22. The use of such phrases as “cap[ability] to of exercising decisive influence,” would help ensure that small, silent- minority shareholders and minor contractual relationships would not subject foreign investment to national security review. Anti-Monopoly Law, *supra* note 131, art. 20(3).

bombarding it with extraneous documents. It would also prevent companies from having to submit repeated filings to satisfy the Ministry of Commerce's requests.

The CFIUS regulations contain lists of required documents and would be a good blueprint for required documents under China's national security review.<sup>150</sup> The list mandates a description of (1) the transaction in question, including its essential elements, nature, parties, and expected date of closing;<sup>151</sup> (2) the assets being acquired;<sup>152</sup> (3) the business activities, locations, government contracts, classified governmental contracts, and defense-related or defense-applicable technological assets of the business being acquired;<sup>153</sup> (4) the business activities of the foreign business, especially its plans for the acquired business or assets;<sup>154</sup> and (5) whether the foreign business is acting on behalf of or is controlled by a foreign government.<sup>155</sup> Articles 21, 22, 23, and 24 of the 2006 M&A Provisions also provide detailed instructions about what is required to be submitted during the normal foreign investment review process,<sup>156</sup> and Articles 32, 42 and 44 provide what additional information must be provided if the transaction meets certain other requirements.<sup>157</sup> These provisions could also serve as a guide in crafting the documentary requirements for Article 12 review.

*E. China Should Create a Timeline to Avoid Unreasonable Delays in the National Security Review Process*

Additionally, China should create timetables for either action or inaction by the Ministry of Commerce to ensure predictable and timely execution of national security reviews. Carefully crafted timelines would speed review of transactions and protect parties, while allowing extended review of questionable investments.

China should look to the other procedures contained in the 2006 M&A Provisions, and the CFIUS regulations for guidance in crafting its review timelines. For example, Article 25 of the 2006 M&A Provisions provides a

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<sup>150</sup> 31 C.F.R. § 800.402(c).

<sup>151</sup> 31 C.F.R. § 800.402(c)(1).

<sup>152</sup> 31 C.F.R. § 800.402(c)(2).

<sup>153</sup> 31 C.F.R. § 800.402(c)(3)-(4).

<sup>154</sup> 31 C.F.R. § 800.402(c)(6)(i)-(ii).

<sup>155</sup> 31 C.F.R. § 800.402(c)(6)(iii)-(iv).

<sup>156</sup> 2006 M&A Provisions, *supra* note 9, arts. 21, 22, 23, 24. These requirements include descriptions of the parties, the transaction, plans for the acquired assets, and plans for the settlement of current employees.

<sup>157</sup> 2006 M&A Provisions, *supra* note 9, arts. 32, 42, 44. These Articles relate mainly to equity transactions and mandate additional reporting requirements and an additional M&A consultant report concerning equity pricing.



thirty-day period in which “the examination and approval organ shall . . . make a decision of approval or disapproval.”<sup>158</sup> Additionally, Exon-Florio and the associated Treasury regulations provide even more detailed timelines for national security review. After formally accepting a transaction for review, CFIUS has 30 days to complete its initial review.<sup>159</sup> After acceptance of a transaction for review, the Director of National Intelligence is required to provide “a thorough analysis of any threat to the national security of the United States posed by any covered transaction”<sup>160</sup> within twenty days.<sup>161</sup> A 45-day investigation of the transaction begins if CFIUS determines that:

[I] the transaction threatens to impair the national security of the United States and the threat has not been mitigated during or prior to the review . . .; [II] the transaction is a foreign government-controlled transaction; or [III] the transaction would result in control of any critical infrastructure of or within the United States by or on the behalf of any foreign person, if the Committee determines that the transaction could impair national security . . . .<sup>162</sup>

This investigation can also be triggered if “the lead agency recommends, and the Committee concurs, that an investigation be undertaken.”<sup>163</sup>

During the investigation CFIUS must examine “the effects of a covered transaction on the national security of the United States, and take any necessary actions in connection with the transaction to protect the national security of the United States.”<sup>164</sup> An investigation concludes with CFIUS taking one of four actions: (1) dismissing the investigation; (2) drafting a mitigation agreement with the parties of the covered transaction to alleviate the threat to national security; (3) allowing the parties to the covered transaction to withdraw and resubmit; or (4) submitting the findings of the investigation to the President to make a decision as to whether or not to allow the transaction.<sup>165</sup> If CFIUS submits its findings to the President, he or she has fifteen days<sup>166</sup> to decide if it is “appropriate to suspend or prohibit [the] covered transaction [because it] threatens to impair the

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<sup>158</sup> 2006 M&A Provisions, *supra* note 9, art. 25.

<sup>159</sup> 50 U.S.C. App. § 2170(b)(1)(E).

<sup>160</sup> 50 U.S.C. App. § 2170(b)(4)(A).

