Investing in the United States
Is the US Ready for FDI from China?

Edited by

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STUDIES IN INTERNATIONAL INVESTMENT

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INTRODUCTION

In May 2007, President George W. Bush issued a statement on United States policy toward foreign investment, termed by the administration as a statement on “open economies.” The statement was spurred by a desire to affirm to the world that the United States remained open to foreign direct investment (FDI) – a task made essential by the highly politicized reaction of the US Congress in 2006 to the proposed investment in US port operations by Dubai Ports World. The statement also anticipated the more balanced action taken by Congress later in 2007 to adopt reasonable reforms to the primary legal mechanism for vetting FDI, the Exon–Florio Amendment to the Defense Production Act. Importantly, though, President Bush’s statement was not centered only on promoting foreign investment. Rather, it sought a balance between maintaining an open environment for investment and preserving important security interests, as follows:

A free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world. The threat of global terrorism and other national security challenges have caused the United States and other countries to focus more intently on the national security dimensions of foreign investment. While my Administration will continue to take every necessary step to protect national security, my Administration recognizes that our prosperity and security are founded on our country’s openness.

As both the world’s largest investor and the world’s largest recipient of investment, the United States has a key stake in promoting an open investment regime. The United States unequivocally supports international investment in this country and is equally committed to securing fair, equitable, and nondiscriminatory treatment for US investors abroad. Both inbound and outbound investment benefit our country by stimulating growth, creating jobs, enhancing productivity, and fostering competitiveness that allows our companies and their workers to prosper at home and in international markets.¹

President Bush’s statement affirming the importance of foreign investment to the United States was not ground-breaking. On the contrary, it followed a long line of administration policy pronouncements expressing openness to foreign investment.² The significance of President Bush’s statement on “open economies” was that it explicitly linked the policy of open investment to US national security interests. This basic policy framework – recognizing the benefits of open investment, but also emphasizing the importance of national security – is especially important when considering FDI from China. Indeed, not by coincidence, the issues presented by FDI from China in many respects embody the balance set forth in the Bush administration’s statement on “open economies.”
China has the potential to be a tremendous source of FDI for the United States. At the same time, the history of Chinese investments in the United States tells us that, from the perspective of US regulators and policy-makers, Chinese FDI can present unique considerations, especially in the area of national security. As described further below, of the United States’ ten largest trading partners, China is the only one not considered an ally; key institutions, including the Department of Defense, the US intelligence and law enforcement agencies, and Congress view certain Chinese investments with great suspicion; and US concerns over the unlicensed transfer of dual-use technologies are especially acute with China. In fact, the only transaction ever formally blocked under Exon–Florio was an investment by a Chinese company. In early 2008, the US private equity firm Bain Capital Partners and the Chinese technology firm Huawei Technologies were forced to drop their bid for the US computer communications equipment manufacturer 3Com Corp. after they were unable to address the national security concerns of the United States government. Sensitivities over Chinese investment can extend to the state level as well, as demonstrated when the 1990s sale of the Indiana-based magnet company Magnaquench to an investment group that included Chinese state-owned companies belatedly became a political issue in the 2008 Democratic Party primary campaign in Indiana.

In this context, the question of whether the United States is ready, from a regulatory and institutional perspective, for mergers and acquisitions (M&As) from China takes on added significance. Whether Chinese FDI in the US will increase substantially, and the US in turn will receive the attendant benefits of this investment after years of outward investment flowing to China, depends on whether US laws and institutions can treat Chinese investors at least approximately like other investors, that is, whether Chinese investors can approach the US market with some degree of certainty with respect to process, time-frames and, ultimately, results on the regulatory and political fronts – and whether the United States, at the same time, can preserve its legitimate non-economic interests.

Before addressing this subject more fully, it should be emphasized that the discussion herein is not legal advice. As noted, the applicability of particular laws, whether federal, state or local, to any given transaction will depend highly on the facts and circumstances of that transaction. Elements of the US legal and institutional framework addressed in this chapter will not be applicable in every case of foreign investment, or even necessarily in the majority of them. Rather, the chapter is intended to provide a general overview of the framework for cross-border M&As, with a more detailed focus on Exon–Florio, the potential political challenges that Chinese investors can face in Congress and potential strategies to mitigate regulatory and political risk for investment from China. Moreover, the discussion of existing laws in this chapter is based on the status of the laws at the end of 2008. With this in mind, investors would be prudent to consult with US counsel on any particular investment to ensure that all relevant laws and regulatory requirements – at the federal, state and local levels – are identified and addressed.

3.1 THE US REGULATORY LANDSCAPE FOR FDI FROM CHINA AND CONSIDERATIONS FOR INVESTORS

The legal and corporate due diligence evaluation for any particular investment can be a complex exercise, touching on a wide range of laws, regulations and other issues. On the
legal side alone, a due diligence review typically will encompass, among other elements, a review of material contracts, supply and licensing agreements, pending and ongoing litigation, intellectual property portfolios and potential liabilities, labor and employment issues, insurance coverage and environmental issues. Such a due diligence review also must encompass three fundamental issues: (1) What, if any, regulatory compliance issues will be implicated by the investment? (2) What, if any, regulatory approvals are required to complete the investment? (3) What other stakeholders, such as legislative bodies or other third parties, may be interested in the transaction? For certain foreign investors, including in particular Chinese investors, there is an additional consideration that pervades each of these issues: whether the transaction implicates – in fact or in perception – US national security considerations.

These due diligence-related factors and their impact on strategic considerations for an investment are discussed in depth below. As the following due diligence and strategy flow chart in Figure 3.1 demonstrates, and as described more fully herein, the answers to these fundamental questions and how they interact with US national security considerations directly bear on the appropriate strategy for addressing regulatory and political risk for foreign M&A transactions in the United States.

3.1.1 Ongoing Regulatory Compliance Considerations

As an initial matter, a thorough due diligence review of a potential acquisition target should assess not only current liabilities that have been identified, but also ongoing compliance issues that arise from a foreign acquisition. Two ongoing compliance issues, in particular, need to be identified and evaluated for foreign investment from China: foreign trade control compliance and compliance with the Foreign Corrupt Practices Act of 1977 (FCPA).7

Foreign trade controls compliance

Compliance with US laws and regulations governing foreign trade controls laws is particularly important in the context of Chinese M&A activity in the United States because of prominent reported cases of Chinese violations of these provisions. An example of such reported cases is included in the discussion in section 3.4, below. These cases have arguably contributed to a perception among US regulatory officials, whether accurate or not, of heightened risk with respect to foreign trade controls compliance when Chinese companies or partners are at issue. They have also resulted in stricter licensing requirements for the export of products or technologies that could make a contribution to, or be destined for end use by, the Chinese military.8

The unlicensed physical export of controlled US products or technologies is not the only compliance risk that should be understood and mitigated by a Chinese investor. Potential acquirors of US companies as well as Chinese companies evaluating greenfield investments also should understand and be prepared to implement compliance programs for US foreign trade controls governing not only access to and transfers of controlled technologies to foreign nationals in the United States, but also compliance with US trade embargoes. This section summarizes only briefly these US programs which have far-reaching implications for owners of US businesses.

There are three programs that principally comprise the US foreign trade controls regime.9
Investing in the United States

First, US Commerce Department regulations, known as the Export Administration Regulations (EAR), apply to so-called “dual-use items” – that is, products and technologies that may have both military and commercial applications. The EAR specifically provide restrictions on the export of commercial products (including software) and technologies from the United States and on the re-export between foreign countries of US-origin (including foreign-made items with more than de minimis US-origin content) commercial products (including software) and technologies. The degree to which a particular item is controlled (for example, whether export or re-export is prohibited or subject to specific licensing requirements) under the EAR depends upon:

**US Regulatory Due Diligence and Strategy Framework for FDI**

1. **Is there a compliance risk?**
   
   *E.g.: FCPA, export control compliance*

2. **What Approvals/Filings Are Required?**
   
   *Standard: securities filings and disclosures; competition (HSR)*
   
   *Industry specific (e.g., telecom, energy, banking, etc.)*
   
   • Federal approvals
   
   • State approvals

3. **Who Are Other Interested Stake Holders?**
   
   *Legislative bodies:*
   
   • Congress
   
   • State/local
   
   *Other groups:*
   
   • Labor
   
   • Potential rivals for target
   
   • Potential third party validators
   
   • Potential third party opponents

4. **Are There US National Security Issues?**

   **NO**
   
   **Regulatory approvals and address interest of key constituencies, but no real political risk**

   **YES**
   
   **MORE ACTIVE STRATEGY TO MANAGE RISK (E.G., IF THERE ARE POTENTIAL OPPONENTS THAT COULD POLITICIZE TRANSACTION)**

   • More active regulatory strategy to address regulatory interests and modest or localized political risk

   • Full “Washington strategy” (active briefing of Capitol Hill; coordinated press and political strategy; support from third party validators)

   **MODEST STRATEGY TO ADDRESS REGULATORY INTERESTS AND MODERATE OR LOCALIZED POLITICAL RISK**

   • Modest strategy to address regulatory interests and modest or localized political risk

   **BASIC REGULATORY APPROVALS; NO POLITICAL STRATEGY**

   • Basic regulatory approvals; no political strategy

   **STRAIGHT SPECTRUM**

   - E.g.: FCPA, export control compliance

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*Figure 3.1  US regulatory and strategic due diligence flow chart*

First, US Commerce Department regulations, known as the Export Administration Regulations (EAR), apply to so-called “dual-use items” – that is, products and technologies that may have both military and commercial applications. The EAR specifically provide restrictions on the export of commercial products (including software) and technologies from the United States and on the re-export between foreign countries of US-origin (including foreign-made items with more than de minimis US-origin content) commercial products (including software) and technologies. The degree to which a particular item is controlled (for example, whether export or re-export is prohibited or subject to specific licensing requirements) under the EAR depends upon:
(1) the technical capabilities and performance specifications of the product, software or technology involved (according to a classification list maintained by the Commerce Department); (2) the country of destination; and (3) in certain circumstances, the actual end-user and end-use of the item.

Second, the State Department administers the International Traffic in Arms Regulations (ITAR), which control the export or foreign transfer of any defense article or service. In general, defense articles are products, software or technical information that are specially designed, modified or configured for military or intelligence uses, as defined on the US Munitions List. Defense services include any support or training for design, production, repair or use of defense articles, whether in the US or abroad. The State Department requires specific licensing authorization for the export of all defense articles and services to virtually any country. Under current US legislation, export or re-export to China of US Munitions List products, software or technical information subject to the ITAR is prohibited.

Third, the US Treasury Department’s Office of Foreign Assets Control (OFAC) administers certain sanctions programs that generally preclude export–import transactions and other business and financial dealings with targeted countries (for example, Cuba and Iran) and parties (for example, terrorist organizations and drug kingpins and narco-traffickers) for US national policy and security reasons. These restrictions apply quite broadly to US persons, which include not only entities organized under the laws of the United States but, depending on the program, also their foreign subsidiaries (for example, Cuba). In addition, “US person” includes any individual or legal entity physically in the United States or any US citizen or permanent resident wherever located or employed. Thus, no foreign national in the United States and no US citizen located abroad, including as an employee of a foreign company, may take action to facilitate trade or other financial transactions with an OFAC-sanctioned country or party.

Each of these foreign trade controls programs provides for civil penalties, including substantial fines, for violations and criminal penalties for willful violations. In this regard, it is worth highlighting one aspect of US foreign trade controls that can pose particularly challenging ongoing compliance issues – namely, the restrictions on “deemed exports” or technology transfers inherent in the Commerce Department and State Department regulations. As explained by the Commerce Department:

[Technology is ‘released’ for export when it is available to foreign nationals for visual inspection (such as reading technical specifications, plans, blueprints, etc.) even if such release occurs in the United States. This same interpretation applies to technology that is exchanged orally with a foreign national or technology that is made available by practice or application under the guidance of persons with knowledge of the technology.]

