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National Security Review in Foreign Investments: A Comparative and Critical Assessment on China and U.S. Laws and Practices

Xingxing Li

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Article

National Security Review in Foreign Investments: A Comparative and Critical Assessment on China and U.S. Laws and Practices

Xingxing Li*

This Article takes a comparative approach to critically assess the laws and practices of national security review in connection with inbound foreign investment in China and the United States—the two biggest host countries for foreign direct investments. While the two regulatory apparatuses bear a degree of formalistic resemblance as China transplanted some of the mechanisms from the United States, they have contrasting effects in implementation. It explains certain nuanced differences in the two regulatory frameworks as well as the distinctive political economies behind institutional designs that contribute to the deviations observed in the two apparatuses. The assessment focuses on three vital aspects: (i) the criticism on the secrecy, unpredictability and politicization in the decision-making process in national security review, (ii) relatedly, the scope and the standards of review that lead to under-inclusiveness and over-inclusiveness in enforcement, which add to the uncertainty and blur the line between national security and economic interests, and (iii) a few structural layouts that cause unreasonable delay, present undesirable deterrence effects, dampen efficiency, undermine comparative expertise of regulators, and create misplaced incentives for foreign investors.

Regarding the United States, the blurred contour of national security review calls into question whether the review is solely about national security, or if it also concerns economic interests. Against the backdrops of (a) no definition of national security being available, (b) no monetary threshold of reviewable transactions being available, (c) a broad definition of “control,” and (d) the Committee on Foreign Investment (CFIUS) process being immune from judicial review, the case-by-case adjudication approach currently taken by CFIUS is particularly inapt to shed light on a highly secretive CFIUS

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process or to provide meaningful guidance to potential foreign investors ex ante.

In China, the national security review regime is new on the horizon, but has shown symptoms of becoming a new layer of regulation that does more harm than good. Its redundant review structure jointly administered by two ministerial-level agencies has little efficiency justification. A more detrimental flaw in China's design of its national security review regime is its misplacing regulatory resources: (A) focusing on traditional manufacturing sectors, while ignoring the strategically important services sector especially the financial sector, and (B) requiring a threshold of 50 percent equity interest to satisfy the test of "control," which in conjunction with other programs supervising inbound foreign investment has the effect of shifting regulators' attention to less critical sectors.

Key Words: national security review, foreign investment, cross-border M&A, CFIUS, structure of regulation, institutional design, China, United States

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INTRODUCTION

M&A transactions are one of the most important means through which foreign investors gain presence in a host country. In the United States, while mergers and acquisitions of US companies represent a small percentage of total foreign investment influx,¹ they had sizeable deal values of over \$1 trillion during each peak year.²

Compared to greenfield investments, where foreign investors start on a clean slate, cross-border M&A activities have a greater impact on the host country in that foreign investors obtain an ideal conduit through which critical technology, knowhow, sensitive information pertaining to existing client base, and market share are transferred. The other side of the coin, however, is that cross-border M&A transactions may become the Trojan Horse of foreign political goals, raising concerns on the national security of the host country. Thus, one of the regulatory challenges posed is national security concern accompanying the inflow of foreign capital in critical sectors. In response, regulators tend to initiate national security review as a regulatory instrument to scrutinize proposed cross-border M&A transactions.

National security review is a significant yet understudied regime in the regulatory framework governing foreign investment.³ For law practitioners,

¹ See COMM. ON FOREIGN INV. IN THE U.S., ANNUAL REPORT TO CONGRESS 30 (Dec. 2013), <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2013%20CFIUS%20Annual%20Report%20PUBLIC.pdf> [hereinafter CFIUS ANNUAL REPORT 2013].

² See WILMERHALE, 2014 M&A REPORT 2 (2014), https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2014-WilmerHale-MA-Report.pdf.