<sup>161</sup> 50 U.S.C. App. § 2170(b)(4)(B).

<sup>162</sup> 50 U.S.C. App. § 2170(b)(2)(B).

<sup>163</sup> 50 U.S.C. App. § 2170(b)(2)(B)(ii).

<sup>164</sup> 50 U.S.C. App. § 2170(b)(2)(A).

<sup>165</sup> *See* 50 U.S.C. App. § 2170 (listing possible ways a CFIUS investigation can conclude).

<sup>166</sup> 50 U.S.C. App. § 2170(d)(2).

national security of the United States.”<sup>167</sup> Under the three statutorily defined deadlines of the Exon-Florio Amendment, a transaction can be prohibited, at most, ninety days after CFIUS formally accepts it for review.<sup>168</sup>

If Article 12 were amended to provide a similar timeline, the 90-day total period provided would give flexibility to tailor the length of review to varying national security concerns and would still provide the possibility of finality for what has sometimes been an unnecessarily long screening process resulting in delayed or abandoned beneficial investment.<sup>169</sup>

*F. China Should Create a “Safe Harbor” Provision to Ensure Finality in National Security Review Decisions*

Finally, China should create a “safe harbor” guarantee. This guarantee would preclude reexamination of transactions that have been approved by the Ministry of Commerce, absent proof of false, misleading, or incomplete submission by the parties.

The CFIUS provisions provide that once a transaction has been approved by CFIUS or the President, that transaction cannot be reexamined, except under narrow circumstances. Unless a “party to the transaction submitted false or misleading material information to the Committee in connection with the review or investigation or omitted material information, including material documents, from information submitted to the Committee . . .”<sup>170</sup> or a party materially breaches a mitigation agreement<sup>171</sup> the decision of CFIUS or the President cannot be reopened. This provision provides an incentive to parties to voluntarily submit covered transactions to CFIUS for review and protects parties from the costly remedy of divestment. This “safe harbor” provision of the CFIUS regulations is one of its most important qualities.<sup>172</sup>

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<sup>167</sup> 50 U.S.C. App. § 2170(b)(4)(D)(1).

<sup>168</sup> 50 U.S.C. App. § 2170(b)(2)(CB); 50 U.S.C. App. § 2170(b)(1)(E); 50 U.S.C. App. § 2170(b)(4)(BD)(2).

<sup>169</sup> If China feels that the 90-day deadline is too short, it could look to alternative review timelines contained in its other statutes. Under the Anti-Monopoly Law, review periods under certain circumstances are 30, 60, and 90 days for a possible total review time of 180 days, twice the length of the CFIUS review process. Anti-Monopoly Law, *supra* note 131, arts. 25, 26.

<sup>170</sup> 50 U.S.C. App. § 2170(b)(1)(D)(ii).

<sup>171</sup> 50 U.S.C. App. § 2170(b)(1)(D)(iii)(I).

<sup>172</sup> One commentator has argued that even allowing re-examination of transactions after finding material omissions by parties “cripples the effectiveness of the voluntary notice . . . [as] little incentive exists for a foreign company that believes it may be subject to a CFIUS review to submit voluntary notification.” Cox, *supra* note 45, at 313-14.

Adding a “safe harbor” provision to assure parties that Ministry of Commerce approval allows them to confidently pursue their transaction, without fear of a future forced divestment, lends confidence to the review process, and by extension encourages foreign investment.

## V. CONCLUSION

Since the beginning of China’s economic liberalization in 1978, foreign direct investment in China has acted as a driving force behind some of China’s most positive transformations. Foreign investment has helped grow the Chinese economy at a staggering pace and shift hundreds of millions of Chinese citizens from subsistence living to the middle class. One of the most recent steps to liberalize foreign investment was the introduction of the 2006 M&A Provisions. While, overall, this law was a great stride forward in clarifying the review process for foreign investments, the provisions relating to national security review of foreign investments are unclear.

Article 12 of the 2006 M&A Provisions grants the Ministry of Commerce the authority to perform a national security review of proposed foreign investments. This authority is similar to the authority of the CFIUS to review proposed foreign investments in the United States. The authority and procedures of the CFIUS are dictated by strict statutory and regulatory guidelines. These guidelines provide a range of protections for investors and help ensure efficient, effective, and timely review of proposed investments. Unfortunately, Article 12 of China’s 2006 M&A Provisions fails to provide such guidelines. The omission of these guidelines unnecessarily complicates the review process and discourages foreign investment. To correct this problem, China should amend Article 12 to include a definitive framework for review and additional protections for foreign investors. In revising the 2006 M&A Provisions, China should look to the United States’ CFIUS procedures and other sections of the 2006 M&A Provisions. Revising Article 12 to include a clear review framework and express protections for foreign investors would allow China to achieve the twin aims of encouraging foreign investment and safeguarding its national security.