This broad restriction encompasses information necessary for the “development,” “production” or “use” of a product. When such technology – or certain kinds of software source code – is released to a foreign national in the United States, it is deemed to be exported and, therefore, such release may require prior authorization from the Commerce Department. A similar requirement obtains with respect to technology retransfers abroad – namely, if State or Commerce Department-controlled technology is approved for export or otherwise transferred abroad and then, in turn, proposed
for transfer to an individual from a third country that would require licensing for
direct US exports, the additional retransfer without a license would be a violation of
Commerce Department regulations.16 Likewise, with respect to defense articles, the State
Department requires an export license “for the oral, visual, or documentary transmis-
sion of technical data by US persons to foreign persons, by such means as in-person
or telephone discussions and written correspondence including electronic messages,
even when they are in the United States.”17 Like the Commerce Department, the State
Department applies retransfer controls for “deemed” exports that occur outside the
United States.

For Chinese investors who may wish to access US technology in connection with their
investments, it is especially important to be aware of the US restrictions on deemed
exports and to plan for ongoing compliance mechanisms to ensure that the acquired
entity and existing and future employees act in compliance with applicable US foreign
trade control restrictions. In particular, prospective Chinese owners of US businesses
need to evaluate whether limitations on access to certain technology may interfere with
managing their investment.

**FCPA**

The FCPA is a broad anti-corruption statute with both criminal and civil provisions
that address bribery directly (corrupt offers, payments, gifts, and so on, in exchange for
a quid pro quo) and via provisions focused on accounting and internal controls that hide
corrupt transactions.18 (See also the chapter by Lorraine Eden and Stewart Miller in this
volume.) Like the US foreign trade control regimes, the FCPA is nuanced; a thorough
discussion of its provisions, the various permutations in which it may apply, and the
potential pitfalls for US firms and others is beyond the scope of this chapter. For present
purposes, the pertinent point with respect to the FCPA is that while the statute typically
addresses activities of US firms and nationals abroad (indeed, it was adopted in response
to Congressional findings in the 1970s that US firms “were routinely making payments
to foreign officials in exchange for business favors”19), it also has relevance as an ongoing
compliance matter for foreign investors in the United States.

The FCPA in particular can have special relevance for Chinese firms for several
reasons. First, the anti-bribery provisions are not limited to gifts or other graft pro-
vided to employees of state agencies; they also can reach state-owned companies or
quasi-private entities serving state functions.20 Second, the statute’s bribery prohibitions
apply not only to all US companies and persons, but also to any foreign national in the
United States who violates the Act “by use of the mails or any means or instrumental-
ity of interstate commerce.”21 Thus, for example, a Chinese employee from a Chinese
company doing business in the United States who, while in the US, arranges for a gift
to be made to an officer or an employee of a Chinese state-owned entity to obtain an
advantage with that entity in a business matter, could face criminal liability under the
FCPA.

Given the potential scope of the FCPA and its tripwires for liability, it would be prudent
for a Chinese investor to plan and implement a strong FCPA compliance program (if one
does not already exist) in connection with acquisitions in the United States. Likewise,
investors should be aware that, as with other compliance issues, a US counterparty may
seek certain FCPA-related representations or disclosures from the investor.
3.1.2 Required Regulatory Approvals

The second fundamental regulatory issue that foreign companies examining potential targets for acquisition or investment in the United States should consider is what regulatory approvals are required. On this issue, the conceptual framework can be broken down further as: (1) Are there any standard regulatory approvals or disclosures that are required for the transaction based on certain general characteristics, such as the value of the transaction and whether it involves any publicly listed entities? (2) Are there specific approvals that are required because of the nature of the assets, which would encompass approvals that are specific to certain industries?

Standard approvals and disclosures

Foreign M&A activity in the United States may implicate at least two standard regulatory approval and compliance matters depending on the specific transaction’s terms: namely, whether there are any required filings with securities regulators and exchanges in the United States, which turns on whether the US target or foreign entity is publicly listed in the United States; and whether there are any antitrust-related notifications and reviews required.

In terms of US securities laws and regulations, there are several requirements that may be imposed on either the US target company or the foreign investor. Again, the federal securities laws are detailed and nuanced, and the full range of rules and requirements cannot be covered here. However, the following is a non-exhaustive list of the types of filings and disclosures that may be required as a result of an investment or merger involving entities that are registered with the Securities and Exchange Commission (SEC) in the United States:

- Registered US entities must make Form 8-K filings with the SEC to provide prompt disclosure of certain events, which would include a change of control of the entity and any material definitive merger, asset purchase or other business combination agreements.22
- Persons who acquire beneficial ownership interest of more than 5 percent of a class of voting equity securities registered under the Securities Exchange Act of 1934 must file with the SEC a form addressing, among other things, the shareholder’s intent with respect to the target (including plans or proposals with regard to future actions), the percentage of ownership, the source and amount of any financing and an explanation of the transaction.23
- For exchange offers, issuers must submit a form addressing, among other things, the bidder’s financial condition and results of operations, the reasons for the transaction, the shareholder’s financing and prior material contacts with the company being acquired.24
- Tender offers for publicly held stock must comply with the SEC’s tender offer rules, which include filing a schedule with the SEC describing the tender offer and providing substantive disclosures.25
- Shareholder votes required under state corporate law or stock exchange rules for mergers, asset sales, issuances of stock or similar transactions involve the filing of a preliminary proxy statement with the SEC followed by a definitive proxy statement when it is delivered to shareholders.26
The SEC will review, and may provide comments on, certain of these filings, and the parties will not be permitted to complete the transaction until the SEC confirms that it has no further comments on such filings.

In addition to these federal filing requirements, the various exchanges (NYSE, AMEX, Nasdaq) have certain requirements, such as disclosure and notification requirements for material events that may affect the value of a company’s stock. Many states also have anti-takeover laws that govern acquisitions of stock of companies incorporated in their jurisdictions. These state laws may impose requirements for shareholder or board approval for acquisitions of stock above a certain threshold (for example, 10 or 15 percent).

In addition to securities-related disclosures and filings, the other standard federal review in connection with M&A activity is a competition review conducted by the US Federal Trade Commission (FTC) and the Department of Justice (DOJ). The US antitrust laws prohibit acquisitions of interests or assets of a party engaged in interstate commerce where the “effect of such acquisition may be substantially to lessen competition” in a relevant US product market. To provide the FTC and DOJ with an opportunity to review proposed acquisitions in advance, the Hart–Scott–Rodino Antitrust Improvements Act of 1976 (HSR) requires parties to submit a premerger notification for most significant acquisitions. The HSR notification requirements apply if the transaction meets certain thresholds based on the value of the transaction and the parties’ sizes, or if, regardless of the parties’ sizes, the transaction will result in the acquiror receiving at least certain thresholds of the target’s interests and assets (the threshold values may vary annually).

Upon receipt of the HSR notification, the FTC and DOJ have a 30-day “waiting period” to investigate the transaction to determine whether there is any potential harm to competition. If the FTC and DOJ believe that the transaction warrants closer scrutiny, they can further delay the transaction pending their review. Ultimately, if the agencies conclude that the acquisition would substantially lessen competition, they may seek a court injunction prohibiting the transaction. Notably, even if the FTC or DOJ do not act during the HSR waiting period, the transaction is not exempt from US antitrust laws, and is subject to later challenge by the FTC and DOJ, state enforcement officials, and even private parties.

### Industry-specific requirements

Depending on the particular sector and assets at issue in an M&A, the transaction parties may be required to seek additional approvals from US federal or state officials before consummating the transaction. Thus, in addition to potential securities-related filings (for publicly traded companies), a federal competition review (depending on the size of the transaction) and national security review (discussed below), Chinese firms looking to acquire control of a US target must also consider what, if any, industry-specific federal and state regulatory approval processes they will confront. While it is not possible here to address in depth the various industry regulatory regimes in the United States, two sectors provide useful illustrations of the potential additional federal and state approvals required for M&A activity: telecommunications and banking.

First, with respect to transactions in the telecommunications sector, Section 310 of the Communications Act of 1934 restricts foreign ownership of broadcast, common carrier and aeronautical radio station licensees. Section 310 expressly prohibits a foreign corporation or “alien” from holding any broadcast, common carrier or aeronautical radio
station license, but, as interpreted by the Federal Communications Commission (FCC), it does not prohibit indirect foreign control of certain licensees. Section 310 also prohibits foreign governments, individuals and corporations from owning more than 20 percent of the stock of a broadcast, common carrier, or aeronautical radio station licensee. Yet, as the FCC has noted, most foreign investments occur through intermediate companies organized in the United States. Section 310 provides a presumptive 25 percent ownership limitation for foreign investment in entities that in turn control US broadcast, common carrier and aeronautical radio licensees. However, Section 310 also grants the FCC discretion to allow higher levels of foreign ownership at the holding company level unless it finds that such ownership is inconsistent with the public interest. Thus, foreign entities may acquire, directly or indirectly, up to 100 percent of the stock of a US company owning or controlling an FCC licensee if the FCC does not find the foreign ownership to be inconsistent with the public interest. Although the FCC has frequently exercised its discretion under Section 310 to permit foreign investment in excess of the 25 percent limitation with respect to non-broadcast licensees, historically it has declined to do so in the broadcast context.

In addition, acquisitions of telecommunications providers may require approval by state public utility commissions, which typically have jurisdiction over transfers of control of state-issued telecommunications authorizations and also may have authority to review M&As for their competitive effects on the local market and impact on customers’ rates, terms and conditions of service. Transactions in the US telecommunications sector, therefore, may require both FCC approval for the transfer of federal authorizations to a foreign acquirer, and approvals of state authorities based on a review of the qualifications of the acquiror and the competitive effects of the proposed controlling acquisition.

Second, with respect to banking transactions, the US system of financial institution regulation involves multiple regulators, including at the federal and state level, and in turn may require multiple approvals for M&A transactions. As presently constituted, commercial banking in the United States is principally overseen by four primary federal regulators – the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. In addition, states have laws and regulations that govern the business of banking within the state, including in some cases mergers and acquisitions. Most foreign banks elect to enter the United States through the establishment of their own branches or other offices in the US; however, the federal and state regulators have ample authority to review M&A activity, whether it is the initial avenue for a foreign bank to enter the US market or involves a foreign bank that already has existing branches in the United States.

In particular, at the federal level, the federal Bank Holding Company Act (BHC Act) requires the Federal Reserve Board to review and either approve or disapprove any proposed transaction that would result in any company, foreign or domestic, acquiring control of a banking holding company or certain types of banks. This includes, among other things, the acquisition of 25 percent or more of any class of voting securities of a bank or bank holding company. The Federal Reserve also can find control where an investment would result in a lower percentage (down to 5 percent) of ownership over voting securities, if other indicia of control are also present. In considering whether control is present, the Federal Reserve:
considers the size of the investment, the involvement of the investor in the management of the bank or bank holding company, any business relationships between the investor and the bank or bank holding company, and other relevant factors indicating an intent or ability to significantly influence the management or operations of the bank or bank holding company.35

Commercial banking in the United States is principally overseen by various primary federal regulators. Notably, in order for a foreign bank to make an acquisition in the United States, the BHC Act also requires the Federal Reserve to assess a number of other factors, including the supervision exercised by home country authorities. Foreign entrance into the US market may not be permitted if the Federal Reserve does not determine that home country regulators exercise comprehensive consolidated supervision (CCS).