³ There is literature on national security review, a number of which are student notes and comments. E.g., George Stephanov Georgiev, Comment, *The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security*, 25 YALE J. ON REG. 125 (2008); Cathleen Hamel Hartge, Note, *China's National Security Review: Motivations and the Implications for Investors*, 49 STAN. J. INT'L L. 239 (2013); Souvik Saha, Comment, *CFIUS Now Made in China: Dueling National Security Review Frameworks as a Countermeasure to Economic Espionage in the Age of Globalization*, 33 NW. J. INT'L L. & BUS. 199 (2012); Christopher M. Tipler, Note, *Defining 'National Security': Resolving Ambiguity in the CFIUS Regulations*, 35 U. PA. J. INT'L L. 1223 (2014); Colin Stapleton, Note, *The Global Colony: A Comparative Analysis of National Security-Based Foreign Investment Regimes in the Western Hemisphere*, 92 WASH. U. L. REV. 1647 (2015); see also David T. Zaring, *CFIUS as a Congressional Notification Service*, 83 S. CAL. L. REV. 81 (2009); INVESTING IN THE UNITED STATES: IS THE US READY FOR FDI FROM CHINA? (Karl P. Sauvant ed. 2010); Matthew Aglialoro, *Defend and Protect: National Security Restrictions on Foreign Investment in the United States*, 83 U. CIN. L. REV. 1261 (2015). As noted by David Zaring, national security is "the subject of little international scholarship." See Zaring, *supra* note 3, at 129. Relatedly, there is literature on sovereign wealth funds and the prospect of a US-China bilateral investment treaty. See, e.g., Scott J. Shackelford, Eric L. Richards, Anjanette H. Raymond & Amanda N. Craig, *Using BITs to Protect Bytes: Promoting Cyber Peace by Safeguarding Trade Secrets Through Bilateral Investment Treaties*, 52 AM. BUS. L.J. 1 (2015); David A. Gantz, *Challenges for the United States in Negotiating a BIT with China: Reconciling Reciprocal Investment Protection with Policy Concerns*, 31 ARIZ. J. INT'L & COMP. L. 203 (2014); Daniel C.K. Chow, *Why China Wants a Bilateral Investment Treaty with the United States*, 33 B.U. INT'L L.J. 421 (2015); Paul Rose, *Sovereigns as Shareholders*, 87 N.C. L. REV. 83 (2008); Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 U. CHI. L. REV. 111 (2009).

national security review has become an increasingly important apparatus in any investment policy. For policymakers, the institutional design for national security requires a delicate balance between openness to foreign investment and protection of national security. In the trend toward globalization and free trade, most jurisdictions with national security review systems strive to avoid either extreme of the spectrum: unequivocal support of foreign investment, or absolute protectionism. But where to draw the line in between has always been a policy question.

The US national security review rubric, including most notably the Committee on Foreign Investment in the United States (CFIUS), has gained prominence over the years.⁴ This is in part because of the heightened role that CFIUS has played,⁵ represented in its expanding mandate and surge in enforcement activities. In comparison, China's national security review regime, modeled on that of the United States,⁶ is relatively new on the horizon.

This Article adopts a comparative perspective to evaluate the national security review regimes in the United States and China, the top two host countries for foreign investment in terms of monetary value. It considers the structural layouts of national security review regimes in these two countries, the economic backdrops, the political economies underlying institutional design, and their interplay with other regimes. It finds that while the US and Chinese national security review regimes bear a degree of formalistic resemblance due to China's transplantation of some mechanisms from the United States, they have contrasting effects in implementation. The divergence derives from nuanced differences in the two regulatory frameworks and the distinctive political economies behind institutional designs.

The assessment focuses on three vital aspects: (i) the criticism on the secrecy, unpredictability, and politicization in the decision-making process in national security review; (ii) relatedly, the scope and the standards of review that lead to under-inclusiveness and over-inclusiveness in enforcement, which add to the uncertainty and blur the line between national security and economic interests; and (iii) a few structural layouts that cause unreasonable delay, present undesirable deterrence effects, dampen efficiency, undermine comparative expertise of regulators, and create misplaced incentives for foreign investors.