### 3.1.3 Other Interested Stakeholders

In addition to identifying regulatory compliance issues and assessing what regulatory approvals will be required for foreign M&As, a critical due diligence consideration for certain foreign investments is an assessment of how other interested stakeholders may align on the transaction. This, in part, is an assessment of how controversial a transaction will be – and that is particularly relevant to foreign investors from potentially sensitive countries, like China. Specific considerations may include whether a transaction will be welcomed by the employees of the target; whether there are any highly organized political groups, such as unions, that may be interested in the transaction and how it may affect their constituencies; whether there are rival bidders who could seek to interfere in the transaction; and what other third parties will be oriented either in favor of or against the transaction.

As Figure 3.1 demonstrates, national security considerations overlay each of these fundamental due diligence issues, especially with respect to M&A activity from China: reputation for ongoing compliance matters, such as export control and anti-corruption compliance, can impact the trustworthiness and determination of a foreign acquiror for US national security purposes (see section 3.4); prior approval of the Committee on Foreign Investment in the United States (CFIUS), which assesses the impact on US national security of mergers, acquisitions and investments that result in foreign control, may be the most significant regulatory approval for certain foreign investments (see section 3.2); and if there are national security implications of an investment, the existence of other interested stakeholders and their orientation toward a transaction becomes amplified in importance. In particular, with respect to the last point, because national security considerations can generate political interest in a transaction, they can provide greater leverage to potential opponents to create controversy and, in turn, may require more active outreach to potential supporters to head off such controversy. In turn, the combination of national security with the fundamental due diligence questions – compliance, approvals and stakeholders – that accompany cross-border M&As activity should help determine transaction parties’ ultimate strategy for securing approval within the US regulatory and institutional framework.

With this background in mind, the remainder of this chapter will focus in greater depth on the challenging US regulatory and institutional issues associated with Chinese
investment in particular: national security reviews undertaken by CFIUS; the role that the US Congress can play in Chinese transactions; certain characteristics of Chinese investment that can make such transactions challenging for the US system; and, finally, strategies that Chinese firms can deploy to manage regulatory and political risk.

3.2 NATIONAL SECURITY: CFIUS REVIEWS UNDER EXON–FLORIO/FINSA

Mergers and acquisitions of US businesses that may implicate national security are required to receive closer regulatory scrutiny from CFIUS. Of all potential investors, Chinese M&As are among the most likely to receive the greatest scrutiny. In fact, there have been several potential transactions involving Chinese firms that were abandoned after initial consultations with CFIUS or to avoid a potential negative Presidential decision. In addition, the only divestment of an acquisition ever formally ordered by a President under Exon–Florio involved China – namely, President George H.W. Bush’s order in 1990 requiring China National Aero Tech to divest MAMCO Manufacturing, Inc., an aerospace company based in Washington state. Accordingly, as part of assessing the US regulatory framework for investment from China, this section provides a more detailed discussion of the CFIUS process and the statute that controls the CFIUS process – historically known as the Exon–Florio Amendment.

3.2.1 Overview of Exon–Florio

The principal US statute governing regulatory reviews of certain types of FDI is Section 721 of the Defense Production Act of 1950. Section 721 is known as the Exon–Florio Amendment after the original amendment to the Defense Production Act, which was adopted in 1988 amidst concerns over Japanese investment. The Exon–Florio Amendment provided the President with express authority to review the national security effects of foreign acquisitions, mergers and takeovers. The law was recently amended by the Foreign Investment and National Security Act of 2007 (FINSA). FINSA left intact the essential elements of Exon–Florio, while also adopting amendments that provide for greater clarity on process, additional factors related to national security reviews under the statute, greater accountability among the agencies charged with implementing the statute, and enhanced Congressional oversight. The amended law as well as the implementing Executive Order and final regulations are provided as annexes.

Under the statute as amended by FINSA, CFIUS, as the President’s designee, has authority to review “any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.” The purpose of the review is to determine the effects of a transaction on US national security. CFIUS then must investigate any transaction that: (1) threatens to impair the national security of the United States, if the threat has not been mitigated during the initial review period; (2) would involve control by a foreign government; or (3) would result in foreign control of US critical infrastructure, if such control threatens to impair US national security and the threat is not mitigated during the initial review period. The President ultimately has authority to suspend or prohibit
any transaction that threatens to impair the national security if, after a full investigation is completed, “there is credible evidence that leads the President to believe that the foreign interest exercising control might take action that threatens to impair the national security,” and other laws, except for the International Emergency Economic Powers Act,43 “do not in the President’s judgment provide adequate and appropriate authority for the President to protect the national security in the matter before the President.”44

When Exon–Florio became law, President Reagan delegated his initial review and decision-making authorities, as well as his investigative responsibilities, to CFIUS,45 an inter-agency body that President Gerald Ford originally established via Executive Order in 1975 to monitor and evaluate the impact of foreign investment in the United States.46 Since the original adoption of Exon–Florio, CFIUS has been chaired by the Secretary of the Treasury. The fact that the Treasury Department, the most naturally pro-investment of all executive agencies, chairs a national security review process is both a symbolic and a practical nod to the importance of foreign investors and the open investment regime of the United States. The precise membership of the other CFIUS agencies has evolved since the original enactment. Under FINSA and its implementing Executive Order, CFIUS is comprised, in addition to the Treasury Department, of eight other voting members (the departments of Commerce, Defense, Homeland Security, Justice, State and Energy; the US Trade Representative; and the White House Office of Science and Technology); two permanent non-voting members (the Director of National Intelligence and the Department of Labor); and several other White House offices that act as observers and, on a case-by-case basis, participate in CFIUS reviews.47

By statute, CFIUS is authorized to review a transaction either upon a voluntary filing by either party to the transaction, or upon initiation of the committee. By regulation, CFIUS historically has also provided for any committee member to issue its own notice to the full committee requesting a review of a particular transaction.48 The Treasury Department, as chair of CFIUS, also has considerable discretion on whether to accept a notice for review. Thus, for example, while the statute and regulations indicate a single party to a transaction may file a voluntary notice, it is extremely rare for the Treasury to deem a notice containing information and responses from only one party to a transaction sufficient to initiate a review.

Once CFIUS has sufficient information from both parties to begin a review, the statutorily mandated timetable for the review and “investigation” process is as follows:

- Initial 30-day review following receipt of notice.
- Forty-five-day “investigation” period for transactions deemed to require additional review following the initial 30-day period, including foreign government-controlled transactions.
- Formal report to the President at the end of the 45-day investigation period.
- Presidential decision within 15 days of receiving the formal report.

Notwithstanding these statutorily prescribed time-frames for reviews, there is no statute of limitations on the inherent Presidential authority in Exon–Florio (Box 3.1). The President can act at any point, even after a transaction has closed. Moreover, the President’s decision is not subject to judicial review by US courts.49 However, once a transaction has undergone a review, it receives a form of safe harbor: FINSA and the
The US regulatory and institutional framework for FDI

implementing Executive Order provide that the committee can unilaterally initiate another review only if certain limited circumstances are met – such as: the initial review was based on false or materially misleading information, or material omitted information, or if there has been an intentional material breach of a mitigation agreement upon which approval was originally conditioned.50

3.2.2 Exon–Florio in Practice

CFIUS is a unique regulatory body insofar as it operates by consensus51 and includes multiple agencies with viewpoints that reflect their distinct missions and equities. There is an inherent tension between the security agency members of CFIUS, with their focus on defense, homeland security, counter-intelligence and law enforcement, and the economic agencies, which are more focused on trade and investment.52 This tension is purposeful: having a consensus-based, confidential process that requires input from cabinet agencies with differing equities is intended to facilitate careful, objective determinations that permit investments where possible but without sacrificing important national security interests.

At the same time, one consequence of having a consensus-based, confidential process that involves so many agencies and with limited information flow to the regulated parties is that the process itself can be opaque. In turn, much in CFIUS practice turns

### BOX 3.1 EXON–FLORIO AND GREENFIELD FDI

The Exon–Florio law does not provide a mechanism for the Executive Branch to review greenfield investment in the United States. There are sound policy reasons for this distinction. First, by their nature, such investments at the outset will not involve contracts or assets that are inherently central to national security. By comparison, an existing business may have contracts with the US government or access to sensitive or classified information; it is much more difficult to implement measures to guard against potential foreign ownership threats once such assets and contracts exist than it is not to grant the contract or provide access to sensitive information in the first instance. Second, there are likely to exist adequate laws to address any national security risks posed by a greenfield investment. For example, if foreign investors wish to establish new communications lines, they would be subject to licensing authority from the Federal Communications Commission,a which in turn would seek input from the Department of Defense, Department of Justice, Federal Bureau of Investigation, and the Department of Homeland Security on the national security and law enforcement issues raised by the potential grant of such authority. Given these other controls on national security risks and the potential economic benefits that greenfield investments can present, the balancing of economic and security interests in the context of greenfield investments weighs strongly in favor of a lighter regulatory touch.

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a Communications Act of 1934, Section 214.
not only on what is set forth in the statute and regulations, but on understanding which agencies have particular interests in a transaction, who the key decision-makers will be at those agencies, and what questions or considerations are likely to be of principal concern to those decision-makers. Particularly for the hardest cases, understanding the idiosyncrasies of agency interests and perspectives and what issues will matter to the key decision-makers is more a regulatory art than a science. Added to this mix is the fact that prominent transactions, especially those involving FDI from China, can attract media and political attention. (See in this context also Chapter 4 by Timothy Frye and Pablo Pinto in this volume.)

Accordingly, investors and US parties alike are well advised to understand and anticipate CFIUS’s analysis and considerations before launching into transactions that might require a CFIUS review. This is particularly true for investments from China, which for reasons described below are more likely to raise both strategic and political issues. The critical threshold questions for a CFIUS review are: (1) whether there is foreign control over a US business; (2) if there is foreign control, whether the transaction may present any significant national security issues; and (3) if there are national security concerns, whether they can be mitigated through contractual commitments from the transaction parties or other permissible means. For additional data on CFIUS reviews, see Committee on Foreign Investment in the United States Annual Report to Congress – Public Version (December 2008).

**Control over US business**

The threshold question for any CFIUS review is whether there is a transaction that presents a foreign person with “control” over a US business. Where there is potential foreign government ownership or influence, the control analysis is applied twice: first, in assessing whether a foreign entity will be controlling a US business; and second, in assessing whether in fact that foreign entity is itself controlled by a foreign government.

The definition of “control” in the CFIUS regulations is quite broad. “Control” means:

> [T]he power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of 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.54

In practice, “control” is very much a functional definition. The amount of share interests and the right to board seats, for example, are highly relevant to finding control, but they are not necessarily determinative. Rather, CFIUS will take into consideration all relevant factors of a foreign person’s ability to determine, direct or decide important matters affecting a US business. Among other things that CFIUS will consider are the right to direct or determine certain extraordinary corporate actions such as the sale of all assets or dissolution of an entity, as well as other “matters,” such as approval over major expenditures, closing or relocation of facilities, the appointment or dismissal of managers and officers, and how non-public information is treated.55 At the same time, certain standard minority economic protections – including certain negative rights and anti-dilution rights – may not, by themselves, confer control.56
In addition, there must be control over a US business. There are two important points with respect to the term “US business.” First, CFIUS’s jurisdiction extends only to the extent that a business undertakes activities in interstate commerce in the United States. Thus, for example, in the case of a foreign acquisition of a Canadian company that has a sales office in the United States, CFIUS’s jurisdiction would only extend to the sales office and its business in the United States. Second, a transaction does not necessarily have to involve an investment into or acquisition of a legally organized entity to trigger CFIUS’s jurisdiction. For example, the sale of a business unit or of assets in the United States that includes customer lists, intellectual property and employees (that is, elements of a going concern) could be a covered transaction.

National security analysis
FINSA formally requires CFIUS to conduct a risk-based analysis, informed by an analysis performed by the Director of National Intelligence, of the national security risk posed by any transaction. This new statutory requirement simply codifies CFIUS’s existing practice with respect to how it analyzes transactions.

Specifically, for every transaction, CFIUS engages in a three-part analysis comprised of: (1) a threat assessment focused on national security issues associated with the buyer; (2) a vulnerability assessment focused on national security issues associated with the US assets and business at issue; and (3) an assessment of the potential consequences that result from the “interaction between threat and vulnerability.”

What constitutes “national security” for CFIUS purposes – and, in turn, what might inform the threat and vulnerability assessments – is not defined precisely. Prior to FINSA, the Exon–Florio statute asked that the President assess the potential effects of a proposed transaction on:

- Domestic production needed for projected national defense requirements.
- 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.
- The control of domestic industries and commercial activity by foreign citizens as it affects US capability and capacity to meet national security requirements.
- The sales of military goods, equipment or technology to a country that supports terrorism, or proliferates missile technology or chemical and biological weapons.
- US technological leadership in areas affecting US national security.

These criteria focused primarily on protecting the defense industrial base and US technological leadership, which reflected Congress’s preoccupation with two transactions: Fujitsu’s potential takeover of Fairchild (which was deemed to threaten technological leadership), and an attempted takeover of Goodyear Tire and Rubber (a key defense contractor) by the British corporate raider Sir James Goldsmith. However, Congress purposely did not adopt an exclusive list of national security considerations, instead indicating that the term “national security” is “to be read in a broad and flexible manner.” CFIUS, in turn, has never formally defined the term.

FINSA attempted to provide additional indicia of the meaning of “national security” in the CFIUS context – or at least to codify CFIUS’s existing practice with respect to
considering those factors. First, the amendments stated that “national security”: “shall be construed so as to include those issues relating to homeland security, including its application to critical infrastructure.” This reflects the practice of CFIUS, at least since September 11, 2001, and in particular since the Department of Homeland Security was added to CFIUS in 2003, to examine transactions in sectors that relate to “critical infrastructure.” CFIUS has defined “critical infrastructure” to mean “in the context of a particular transaction, a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset . . . over which [foreign] control is acquired . . . would have a debilitating impact on national security.” Under this definition, not every foreign investment occurring in a critical infrastructure sector will be covered by CFIUS. Rather, it is the particular character of the assets and business at issue in the particular transaction that matters for CFIUS’s purposes.

Second, FINSA codified many of the factors already discussed as additional indicia for the President to consider in assessing the national security impact of a transaction. Specifically, it added the following factors for the President to consider:

- The potential national security-related effects on United States critical infrastructure, including major energy assets.
- The potential national security-related effects on United States critical technologies (which means “critical technology, critical components, or critical technology items essential to national defense,” subject to regulations issued by CFIUS).
- Whether the covered transaction is a foreign government-controlled transaction.
- For transactions involving foreign government control that result in an investigation, whether the host country adheres to non-proliferation regimes, whether the host country presents any risk of transshipment of export and military-controlled items, and the relationship of the host country to US counterterrorism efforts.
- The long-term projection of United States requirements for sources of energy and other critical resources and material.

Third, FINSA required CFIUS to issue guidance on the types of transactions that the committee has reviewed and that have presented national security considerations. This includes transactions that may constitute covered transactions that would result in control of critical infrastructure relating to United States national security by a foreign government or an entity controlled by or acting on behalf of a foreign government. However, in providing this guidance, CFIUS was also obligated to preserve the statutory confidentiality afforded. To strike this balance, the guidance issued by CFIUS ultimately offered a measure of additional clarity in identifying transactions that present “national security considerations,” while also largely repeating the aforementioned statutory factors for national security and the information requests contained in the CFIUS regulations.

Beyond the guidance and an enhanced number of information requests in the final regulations under FINSA, there are other unidentified factors that CFIUS will consider in its national security analysis. A more analytical list of factors that CFIUS considers is provided below at Table 3.1. In section 3.4, this chapter will examine how characteristics of Chinese FDI relate to some of these factors, including the connection of a foreign company to its home country government; its reputation for compliance on regulatory issues related to national security, such as export control laws; the perception of a
Table 3.1  Factors considered by CFIUS in national security analysis

<table>
<thead>
<tr>
<th>Foreign acquiror</th>
<th>US company</th>
</tr>
</thead>
<tbody>
<tr>
<td>● The acquiror’s reputation for compliance with laws and regulations, with a</td>
<td>● The assets of the US target company, including whether those assets themselves are part of US critical infrastructure, supply US critical infrastructure, or otherwise could be a threat (e.g., are assets or materials that could be used for terrorist purposes).</td>
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<tr>
<td>particular focus on export control compliance and/or prior commitments to</td>
<td>● Government customers of the US company, including in the first instance defense customers but also including non-defense and intelligence customers.</td>
</tr>
<tr>
<td>CFIUS.</td>
<td>● Access of the US company to government systems.</td>
</tr>
<tr>
<td>● The reputation of the acquiror’s home country for cooperating on important</td>
<td>● Access to US government classified information (and, in turn, the existence of a US government approved facility security clearance).</td>
</tr>
<tr>
<td>US national security policy objectives, including non-proliferation and</td>
<td>● The importance of the US assets to US law enforcement interests.</td>
</tr>
<tr>
<td>counter-terrorism matters.</td>
<td>● The importance of the US assets or technology to the defense supply chain.</td>
</tr>
<tr>
<td>● The reputation of the acquiror’s management, including whether the</td>
<td>● What other assets or businesses are located near the US company.</td>
</tr>
<tr>
<td>acquiror’s officers and directors have any past or current connection to the</td>
<td>● What existing security procedures the US business has in place.</td>
</tr>
<tr>
<td>home country’s military or intelligence agencies.</td>
<td>● Whether US management will remain in place, and whether US citizens will occupy important security-related positions after the transaction.</td>
</tr>
<tr>
<td>● The reputation of the acquiror’s home country for commercial or state</td>
<td>● The existence of sensitive technology, including export controlled technology.</td>
</tr>
<tr>
<td>espionage.</td>
<td>● The record of the US company on compliance issues, including in particular export control compliance.</td>
</tr>
<tr>
<td>● Whether the acquiror does business in countries subject to US embargoes (e.g.,</td>
<td>● The non-government customer base of the US company (i.e., whether the US company supplies a customer base that is critical to homeland or national security).</td>
</tr>
<tr>
<td>Iran, Democratic People’s Republic of Korea, Sudan, Cuba).</td>
<td>● The level of competition in the applicable marketplace and, in particular, whether the US company occupies a dominant position in a market that involves important strategic products, services or technologies.</td>
</tr>
<tr>
<td>● Whether the transaction could aid the military or intelligence capabilities</td>
<td></td>
</tr>
<tr>
<td>of a foreign country with interests adverse to those of the United States.</td>
<td></td>
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<tr>
<td>● Whether the acquiror is likely to move critical technology or key products</td>
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<tr>
<td>offshore.</td>
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<tr>
<td>● Whether a foreign government exercises control or influence over the acquiror.</td>
<td></td>
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<tr>
<td>● How the acquiror is financing the transaction, and whether the financing</td>
<td></td>
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<td>would give any other party, including a foreign government, control over the</td>
<td></td>
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<tr>
<td>acquiror or the transaction.</td>
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</tbody>
</table>
military rivalry with the foreign country; and the foreign country’s reputation for commercial and state espionage.

Mitigation
If CFIUS – specifically, the agency or agencies with the primary security equities presented by a transaction – determines that a particular transaction presents national security risks, it will seek to mitigate the perceived threats by imposing conditions and/or extracting commitments from the parties to a transaction. Such conditions and commitments may take the form of a signed agreement with agreed-upon penalties between the transaction parties, on the one hand, and the relevant security agencies, on the other. Alternatively, parties have been requested to provide somewhat more informal “assurances” via a letter from the principals of the parties to the applicable agencies.

The types of commitments and assurances sought by CFIUS can vary. At the most basic level, they can be straightforward assurances that the foreign acquiror does not intend to change continued production levels, facilities in the United States or participation in certain US government programs. Such assurances also can include concomitant record-keeping and reporting obligations. On the other end of the spectrum, certain mitigation agreements impose various governance requirements and more costly and onerous security measures, including technical and physical security requirements, US government access to systems and personnel, testing and screening of personnel, and third-party auditing. The most extreme agreements also can limit a foreign acquiror’s decision-making authority and access to the US company.

In adopting FINSA, the US Congress sought to clarify that mitigation agreements should only be adopted when: (1) the transaction causes an incremental increase in the risk to national security; (2) existing regulatory authority is not adequate to address the incremental risk; and (3) a “risk-based analysis” of the threat to national security has been performed and approved by the committee. Specifically, FINSA states that a mitigation agreement “may” be imposed “in order to mitigate any threat to the national security of the United States that arises as a result of the covered transaction” and that such an agreement “shall be based on a risk-based analysis . . . of the threat to national security of the covered transaction.”

The reports of the US House of Representatives and Senate that accompanied the Act reinforce Congress’s intent that mitigation agreements should be used only where existing legal authorities are inadequate to protect national security. For example, the House report states:

The Committee believes that mitigation agreements should address national security threats that arise as a result of the covered transaction, when those threats cannot be adequately addressed by other areas of law or regulation. The Committee believes that an important principle in the original Exon–Florio Amendment with respect to Presidential action should also apply to mitigation agreements. Specifically, mitigation agreements should not be considered the first line of defense in addressing general national security concerns and should be focused on threats that arise directly from the transaction when other areas of law or regulation can not adequately mitigate those threats.

CFIUS has described its process for developing mitigation agreements in light of the FINSA amendments, as follows:
First, before CFIUS may pursue a risk mitigation agreement or condition, the agreement or condition must be justified by a written analysis that identifies the national security risk posed by the covered transaction and sets forth the risk mitigation measures that the CFIUS member(s) preparing the analysis believe(s) are reasonably necessary to address the risk. CFIUS must agree that risk mitigation is appropriate and must approve the proposed mitigation measures. Second, CFIUS may pursue a risk mitigation measure intended to address a particular risk only if provisions of law other than [Exon–Florio] do not adequately address the risk.\footnote{71}

Finally, while CFIUS agencies can bargain for various penalties, including agreed-upon damages figures, FINSA also makes clear that CFIUS can reopen a transaction for a material breach of a mitigation agreement if there is a finding of intentional breach by the lead agency and a finding by all of CFIUS that no other remedies are available.\footnote{72}

While the CFIUS process focuses on a specific class of transactions – that is, those that may raise legitimate national security issues – it can entail significant costs for FDI in certain types of US businesses, including ongoing compliance costs with mitigation commitments to which investors must agree to receive CFIUS approval.\footnote{73} In the most extreme cases, the Exon–Florio statute, as amended by FINSA, can serve as an absolute bar to certain acquisitions that present national security issues. As evidenced by the experience of Huawei Technologies, the risk of investment screening and the potential costs related to CFIUS is greater for Chinese investors. Accordingly, as part of any due diligence exercise that Chinese companies undertake when considering an acquisition or significant investment in a US business – and, likewise, as part of the US business’s consideration of Chinese investment – it would be prudent to assess fully the risks and costs associated with a potential CFIUS review and to plan appropriately for addressing those risks. The concluding section of this chapter sets forth certain strategies and steps that Chinese investors can take to help manage such risks.