⁴ The Dubai Ports World controversy was one of the most salient cases that symbolize the raised profile of CFIUS, which led to the passage of FINSAs. See Stephen K. Pudner, *Moving Forward from Dubai Ports World—The Foreign Investment and National Security Act of 2007*, 59 ALA. L. REV. 1277 (2007).

⁵ See discussion *infra* Section IV.B.

⁶ See Andrew Batson & Matthew Karnitschnig, *China Plans System to Vet Foreign Deals for Security*, WALL ST. J. (Aug. 26, 2008, 12:01 AM), <http://www.wsj.com/articles/SB121968793079569903> (quoting lawyer Michael Han, who said that “[i]t looks like a national-security-review mechanism similar to CFIUS in the U.S., where several ministries are involved”); see also Saha, *supra* note 3, at 217-20.

This Article proceeds as follows. Part I discusses the general regulatory frameworks concerning national security review regimes in the United States and China. It places the regimes in context by examining their interplay with other regulatory schemes relevant to foreign investment. Part II presents a critical examination on the scope and standards of national security review as enforced by CFIUS. It questions the validity of the arguments in favor of the CFIUS's current case-by-case adjudication approach by analyzing the regulatory environment under which the CFIUS enacted the approach. Part III states that while the Chinese regulatory framework may resemble its US counterpart, China's scope and standards face novel issues due to other schemes currently in place. China's policymakers fail to place adequate resources on more critical sectors, such as the financial sector, in the design of its national security review scheme. Also, China's relatively clear (but arbitrary) rules on the definition of "control" invite under-inclusiveness as well as over-inclusiveness in implementation. Part IV contrasts several structural aspects of national security review regimes in the United States and China. It analyzes the structural layouts in national security review regimes that cause unreasonable delay, generate undesirable deterrence effects on foreign investors, dampen efficiency and institutional competence of regulators, and create misplaced incentives for foreign investors. Part V draws conclusions.

I. THE REGULATORY FRAMEWORKS COMPARED

A. *Inward Investment in the United States: What CFIUS Is and How It Came into Play in Acquisitions*

CFIUS is an interagency committee that conducts national security review on inbound foreign investments in the United States, when investments take the form of mergers, acquisitions or takeovers (M&A).⁷ It does not review greenfield investments; only transactions involving a foreign investor⁸ acquiring an existing "U.S. business"⁹ and gaining control¹⁰ triggers the CFIUS process. As an interagency committee, CFIUS consists of representatives from seven cabinet-level executive branch departments, including the Departments of Treasury (which chairs the CFIUS), Defense (DoD), Homeland Security (DHS), State, Justice, Commerce, and Energy, as well as two White House offices: the Offices of the US Trade Representative, and Science and

⁷ 50 U.S.C. app. § 2170(a)(3) (2015) ("The term 'covered transaction' means any merger, acquisition, or takeover that is proposed or pending . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States."); *see also* 31 C.F.R. § 800.207 (2015) ("[A]ny transaction . . . by or with any foreign person, which could result in control of a U.S. business by a foreign person."); *id.* § 800.214 ("[A]ny covered transaction."); *id.* § 800.301 (clarifying the term "covered transaction").

⁸ 31 C.F.R. § 800.216 (defining "foreign person").

⁹ *Id.* § 800.226 (defining "U.S. business").

¹⁰ *Id.* § 800.204 (defining "control").

Technology Policy. In addition, the Director of National Intelligence (DNI) and the Secretary of Labor are non-voting, *ex-officio* members. The Department of Treasury and a Treasury-designated agency act as co-lead agencies on a case-by-case basis.

To retrace the history of CFIUS, President Gerald Ford established CFIUS in 1975, following the energy crisis from 1972 through 1975. In the 1970s, it was of concern that Organization of the Petroleum Exporting Countries (OPEC) would use the surpluses gained in the oil embargo on the United States to buy up critical US assets. Originally, CFIUS merely functioned as a means of monitoring—requesting foreign investors to file preliminary reports regarding their foreign investment activities;¹¹ it did not possess the authority to block or divest a transaction during the period from 1975 to 1988.¹² In its first five years after its establishment, the CFIUS Committee had met only ten times,¹³ making it unrealistic to respond to national security concerns of foreign direct investment in the United States.