3.3 THE US POLITICAL LANDSCAPE FOR CHINESE INVESTMENT

Apart from CFIUS and other regulatory approvals, the US Congress can take an active interest in FDI and be an important institution for investors to consider and engage in the context of specific transactions. (See also Chapter 4 by Timothy Frye and Pablo Pinto in this volume.) This is particularly true for investments that present national security issues. In that regard, Congress’s interest and attempted intervention in foreign investments has not been circumscribed to Chinese investment. A Japanese investment in Fairchild and a proposed British takeover of Goodyear Tire & Rubber Company originally led to the adoption of Exon–Florio. In 2000, members of Congress expressed concern over the sale of Silicon Valley Group, a semiconductor equipment manufacturer, to the Dutch company ASML Holding N.V., and in 2006 Congress famously intervened in the sale of US port terminals to the Emirati firm Dubai Ports World.\footnote{74}

There is no question, however, that Congress will likely to continue to be a more important institutional consideration for investments from China than it will be for FDI from virtually any other country. Indeed, in 2000, Congress created a bipartisan committee, the United States–China Economic and Security Review Commission (USCC), specifically
“to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China.”75 The USCC must submit an annual report to Congress, which includes recommendations for legislative and administrative action. In 2005, Congress directed the USCC to focus its work and study on proliferation practices, economic transfers, energy, US capital markets, regional economic and security impacts, US–China bilateral programs, World Trade Organization (WTO) compliance, and the implications of restrictions on speech and access to information in China.76

The experience of a number of Chinese companies – which can be defined broadly to encompass Hong Kong (China)-based companies as well – has proven the impact that Congress can have directly on individual transactions involving Chinese investors. These case studies include the transfer of port operations in Long Beach, California, to China Ocean Shipping Company (COSCO); the Hong Kong (China)-based company Hutchison Whampoa’s acquisition of rights to operate the Panama Canal; China National Offshore Oil Corporation’s (CNOOC) bid for Unocal; and, more recently, the proposed investment by Huawei Technologies (Huawei) in 3Com.

As described further below, these case studies demonstrate that Congress is an important consideration for FDI from China. However, as also described below, Congress does not always intervene in even high-profile transactions from China, and even if some members express concern over a particular investment – which is likely to be the case in any high-profile investment from China – that does not in all cases mean the transaction is politically doomed.

3.3.1 COSCO’s Port Operations in Long Beach

The transfer of a former military base in Long Beach, California, to COSCO in 1997 provoked considerable criticism in Congress. Although several administration officials and a few members of Congress stated that the transaction posed no security concerns, the weight of the political response was negative, focusing on an alleged connection between COSCO and the People’s Liberation Army (PLA) and the threat posed by having China operate the former naval station.

Rep. Duncan Hunter, one of the most vocal critics of the transaction, summarized the arguments of the opponents:

COSCO is not a private enterprise. It is an arm of the Chinese government and an auxiliary to the People’s Liberation Army . . . Chinese control of a 135-acre terminal in Long Beach would pose a number of security threats to the United States. The terminal obviously would become a center for Chinese espionage on the West Coast. And it also would give the Chinese a stable, high-powered listening post for the interception of communications throughout California and beyond. The Chinese would know every move the US military makes and could monitor training exercises as well as operational deployments. Beijing also could develop ways to interrupt, neutralize or mislead the command, control and communications networks upon which our military operations depend.77

However, the Pentagon and at least two members of Congress publicly stated that the deal posed no national security threat. Pentagon spokesperson Kenneth Bacon said: “There are no national security concerns attendant to expanding COSCO’s presence in
the United States.” Representatives Steve Horn and David Dreier wrote in a joint letter to their colleagues that, based on intelligence briefings from the Central Intelligence Agency (CIA), Office of Naval Intelligence, Coast Guard and Bureau of Customs: “there is no evidence that the agreement between the City and Port of Long Beach and the China Ocean Shipping Company is a national security issue.”

Nevertheless, Congress incorporated into the Defense Authorization Act for fiscal year 1999 restrictions that prohibited “any funding to be used to enter into or renew a contract with any company owned, or partially owned, by the People’s Republic of China.” Long Beach and COSCO worked around the restriction by having other port tenants use the new facilities, with COSCO picking up the areas vacated by those tenants.

### 3.3.2 Hutchison Whampoa Panama Canal Ports Acquisition

Two years after the uproar over COSCO, there was a similar Congressional reaction to Hutchison Whampoa’s winning bid to acquire the rights to operate Atlantic and Pacific entrances to the Panama Canal. A number of Congressional leaders and retired military officers expressed concern over the transaction, with criticism centered on an alleged relationship between Hutchison Whampoa and the PLA, the strategic importance of the canal to US interests and the bidding process instituted by Panama:

- Sen. Trent Lott (R-MS) stated that Panama’s decision to let Hutchison Whampoa operate ports at both ends of the canal meant: “the Chinese Communist Party will gain an intelligence information advantage by controlling this strategic chokepoint.”
- The former Chairman of all Joint Chiefs of Staff, Adm. (Ret.) Thomas Moorer, also weighed in, stating: My specific concern is that Beijing, operating through this company, has virtually achieved, without a single shot being fired, not just a beachhead but a stronghold at the Panama Canal.
- Former Secretary of Defense Caspar Weinberger seemed to concur, stating: “The biggest threat to the canal is that in 1997 Panama granted a subsidiary of Hong Kong-based Hutchison Whampoa Ltd. a 25-year concession to operate the canal’s Atlantic and Pacific entrances at Balboa and Cristobal.”
- Resolutions were introduced in both the House and the Senate calling for the Clinton administration to request that Panama investigate corruption charges related to the award of the port concessions to Hutchison Whampoa and nullify the concessions if corruption was found.

However, Congress never took any formal action to block the Hutchison Whampoa deal in Panama, and other military leaders, administration officials and at least one senator viewed the transaction less critically and as motivated by commercial interests.

- Ambassador Peter F. Romero, Acting Assistant Secretary of State, Bureau of Western Hemisphere Affairs in the State Department stated in Congressional testimony: “We have concluded that the presence of Hutchison Whampoa in the ports of Balboa and Cristobal does not represent a threat to Canal operations or to US interests in Panama.” He explained that: “the process leading to the award to
Hutchison Whampoa has been reviewed by, inter alia, a Senate Foreign Relations Committee staff delegation and the Federal Maritime Commission. These studies concluded that though the bidding process was at best unorthodox, there did not appear to be discrimination against US companies.”

He further emphasized that he had “asked the intelligence community to use all sources to look at any threats to the canal and where those threats might be coming from,” and a classified report concluded that the “particular business arrangement of Hutchison-Whampoa, does not constitute a threat to canal operations.”

- Assistant Secretary of Defense Brian Sheridan noted similar conclusions in his Congressional testimony: “Our analysts have no evidence to suggest that China, through Hutchison Whampoa or any other firm, has the capability, the desire or the wherewithal to seek to control the Panama Canal after its transfer to Panama on 31 December 1999. Our analysts believe that . . . Hutchison Whampoa’s motivations are commercial.”

- US Secretary of State Colin Powell similarly stated: “I have not found that the so-called ‘presence’ in the form of shipping companies and the like have created any danger to the Panamanian people, the Panamanian government, or to the canal itself. Our interests are served . . . I don’t see anything that should cause . . . any great distress.”

- The US Ambassador to Panama, William Eaton, stated the US view of the Chinese interest in the canal as being “purely economic.”

- Sen. Carl Levin (D-MI) was one of the few members of Congress to challenge those who were opposed to the transaction, saying: “I would . . . note a statement of Henry Kissinger’s that would be wise advice for us to follow, and at least I’m going to try to follow it, that in the domestic debate that we should not invent imaginary dangers of foreign influence threatening the security of the canal.”

### 3.3.3 CNOOC’s Proposed Bid for Unocal

Graham and Marchick (2006, pp. 128–136) comprehensively reviewed the political firestorm that erupted over CNOOC’s bid for Unocal in 2005. They identified five arguments put forth by opponents to the transaction: (1) the transaction put global energy sources at risk, due to the possibility of CNOOC hoarding Unocal’s reserves for China’s exclusive use, thereby compromising US national security interests that depend on secure supplies of oil and gas; (2) the CNOOC bid was an attempt by the Chinese government to control critical oil and gas supplies, and the control and accompanying revenues would strengthen China’s government; (3) CNOOC’s bid relied upon preferential loans from Chinese state-owned banks and CNOOC’s state-owned parent, which put US companies at a competitive disadvantage; (4) CNOOC’s acquisition of Unocal would have potentially facilitated the transfer of sensitive technologies to China; and (5) because the Chinese would never allow a US company to acquire a major Chinese oil company, based on reciprocity, the United States should not allow the transaction.

Notwithstanding sound counter-arguments from supporters of the transaction, politics carried the day and overwhelmed CNOOC’s bid. Congress’s actions, which were detailed at length in Graham and Marchick, included the following:
Multiple letters were written by Members of Congress to Cabinet-level officials in the Bush administration expressing concern over the transaction. More than three dozen members of Congress wrote to then Treasury Secretary John Snow asking that the potential transaction “be reviewed immediately to investigate the implications of the acquisition of US energy companies and assets by CNOOC and other government-controlled Chinese energy companies.”94 Senators Kent Conrad (D-ND) and Jim Bunning (R-KY) complained to US Trade Representative Rob Portman and Secretary of Commerce Carlos Gutierrez that CNOOC’s bid was “inconsistent with China’s WTO commitments,” citing the financing terms for CNOOC as evidence that: “The proposed acquisition is not being conducted on commercial terms and has little commercial justification.”95

The House of Representatives was active in passing legislation expressing opposition to the CNOOC bid. It overwhelmingly (by a vote of 333 to 92) passed a bill prohibiting the Treasury Department’s use of funds for recommending approval of the sale of Unocal to CNOOC.96 It also approved, by a vote of 398 to 15, a non-binding resolution urging an Exon–Florio review of the bid.97

The House Armed Services Committee held a hearing on the CNOOC–Unocal transaction on July 13, 2005.

Ultimately, Congress provided the death knell for CNOOC’s bid by adopting an amendment to an energy bill requiring that the Secretaries of Energy, Defense and Homeland Security conduct a study of China’s growing energy requirements and the implications of “such growth on the political, strategic, economic, or national security of the United States.”98 The amendment would have prohibited CFIUS from completing any review of a CNOOC–Unocal transaction for 141 days, which is 51 days longer than the maximum of 90 days established by the Exon–Florio Amendment – thereby greatly increasing the cost of the CNOOC bid. Faced with this pressure, CNOOC withdrew its bid.