In the 1980s, an increasing number of Japanese companies acquiring large US brands drew heightened attention from Congress. One of the salient cases at the time was Fujitsu's attempted acquisition of Fairchild Semiconductor in 1986.¹⁴ The concerns over acquisition of US firms by Japanese companies prompted Congress to transform the review system from one of mere monitoring to one focused on systematic review. These concerns were exemplified through the Exon-Florio Amendment of 1988 to the Defense Production Act of 1950.¹⁵ The Exon-Florio Amendment authorized the President to investigate the effect of foreign acquisitions on national security and to block a transaction that threatened to impair national security.¹⁶ The

¹¹ Upon its establishment, CFIUS was charged with reviewing all inbound M&A investments that "might have major implications for United States national interests." Exec. Order No. 11,858, 3 C.F.R. § 990 (1971–1975), *amended by* Exec. Order No. 12,188, 3 C.F.R. § 131 (1981); Exec. Order No. 12,661, 3 C.F.R. § 618 (1989); Exec. Order 12,860, 3 C.F.R. § 629 (1994); Exec. Order 13,286, 3 C.F.R. § 166 (2004); Exec. Order 13,603, 77 Fed. Reg. 16651 (Mar. 22, 2012). It was to "monitor[] the impact of foreign investment in the United States." *Id.* § 1(b).

¹² See Joanna Rubin Travalini, Comment, *Foreign Direct Investment in the United States: Achieving a Balance Between National Economy Benefits and National Security Interests*, 29 NW. J. INT'L L. & BUS. 779, 783–84 (2009).

¹³ H. COMM. ON GOV'T OPERATIONS, THE ADEQUACY OF THE FEDERAL RESPONSE TO FOREIGN INVESTMENT IN THE UNITED STATES, H. REP. NO. 96-1216, at 166–84 (1980); see also Matthew C. Sullivan, *CFIUS and Congress Reconsidered: Fire Alarms, Police Patrols, and a New Oversight Regime*, 17 WILLAMETTE J. INT'L L. & DISP. RESOL. 199, 211 (2009).

¹⁴ In 1987, Fujitsu Ltd.—a Japanese computer manufacturer—made an offer to buy Fairchild Semiconductor Corp.—a company that had supply contracts with US defense contractors. Many feared losing the technological edge to the Japanese and feared that the United States would have no other comparable microchip manufacturers if a Japanese company purchased Fairchild Semiconductor. In response, CFIUS instituted a review, and Fujitsu Ltd. withdrew its offer. See JAMES K. JACKSON, CONG. RESEARCH SERV., RL33388, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) 4 (2014), <https://www.fas.org/sgp/crs/natsec/RL33388.pdf>; see also Pudner, *supra* note 4, at 1279.

¹⁵ 50 U.S.C. app. § 2170 (2014).

¹⁶ *Id.* § 2170(d)(1).

President in turn delegated to CFIUS the authority to review transactions under the Exon-Florio Amendment.¹⁷ In reality, the President has rarely been involved in the review of inbound M&A transactions. Even when the President steps in, he acts on the recommendations made by CFIUS.¹⁸ Thus, CFIUS plays a decisive role in deciding the fate of acquisitions by foreign entities that could result in control of a US business.¹⁹ The cases at the time when the Exon-Florio Amendment was enacted already raised the question as to what, exactly, CFIUS deemed “national security.” For example, it is hard to justify why and how Japan, a long-standing political ally of the United States, would pose threats to the national security of the United States in a wave of investments, as in the failed Fairchild acquisition attempt.