3.3.4 Huawei’s Proposed Investment in 3Com

In 2007 to 2008, Huawei’s proposed joint investment with Bain Capital Partners in the telecommunications firm 3Com elicited concern from Congress. According to public filings by 3Com, Bain Capital Partners and Huawei:

agreed to purchase 3Com . . . for $2.2 billion. Bain Capital will control 83.5 percent of the voting shares. Bain Capital will appoint 8 of 11 board members. Huawei will acquire a minority interest of 16.5 percent. Huawei will appoint 3 of 11 board members. Huawei can increase its equity by up to 5 percent (but no more), based on certain performance criteria, but cannot gain additional seats on the board or gain any measure of additional operational control.99

The Congressional response included the following actions and statements:

- A small group of principally Republican members of the House of Representatives introduced a proposed resolution opposing the transaction. Reciting a litany of alleged espionage-related activities attributed to China, Huawei’s alleged ties to the PLA and other publicly reported concerns over Huawei’s business, the proposed
resolution specifically stated that the transaction “threatens the national security of the United States” and called on CFIUS to reject the transaction.\textsuperscript{100}

- Sen. John Kyl (R-AZ), joined by 13 other senators, sent a letter to the Treasury Department urging that the transaction be closely reviewed under FINSA. The letter stated the senators’ belief that: “Huawei has built and currently maintains most of the PLA’s telecommunications backbone systems and is the Chinese military’s preferred provider for a wide variety of telecommunications products.” The letter went on to say that: “because of this long-standing and apparently deeply-engrained relationship between Huawei Technologies and the PLA, we are concerned about the national security implications of this acquisition for the United States.”\textsuperscript{101}

- Senator Chris Bond (R-MO), the ranking Republican on the Senate Select Committee on Intelligence, stated: “It is troubling to me that a foreign military organization with interests in communications might obtain access to our security systems.”\textsuperscript{102}

- Representatives Peter Hoekstra and Duncan Hunter wrote to Treasury Secretary Paulson formally requesting CFIUS review of the transaction regardless of whether it was submitted for examination by the parties.\textsuperscript{103} The letter stated in part: “This review should be conducted, and a determination made, as to whether this sale will in any way impact the national security of the United States or increase the vulnerability of US computer networks and telecommunications systems to Chinese intrusion.” In an interview, Rep. Hoekstra (R-MI) said: “There is no doubt as to why the Chinese want a partnership with 3Com. They look at this as a key connection to stealing additional secrets from US corporations and from our national security apparatus.”\textsuperscript{104}

- The House of Representatives Committee on Energy and Commerce, chaired by Representative John Dingell (D-MI) and led on the Republican side by Ranking Member Joe Barton (R-TX), wrote to the Treasury Department on January 31, 2008 – in the middle of the investigation by CFIUS – that it intended independently to investigate the transaction, and requested that CFIUS respond to certain questions. The letter cited “growing apprehension” among Members of Congress over the deal and stated that concerns over national security “are more justifiable, especially in light of recent increases in attacks on government and private networks [by Chinese military hackers].”\textsuperscript{105}

- Representative Thaddeus McCotter (R-MI) made repeated statements, including on the House floor, calling on CFIUS to block the investment by Huawei.

On February 20, 2008, 3Com, Bain Capital and Huawei announced that they had withdrawn the transaction from CFIUS following their failure to reach a mitigation agreement that adequately addressed CFIUS’s concerns.\textsuperscript{105} On March 20, 2008, Bain Capital announced its intent to terminate the merger agreement with 3Com.\textsuperscript{106}

\subsection*{3.3.5 The Political Environment Going Forward}

The experiences of COSCO, Hutchison Whampoa, CNOOC and Huawei demonstrate that Congressional reaction to a potential investment is a factor that Chinese investors would be wise to consider and to strategize for. To be sure, the potential for a Chinese
investment to become highly politicized – to the point that it might not be feasible – is significant. However, not all FDI from China has been subject to the same degree of Congressional scrutiny, and Chinese investors should not necessarily anticipate a Congressional environment that will always be as hostile as in the CNOOC case.

For example, the political reaction to Lenovo’s acquisition of IBM’s personal computer division was relatively mild. In that case, three Republican members of Congress – Henry Hyde, then chair of the House International Relations Committee; Don Manzullo, then chair of the House Small Business Committee; and Duncan Hunter, then Chair of the House Armed Services Committee – requested that CFIUS investigate the national security ramifications of the Lenovo–IBM deal. They warned that the sale could result in corporate assets and technology with military uses being passed to the Chinese, and the Chinese could use its new acquisition to conduct espionage activities in the United States. Representatives Hyde, Manzullo and Hunter indicated, however, that they were not necessarily opposed to the transaction going forward, so long as a proper review was undertaken. After the extended review by CFIUS that resulted in approval of the transaction, Congressional criticism was muted.

Other financial investments, while eliciting some concern on Capitol Hill, have also been less politicized. Senator Jim Webb (D-VA) expressed concern over CIC’s minority investment in the US private equity company Blackstone, but he was relatively isolated in making an issue of that investment. The Congressional reaction to CIC’s investment in Morgan Stanley was even more muted. CITIC’s proposed investment in the subsequently defunct Bear Stearns likewise caught the attention of Congress at the time but no Member issued exceptionally critical statements. Even in the case of 3Com-Huawei, the Congressional reaction arguably was milder than prior Chinese transactions, such as CNOOC.

The political environment for investment from China likely will remain dynamic for the foreseeable future, dependent upon tangential factors that may rise or fall quickly as well as the particular facts of a transaction and transaction timing. Those factors may include the overall health of the US economy, broader US–China trade balance issues, attention by the press and human rights groups on Tibet, debate in the US on sovereign investment, prominent press articles regarding potential Chinese espionage, and US sensitivities to energy prices and consumption. Election cycles also may contribute to the politicization of certain investments.

Yet, there also is arguably a stronger overall sense today among leadership and rank-and-file members of Congress that, for transactions that undergo a CFIUS review, the CFIUS process should be permitted to play out before even broaching the possibility of any Congressional intervention. In this regard, FINSA’s increased accountability and reporting mechanisms and the additional formal role of the intelligence community in the CFIUS process may enhance the faith of US politicians in the CFIUS process and tamp down instincts to intervene.

3.4 SPECIAL CONSIDERATIONS OF CHINESE INVESTMENT

Why is certain M&A activity from China likely to attract greater scrutiny from CFIUS and perhaps be prohibited outright? What factors about particular Chinese transactions
may present other institutional challenges, including creating greater political risk? Apart from certain interest groups and geopolitical issues, including human rights, there are at least six factors that may be presented by Chinese FDI that can present challenging national security and political issues: (1) the predominance of state ownership and the perceived ties of Chinese companies to the Chinese military; (2) the use of state subsidies to assist Chinese investors; (3) a perceived risk of espionage presented by a transaction; (4) the regulatory compliance record, including in particular export control compliance record, of Chinese companies; (5) the other markets in which the Chinese company may do business; and (6) a perceived rivalry between the US military and the Chinese military.

3.4.1 State Ownership and Control

As noted, FINSA formalizes a presumption of investigation in the CFIUS process where an acquiror is foreign government-controlled. Given the landscape of the Chinese economy and the strong history of Chinese companies being at least partly owned by the government, this issue of state control, and whether an entity is acting on the basis of commercial concerns or on behalf of government interests, may result in increased scrutiny when a Chinese company is involved.\(^{108}\)

A 2008 US State Department report noted that the state-owned sector accounts for approximately 40 percent of China’s (gross domestic product) GDP.\(^{109}\) Indeed, as of 2008, the ten largest multinational enterprises in China were all state-owned enterprises (SOEs).\(^{110}\) Most large publicly traded SOEs remain subject to substantial state control due to restrictions on the transfer of state-owned shares, which constitute a majority of shares issued by listed companies,\(^{111}\) as well as state approval over officers in management positions.\(^{112}\)

Many of the largest SOEs are also owned by the State-owned Assets Supervision and Administration Commission (SASAC), which has control over the budgets of the SOEs and has ultimate authority over approving M&As.\(^{113}\) In addition, publicly listed firms have a parallel structure to their board – the firm’s Party Committee, chaired by the Party Secretary, who reports to the Communist Party of China’s Organizational Department. According to one study, the CEOs of the 53 largest SOEs in China are appointed directly by the Communist Party of China’s Organizational Department.\(^{114}\) Local governments or the Communist Party also can exercise control by informally influencing the composition of corporate boards and the corporation’s management team.\(^{115}\)

From the perspective of US government officials and politicians evaluating Chinese investment, even publicly traded Chinese companies that otherwise look and feel like Western companies not affiliated with the state may present government control issues. Ministries and agencies within China have served as incubation grounds for companies that were later spun off privately. The fact that the founders of these companies have their origins with the Chinese government can contribute to a view of the companies as government-affiliated or controlled. Furthermore, the Chinese government often retains shares in publicly traded company.

That even publicly listed Chinese companies can have ownership interests held by the government or be aligned in some way with the government even when there is no apparent state ownership (for example, if officials are tied to the government) is significant from
the perspective of the US regulatory and political environment. SOEs comprise a high share of China’s outward-bound FDI. Of the 30 Chinese companies that are the largest outward investors, only one – the Lenovo Group – is not officially state controlled. Indeed, ten of these companies accounted for approximately 84 percent of all outward FDI from China between 2004 and 2006. With this background, the US officials involved in the CFIUS process may start with the presumption that all Chinese companies seeking to invest in the United States are controlled by the Chinese government – and it will be left to the Chinese company to convince the US government otherwise.

3.4.2 State Subsidies

As the CNOOC experience with Unocal indicates, the funding that Chinese companies rely upon in making investments in the United States may be an important regulatory and political factor. First, on the regulatory front, such funding can be indicative of state control. As Graham and Marchick noted, one of the factors that CFIUS considers to determine government control is “contractual arrangements” and the “pledge or other transfer of any or all of the principal assets of the entity.” As a contract, a loan agreement likely could be considered to meet these terms if it included a “pledge” of certain of the acquirer’s assets as collateral. Further, if an entity appears to be making an investment on non-market terms, CFIUS may question whether the transaction is purely a commercial transaction or, instead, reflects state-related interests and direction. In this regard, it is significant that four state-controlled banks – the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank, and the Agricultural Bank of China – are responsible for a sizeable portion of all commercial loans in China. Financing from such state-controlled entities may impact CFIUS’s threat assessment of the transaction.

State subsidies also can present policy questions that garner attention from Congress. For example, CNOOC reportedly received two low- or no-interest loans totaling $7 billion from its state-owned parent to make its bid for Unocal. In response, members of Congress, in a joint letter to the President, expressed concern about the appropriateness of states subsidizing investment transactions to acquire scarce natural resources that are in high demand. They observed that, when government subsidies are directed toward such highly demanded and scarce resources: “any ensuing market distortions should be of particular concern . . . [because] [s]uch subsidies may facilitate the allocation of scarce resources to inefficient or less-efficient producers.” The OECD has noted that large Chinese SOEs:

have inherent advantages in undertaking large foreign investments since they enjoy formal as well as informal support from the government in the area of finance, networking, information access, and administrative procedures. They can also rely on monopolistic power in their respective subsector in the domestic market which has been protected by the government.

More to the point, state subsidies to Chinese companies can easily translate into political concerns over the impact of FDI from China on small and medium-sized US businesses. Indeed, in its 2007 report to Congress, the USCC claimed that subsidies from the Chinese government negatively impact market conditions for US companies, stating that:
“China’s unfair trade practices, including . . . illegal subsidies for Chinese exports,” harm small and medium-sized US manufacturers.\textsuperscript{123} Another policy concern related to state subsidies is that they obscure inherent inefficiencies or other weaknesses in SOEs. These weaknesses can include, for example, a high cost of production, inefficient capital–labor combinations and artificially determined product mixes and technology.\textsuperscript{124} In the context of Chinese investment, subsidies to SOEs can raise questions, whether fair or not, about the SOE’s ability to make efficient decisions and be a beneficial investor for the US company.