Subsequently, in 2007, Congress adopted the Foreign Investment and National Security Act (FINSA)²⁰ as part of the backlash from the 2006 United Arab Emirates-based Dubai Ports World’s acquisition of Peninsular and Oriental Steam Navigation Company (P&O, a British firm). The proposed acquisition involved the sale of port management businesses in six major US seaports and its subsequent divestiture of US port facilities.²¹ FINSA and its follow-on regulations made significant changes to the Exon-Florio Amendment, including broadening the definition of national security²² and creating a presumption of CFIUS investigation beyond the preliminary review stage in cases involving critical infrastructure as targets or government-owned investors as acquirers.²³

The evolution of the CFIUS mandate against the changing political and economic landscape helps explain why CFIUS did not come into the spotlight until the 1990s; it was only after CFIUS had some real teeth—obtaining the power to block or unwind a transaction—that it gained prominence.

B. National Security Review in China

The national security review regime in China is modeled on the CFIUS process. Compared to the relatively sophisticated practices in the United States,

¹⁷ *Id.* § 2170(b)(1)(A).

¹⁸ *Id.* § 2170(b)(3)(B), (d)(1). For an example of presidential action, see discussion of *Ralls Corp. v. CFIUS*, 758 F.3d 296 (D.C. Cir. 2014), *infra* Section II.B.

¹⁹ A U.S. business refers to any business that operates in the interstate commerce of the United States. This means any business entity that has an office, some employees, and almost any type of operations in the United States. A U.S. business can also be a collection of assets that could be considered to constitute an operating business.

²⁰ Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (codified at 50 U.S.C. app § 2170 (2014)).

²¹ For further details about the Dubai Ports World transaction, see Thomas E. Crocker, *What Banks Need to Know About the Coming Debate over CFIUS, Foreign Direct Investment, and Sovereign Wealth Funds*, 125 BANKING L.J. 457, 459-60 (2008) (the author represented Dubai Ports World before CFIUS).

²² 50 U.S.C. app. § 2170(a)(5), (f).

²³ *Id.* § 2170(b)(2)(B)(III).

China's regime is still in its infancy, yet to mature into an effective regulatory framework. In January 2015, China's Ministry of Commerce (MOFCOM) published a draft Foreign Investment Law to solicit public comments (hereinafter the "Draft Foreign Investment Law").²⁴ In the most optimistic scenario, the public anticipates at least eighteen months before the formal Foreign Investment Law can be promulgated.²⁵ The Draft Foreign Investment Law aims to incorporate existing regulations on national security review into the new legal regime. It is expected that once finalized in the Foreign Investment Law, national security review will play a heightened role in China's foreign investment regulatory regime.

Similar to the institutional setting of CFIUS, the Draft Foreign Investment Law charges an inter-ministerial committee to conduct national security review.²⁶ The National Development and Reform Commission (NDRC, China's economic planning agency) and MOFCOM are designated as standing lead agencies (so called "conveners") in the review process, with a number of other agencies acting as member agencies in the committee.²⁷ The Draft Foreign Investment Law does not specify the identities of member agencies apart from the NDRC and MOFCOM, but another set of rules implemented in China's pilot free trade zones provides us with a flavor of what the likely member agencies are.²⁸ As many as thirty agencies, including the Department of Justice, the Department of Finance, the Ministry of Industry and Information Technology (but ironically without China's Ministry of National Defense), may participate in the review process as member agencies.²⁹

To elaborate on the history of national security review in China, China's national security review regime did not formally debut until 2011—more than three decades after China opened up to foreign investments. Before 2011, China did not have a systematic national security review in place, despite certain scattered provisions in foreign investment-related regulations. For

²⁴ See *Waiguo Touzi Fa (Cao'an Zhengqu Yijian Gao) (外国投资法(草案征求意见稿)) [Foreign Investment Law of the People's Republic of China (Draft for Comments)]* (promulgated by the Ministry of Commerce, Jan. 19, 2015) [hereinafter *Draft Foreign Investment Law*], <http://tfs.mofcom.gov.cn/article/as/201501/20150100871010.shtml> (China).

²⁵ See Jie Guo, *Zhongguo Fabu Waiguo Touzifa Cao'an (中国发布外国投资法草案) [China Publishes Draft Law on Foreign Investment Law]*, HONG KONG LAW. (Apr. 2015), <http://www.hk-lawyer.org/tc/article.asp?articleid=2803&c=116> (China).