3.4.3 Commercial and State Espionage

Chinese FDI in certain sectors – in particular defense, aerospace, telecommunications and information technology – also can present regulatory and political challenges because of US concerns over Chinese commercial and state espionage. The US intelligence community has characterized the Chinese intelligence services as “among the most aggressive in collecting against sensitive and protected US targets,”\textsuperscript{125} and the Department of Justice “consider[s] China to be one of [its] top counter-intelligence priorities.”\textsuperscript{126} The USCC claims: “Chinese espionage in the United States . . . comprises the single greatest threat to US technology,” and “is straining the US counterintelligence establishment.”\textsuperscript{127} According to the US government, China’s intelligence-gathering is more complicated than traditional state espionage because it is decentralized, involving data collection through Chinese students, scientists, researchers and other visitors to the United States.\textsuperscript{128} US officials have publicly claimed that there are over 3000 Chinese “front companies” operating in the United States whose purpose is to gather intelligence and technology.\textsuperscript{129} While that may have been an exaggerated number, in response to the threat, the FBI reportedly increased the number of counter-espionage agents assigned to China from 150 in 2001 to more than 350 in 2007.\textsuperscript{130} One-third of all economic espionage matters being actively pursued by the FBI in 2007 were reportedly tied to China.\textsuperscript{131} Since the beginning of 2007, there have been at least a dozen guilty pleas or criminal charges resulting from alleged Chinese espionage activity in the United States.\textsuperscript{132} A frequently reported target of commercial and state espionage is the US technology sector. For example, according to a report to Congress, China accounted for almost half of the illicit attempts in the United States to obtain space-related technology between 1997 and 2005.\textsuperscript{133} Concerns over Chinese industrial espionage in the technology sector also have not been limited to the United States. A senior official in Germany’s domestic intelligence agency identified China as the most frequent source of industrial espionage against German companies, noting that: “China is intensively collecting information around the world – political, military and scientific data, and company strategies in order [to] close the gap in their [sic] technology developments as quickly as possible.”\textsuperscript{134}

The implications of these concerns over Chinese espionage are two-fold. First, Chinese FDI in defense, aerospace, telecommunications, IT and other high-technology sectors will face very close scrutiny from CFIUS and may not be permitted; if it is permitted, it would likely only be on the basis of an entirely passive investment and/or considerable mitigation commitments. Second, as the proposed Huawei–3Com transaction makes clear, the potential nexus between an individual investment from China and broader concerns over Chinese espionage will remain a focus for Congress.
3.4.4 Regulatory Compliance

A fourth special consideration for FDI from China is the issue of regulatory compliance by Chinese companies, including in particular with US export control laws. The importance of export controls as an ongoing compliance matter is described in section 3.1 above. However, the issue of export control compliance also may have a broader regulatory and political impact on the ability of Chinese firms to make investments in the first instance. As noted, under FINSA, CFIUS must formally consider compliance with the US export control regime when investigating a transaction that involves foreign government ownership. And, as noted, the US government believes that China focuses industrial espionage on the technology sector, with the purpose of obtaining cheap and easy access to technologies that might be restricted for transfer to China. Moreover, the US government has adopted stricter licensing requirements for export to China. Specifically, under the so-called “China Rule,” items controlled on the Commerce Control List will generally be denied for export if they would “make a direct and significant contribution to Chinese military capabilities” or otherwise would be destined for “military end-use” in the People’s Republic of China, even if such items would not need an export license in typical circumstances.135

Compliance with US export controls has taken on significance for certain Chinese investments in part because of the prevalence of reported violations involving Chinese nationals and firms. For example, the US has imposed sanctions against several Chinese companies for violating embargoes to sanctioned countries, including against Norinco, China’s largest military conglomerate, for transshipments to Iran.136 As a result of this history – and virtually irrespective of the compliance record of the particular Chinese firm at issue in a transaction before it – CFIUS will apply additional scrutiny to transactions involving Chinese investment in US companies possessing export-controlled technology.

Another compliance factor that may impact the regulatory and political environment for Chinese investment is the reputation of both the foreign investor and the US party for compliance with anti-bribery laws. As with export controls, ongoing compliance with the Foreign Corrupt Practices Act137 is discussed in section 3.1 (and in the chapter by Lorraine Eden and Stewart Miller in this volume). And, as with export controls, the broader issue of FCPA compliance may be relevant to the ability of Chinese firms to invest in the United States.

First, as a political matter, ties between Chinese firms and the Chinese government and, in turn, any connection with public corruption, whether real or alleged, can be exploited politically by opponents of any particular investment.

Second, because so many Chinese firms are state-owned, there can be particular challenges for US firms dealing with Chinese business partners, even when the dealings occur in the United States. For example, a US firm may be interested in a particular investment from a Chinese firm because the partnership could also help open markets in China. However, in assessing that investment, the record and reputation of US management for regulatory compliance and the Chinese firm with respect to its own compliance can impact the trustworthiness analysis conducted by CFIUS. In particular, CFIUS may consider compliance with the FCPA and the corruption reputation of the buyer when performing its analysis. Thus, in part because of the state ownership characteristics
of Chinese investors, the general compliance record of both the Chinese firm and the US firm in an M&A transaction – in particular, their respective reputations for export control and anti-bribery compliance – can take on added significance in the regulatory and political risk calculus associated with that transaction.

### 3.4.5 Investments in Other Markets

Closely related to concerns that US authorities may have over export control risks associated from Chinese investment are concerns over the markets in which a Chinese investor conducts business. In particular, US government authorities and Congress are focused on Chinese investment in countries subject to US sanctions, such as Iran, the Sudan and the Democratic People’s Republic of Korea, as well as other countries where the US has proliferation concerns. Thus, for Chinese investors, CFIUS will consider the potential threat posed by the transaction for controlled materials and technology, including dual-use technology relevant to nuclear and missile proliferation, to be transshipped to countries such as Iran, Pakistan and the Democratic People’s Republic of Korea.

In addition, given the level of Chinese energy-related investment in Iran and the Sudan, investments by the major Chinese energy SOEs in the US in particular may be more difficult politically. In 2005, CNOOC did not have major concessions in Iran or the Sudan; however, other large Chinese SOEs, Sinopec and China National Petroleum Corporation, had investments in Iran and the Sudan that contributed to the politically charged nature of CNOOC’s bid for Unocal.

### 3.4.6 Military Rivalry

Finally, the United States’ view of the Chinese military as an emerging strategic threat impacts the US regulatory and institutional environment for Chinese FDI. The National Defense Authorization Act for Fiscal Year 2000 required the US Department of Defense to issue an annual report to Congress on Chinese military power and strategy.\(^\text{138}\) In its 2008 annual report, the Pentagon noted an increased “pace and scope of China’s military transformation,” “fuelled by continued high rates of investment in its domestic defense and science and technology industries, acquisition of advanced foreign weapons, and far reaching reforms of the armed forces.”\(^\text{139}\) The report stated that, while “China’s ability to sustain military power at a distance remains limited,” China “has the greatest potential to compete militarily with the United States and field disruptive military technologies that could over time offset traditional US military advantages.”\(^\text{140}\)

The Pentagon’s concerns over Chinese military objectives and strategic behavior are important for Chinese FDI for three reasons. First, to the extent Chinese FDI involves a state-owned company or CFIUS has questions about the connection of a Chinese investor to the Chinese government or military, CFIUS will assess the Chinese investment in terms of how it might strengthen the Chinese military or reduce the strategic standing of the United States military. This may well be a significant factor given that many of the largest Chinese SOEs have been involved in the production of military items.\(^\text{141}\) Second, in turn, Chinese investments in the technology sector as well as in the energy or natural resource sectors will receive even greater scrutiny from the Defense Department – and the other CFIUS agencies likely will provide great deference to the DOD’s interests.
in such transactions. Third, as CNOOC and Huawei Technologies experienced, the perceived threat of the Chinese military is an issue that resonates with Congress, and Chinese investments that arguably might benefit the Chinese military or have some connection to the military – even remotely – stand the greatest likelihood of becoming highly politicized.

3.5 CONCLUSIONS: STRATEGIC MEASURES FOR CHINESE FDI

Notwithstanding that Chinese SOEs and other investors may have inherent characteristics that, at least in the United States, raise their regulatory and, in particular, political risk profile, there are a number of practical measures that Chinese investors can take to help manage these risks and enhance the prospects of regulatory approval without political interference.

First, investors should understand the potential risks associated with any investment and be strategic about the sectors and US businesses in which to invest. The recent experience of Bain Capital, 3Com and Huawei Technologies reflects the perils of potentially underestimating the risk inherent in Chinese investments in certain sectors. Based upon the public statements of the transaction parties, it would appear from the outside that, to varying degrees, they may have underestimated the degree to which Huawei’s proposed 16 percent interest in 3Com and minority representation in 3Com’s Board would jangle regulatory and political nerves.\textsuperscript{142}

This is not to argue that Bain Capital and Huawei Technologies should have refrained from pursuing the investment in 3Com, or that the decision by CFIUS to block the transaction was the right result. Outsiders to any transaction cannot know exactly the considerations that factored into the respective analyses of the transaction parties or CFIUS. However, the 3Com case does exemplify the importance for Chinese investors to conduct an informed regulatory and political risk analysis in connection with the due diligence evaluation of potential investments in the United States. In this regard, Chinese investors should be aware that certain US businesses, including those in the defense, aerospace, telecommunications, information technology and, to a lesser degree, energy sectors, will present considerable regulatory and/or political risk and may not be realistic transaction targets. Other assets may still be subject to CFIUS review but potentially will be less sensitive, such as chemicals and certain infrastructure (for example, sea ports). Even with these assets, however, political risk may remain high. And still other assets, such as real estate and manufacturers of consumer retail products, may present minimal regulatory and political hurdles even for Chinese investors. In each asset class, though, the same lesson remains: be smart about the investment and conduct a full risk analysis before proceeding.

Second, in connection with a long-term strategy to develop and grow their position in the US marketplace, investors from potentially sensitive regions and countries, including China, often are wise to initiate their entrance into the US merger market by picking up “low-hanging fruit” with their initial investments. This may mean taking a minority share in a non-sensitive US business with another US partner holding the majority share. It also could mean exploring greenfield investments, if those make economic sense.
Or, it may mean making a relatively easy acquisition that is likely to receive CFIUS approval. The benefit of the latter approach is that the investor becomes a known quantity to CFIUS, including through a full intelligence analysis by the Director of National Intelligence. Having this first-time review occur in the depressurized context of a non-sensitive transaction can help reduce questions and establish a better environment for larger transactions down the road.

Third, along similar lines, establishing a strong record of business in the United States can be helpful to ease concerns and address questions from certain regulatory bodies like CFIUS. Indeed, in virtually every CFIUS review, it is helpful, albeit far from dispositive, for the transaction parties to be able to note that the foreign investor is already selling products into the US market and has an established record of doing business in the US – the point being that the investment should not present any additional threat.

Fourth, measures to enhance corporate transparency of Chinese investors are important both for the CFIUS process and to help pre-empt potential criticisms from Congress. As described more fully above, among the characteristics that can make Chinese investment challenging for CFIUS and contribute to political risk are the perceived opacity of corporate governance structures and the belief that Chinese investors may benefit from government subsidies when making their investments. There is no magic bullet for any Chinese investor to address completely US government concerns over the investor’s ties, perceived or actual, to the Chinese government. However, as a regulatory matter, CFIUS seeks to probe ownership structures, examine management of the foreign investor, understand business lines and practices, and examine the financing for transactions. In this regard, there are certain fundamental steps that Chinese companies can take to address these questions and create greater confidence that they are acting on commercial grounds. These include publishing annual reports with standard financial disclosures, briefing reporters and financial analysts on commercial strategies, using Western financial advisors and financing transactions solely on commercial terms, and in certain circumstances, offering briefings to CFIUS agencies regarding business plans and product developments.

Fifth, given the potential post-transaction compliance concerns that are frequently attributed to Chinese investment, being able to demonstrate a strong compliance program and culture to US authorities is another important measure to enhance prospects for successful investment in the United States. For example, having sound written policies and procedures for export control compliance and anti-corruption compliance, including training materials for employees, would reflect an understanding of US regulatory interests and enhance the reputation for the Chinese investor.

Sixth, in certain transactions, the Chinese investor may wish to join with a well-known and reputable US partner to pursue an investment or to defer to the US party on the opposite side of a transaction to take the lead in public statements and political strategy. Having a US partner obviously will not equate to a successful and quiet investment in all circumstances – after all, Huawei Technologies was the minority partner to Bain Capital’s predominant position in the failed 3Com transaction. However, US parties will often be able to deliver political supporters, and involving US citizens in a transaction, in turn, may be prudent politically. The IBM–Lenovo transaction is one that demonstrates the potential import of having a strong US party to a given transaction. In that case, IBM, with its virtually unparalleled reputation both in the Executive Branch and in Congress,
provided a strong voice to the rationale for the transaction. Lenovo, to its credit, exercised discipline and enabled IBM to take the higher profile publicly in the transaction. By comparison, executives from CNOOC and Huawei each made public comments that hurt their cause and contributed to political controversy. Huawei’s chief marketing officer famously called US concerns over the transaction “bullshit.”

Seventh, it is important for all investors, including especially Chinese firms, to understand how business outside the United States can impact the ability to make investments in the United States. In particular, transacting business with and having significant investments in countries subject to US sanctions, including Iran, Sudan, the Democratic People’s Republic of Korea and Cuba, can present regulatory compliance challenges as well as political risks for investments in the United States. Some potential investors may conduct a cost–benefit analysis of business opportunities in these sanction countries and conclude the risks, including risks of impact on US opportunities, outweigh the potential rewards. Others may reach the opposite conclusion. In all events, for those firms that seek to invest in the United States and that also conduct business in such sanctioned markets, it is imperative that they be thoughtful about how their various investments are structured and who is involved, to avoid legal minefields of US sanctions laws.

Eighth, and finally, Chinese firms potentially contemplating major acquisitions in the United States may wish to develop a comprehensive strategy – well before any investment is made – to help manage political risk, especially in Washington. Such a “Washington strategy” might include: a communications effort intended to help lay the groundwork for future investment and improve the investor’s reputation among key Washington institutions; efforts to make the Chinese investor more transparent publicly as well as to key agencies and members of Congress, including by providing briefings to these audiences; and establishing a framework of third-party validators – that is, well-respected third parties who, when asked to comment about the Chinese firm, will be favorably inclined. Such a “Washington strategy” may also involve participating in the larger Washington policy-related environment outside the context of any particular transaction – such as by participating in events hosted by trade organizations and think-tanks and potentially even seeking opportunities to participate in certain industry organizations.

None of these measures is necessarily easy to implement. Even with the best intentions, Chinese firms may face resistance in pursuing certain of these measures – for example, certain members of Congress may not wish to meet directly with a Chinese firm, and other parties may be wary about being publicly associated with a prominent Chinese investor. Nor would these measures collectively insulate all Chinese firms against political and regulatory risk for all types of transactions. In the end, there will remain investments in certain US assets that may be entirely off-limits to Chinese companies because of regulatory considerations (that is, CFIUS would not approve the transaction), political considerations (the US Congress or state or local officials would interfere to the point of killing the transaction), or both.

Nevertheless, the United States maintains an official policy of welcoming investment. The challenge for Chinese investors, therefore, is to find the right transactions that enable them to invest in the US market without incurring regulatory or political trouble. This is the aim of the foregoing recommendations: namely, to help provide Chinese investors...
Investing in the United States

with a broad roadmap to lessen regulatory and political risk and avail themselves of the open investment environment in the United States.

NOTES

* This chapter was prepared in the context of the Deloitte–Vale Columbia Center on Sustainable International Investment project on “Is the US ready for FDI from China?” For their insights and guidance throughout this project, I would especially like to thank Karl Sauvant, Clarence Kwan, Wendy Cai-Lee and Kris Knutsen, as well as the other authors in the project. I owe a special gratitude for the support and guidance of Mark Plotkin, and for the opportunity provided to me in this chapter by David Marchick. Finally, my love to Marnie, Chloe and Ian for tolerating the late nights and much more.


2. In 1977, the Carter administration had issued a policy statement recognizing that: “international investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces,” and “the United States has an important interest in seeking to assure that established investors receive equitable and nondiscriminatory treatment from host governments” Jackson (2007, p. 6) (internal citation omitted). In 1983, President Reagan issued a statement welcoming foreign investment, and clarifying the US government’s “neutrality” position on international investment to include three objectives: liberalization of barriers to international investments abroad, encouraging FDI to assist in the economic development of developing countries and maintaining an open US economy to contribute to FDI. Id. p. 7 (internal citation omitted). The administration of George H.W. Bush then issued a statement promoting foreign investment in 1991. The Clinton administration, while not formally adopting a policy statement, sought the development of a Multilateral Agreement on Investment (MAI) among OECD countries that would have formally addressed various issues that hamper the free flow of investments, such as discriminatory treatment and creating dispute settlement mechanisms. Id. (internal citation omitted).


4. See infra note 37 and accompanying text.

5. See infra notes 105–106 and accompanying text.


7. 15 U.S.C. §§ 78m, 78dd.


9. For a thorough overview of the basics of the US foreign trade control regime, see Flanagan and Brown (2003); see also GAO (2006).

10. 15 C.F.R. Parts 730 to 774.

11. 22 C.F.R. Parts 120-130.

12. 22 C.F.R. Pt. 121.


14. The restrictions are even broader with respect to the Cuba embargo, which applies to “persons subject to the jurisdiction of the United States” – a term that can mean even foreign affiliates are subject to control of a US party and, in turn, the Cuba embargo.


16. Id.


18. For a thorough overview of the FCAPA’s criminal provisions and pitfalls, see Wolff and Clarke (2007).

19. Id. at 13. FCAPA also applies to “issuers” of registered securities in the United States, which can include foreign companies that trade American Depository Receipts in US financial markets.

20. Id. at 15 (citing 15 U.S.C. § 78dd-1(f)(1) and U.S. v. BPC (Tianjin) Co. Ltd, No. 05 Cr. 282 (C.D. Cal. May 20, 2005)).

21. Id. (quoting 15 U.S.C. § 78dd-3(a)).

22. Levin at ¶ 503.3.2.1 (2007).
23. Id. at ¶ 503.3.2.2; see also Tafara (2008).
25. Levin (2007) at ¶ 503.3.2.4.
26. Id. at ¶ 503.3.2.7.
27. Id. at ¶ 503.2.1.
28. Id. at ¶ 503.3.3.
31. Figure current as of 2008.
33. Id. at 10.
38. In particular, Fujitsu’s attempted acquisition of an 80 percent interest in the US semiconductor manufacturer Fairchild prompted a backlash on Capitol Hill that ultimately led to the adoption of Exon–Florio. See infra note 62 and accompanying text.
41. Id. § 2(a)(3) (codified at 50 U.S.C. App. § 2170(a)(3)).
42. An investigation of such transactions is not required if the Secretary or Deputy Secretary of the Treasury, and an equivalent official at the “lead” CFIUS agency, determine that the proposed transaction will not impair national security. The concept of a “lead” CFIUS agency is discussed further below. For those acquisitions by state-owned enterprises that reach the investigation stage, the law requires an assessment of the foreign country’s compliance with US and multilateral counter-terrorism, nonproliferation and export control regimes.
44. FINSA, § 6 (codified at 50 U.S.C. App. § 2170(d)).
46. Executive Order 11858 (1975).
47. Executive Order 13456, Further Amendment of Executive Order 11858 Concerning Foreign Investment in the United States § 3 (2008) (hereinafter “FINSA Executive Order”). The additional White House offices are the Office of Management and Budget, the Council of Economic Advisers, the Assistant to the President for National Security Affairs, the Assistant to the President for Economic Policy, and the Assistant to the President for Homeland Security and Counterterrorism.
48. 31 C.F.R. § 800.401.
49. FINSA, § 6 (codified at 50 U.S.C. App. § 2170(e)).
51. The drive toward a consensus reflects the desire among CFIUS members to avoid sending a transaction to the President, if at all possible. Thus, there is internal pressure among the CFIUS cabinet membership to form a consensus view on every transaction. In the rare instance when a transaction does proceed all the way to the President for a decision, the reports prepared for the President by the member agencies of CFIUS can reflect differing views.
53. While perhaps less significant for purposes of this chapter – given its focus on inward-bound investment – it is important to note that for CFIUS persons, “foreign person” includes any foreign national, foreign government, or entity over which “control” is exercised by a foreign national, foreign government, or another foreign entity. Thus, controlling acquisitions of US businesses by US subsidiaries of foreign companies fall within the jurisdiction of CFIUS if they potentially impact US national security.
54. 31 C.F.R. § 800.204(a).
55. Id.
56. Id. at § 800.204(c).
57. Id. at § 800.226.
58. Id. at § 800.301(c)(Examples 6 and 7).
60. Department of Treasury, Guidance Concerning the National Security Review Conducted by the

51. 50 U.S.C. App. § 2170(f).


54. FINSA § 2, 50 U.S.C. App. § 2170(a)(5).

55. 31 C.F.R. § 800.208.

56. A working group of US government agencies, chaired by the Department of Treasury, has identified 14 sectors in which critical technologies arise: advanced materials and processing; chemicals; advanced manufacturing; information technology; telecommunications; microelectronics; semiconductor fabrication equipment; military-related electronics; biotechnology; professional and scientific instruments; aerospace and surface transportation; energy; space systems; and marine systems. See Report to Congress on Foreign Acquisition of and Espionage Activities Against US Critical Technology Companies (Unclassified) 9-10 (Sept. 2007).


58. That information focuses on certain obvious national security criteria, including whether the US company has any contracts with US defense or intelligence agencies or defense contractors, whether the US company has technology that is controlled under export control laws, whether a foreign government controls or directs the foreign acquiror, and what the foreign acquiror’s intentions are for the US operations.


63. In addition to the investment review provided by CFIUS, it should be noted that the Department of Defense, US intelligence agencies, the Department of Energy, and the Nuclear Regulatory Commission have independent authority to review and restrict investments into companies that, as contractors to those agencies, possess US government classified information. These authorities are less likely to be relevant to Chinese investors; it would be extremely unlikely for a Chinese company to be permitted to acquire outright or even to make an investment that would be deemed “controlling” – in a business that is part of the defense industrial base or that possesses any classified contracts with the US government.


70. “The town the Navy left behind: Long Beach reinvents itself as tourist, shipping port of call,” CNN.

71. Leavitt et al. (1999), quoting letter from Sen. Lott to then Defense Secretary Cohen.


93. Graham and Marchick (2006), p. 120.
94. Letter to Treasury Secretary John W. Snow from Representative William J. Jefferson et al. (undated).
102. Id.
103. Id.
112. Of nearly 1400 publicly listed Chinese companies at the end of 2005, nearly two-thirds of the outstanding shares were non-tradeable. Morck et al. (2007). More than half of the non-tradeable shares were owned directly by governmental entities, and the remainder were owned principally by other large SOEs or state-managed investment funds (Id.).
113. Hemerling et al. (2006); Draft OECD Report on China OFDI, op. cit., ¶ 104.
120. Sloan (2005).
125. Statement of John Negroponte, Director of National Intelligence, Before the Senate Select Committee on Intelligence, January 11, 2007.
Investing in the United States

131. Id.
140. Id. (internal quotation and citation omitted).
142. In a supplemental to a proxy statement issued by 3Com in February 2008, the company disclosed: “The Board of Directors considered Huawei’s participation in the proposed transaction as a factor in their recommendation of the Merger. The Board believed that Huawei’s participation increased deal certainty.” 3Com Corporation, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Feb. 19, 2008).

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