²⁶ See *Draft Foreign Investment Law*, *supra* note 24, at art. 49.

²⁷ *Id.*

²⁸ See *Guowu Yuan guanyu Tongyi Jianli Guowu Yuan Ziyou Maoyi Shiyan Qu Gongzuo Buji Lianxi Huiyi Zhidu de Pifu (国务院关于同意建立国务院自由贸易试验区工作部际联席会议制度的批复) [Approval Reply of the State Council Pertaining to the Establishment of the Working-Level Inter-Ministerial Joint-Committee System in Free Trade Zones That Were Set Up by the State Council]* (promulgated by the State Council, Feb. 7, 2015, effective Feb. 7, 2015), http://www.gov.cn/zhengce/content/2015-02/16/content_9486.htm (China).

²⁹ See *id.* at art. 2.

example, China's M&A Rules of 2006, as amended in 2009,³⁰ state that parties should make a filing to MOFCOM where a foreign investor acquires a domestic Chinese company, obtains de facto controlling power, and the acquisition (i) concerns critical sectors or (ii) impacts, or has the possibility of impacting, China's national economic security.³¹ Despite the grand declaration that national security review should be conducted, no further details were crafted out in the M&A Rules for how to carry out such a review. For example, terms such as "de facto control" and "national economic security" are not fleshed out by way of definition or guidelines. The result was that the M&A Rules did not enable national security review in China.³² No penalties have ever been invoked in any M&A transactions.

Another example of preexisting foreign investment regulation is China's Anti-Monopoly Law of 2007,³³ which includes a clause skimming national security review. It provides that in the case of foreign investors acquiring domestic Chinese companies or in the event of other forms of undertaking business concentration, a national security review should be conducted.³⁴ A national security review provision in the Anti-Monopoly Law is misplaced; national security review should be separated out from antitrust review as the two regimes imply different policy considerations. It suggests that Chinese legislature had confusion about the distinctions between an antitrust merger control review and a national security review in an M&A transaction. The intertwining of national security review regime and the antitrust clearance regime led to the phenomenon that in China, antitrust lawyers concurrently handle national security analysis for their customers. Besides emphasizing the necessity of a national security review, the Anti-Monopoly Law does nothing to turn national security review into a feasible scheme; the policy statement in the Anti-Monopoly Law does not carry much beyond emphasizing the broad goal of establishing a national security review regime.

Prior to the debut of national security review regime in China, the one and only notable case in which national security review concerns were raised was Carlyle Group, a US private-equity fund's attempted \$375 million acquisition of 85 percent stake in Xugong Machinery, China's largest construction-

³⁰ Guanyu Waiguo Touzizhe Binggou Jingnei Qiye de Guiding (关于外国投资者并购境内企业的规定) [Provisions on Foreign Investors' Merger with and Acquisition of Domestic Enterprises] (promulgated by the Ministry of Commerce et al., Jun. 22, 2009, effective Jun. 22, 2009), <http://www.mofcom.gov.cn/article/b/c/200907/20090706416939.shtml> (China).

³¹ *Id.* at art. 12.

³² The M&A Rules set forth possible adverse consequences for any failure to make the national security filing, but the penalties are worded strongly and are vague on details. *See id.*

³³ Fan Longduan Fa (反垄断法) [Anti-Monopoly Law] (promulgated by the Standing Comm. of the Tenth Nat'l Peoples Congress, Aug. 30, 2007, effective Aug. 1, 2008), http://www.gov.cn/flfg/2007-08/30/content_732591.htm (China).

³⁴ *Id.* at art. 31.

equipment manufacturer.³⁵ It is hard to know the extent to which national security concerns actually weighed on the failed acquisition;³⁶ more controversies over monopoly control and the sale of State-owned assets to foreign acquirers at an unreasonably low price hovered over the failed attempt.³⁷

Beginning in 2010, the Chinese government had placed more emphasis on the design of a national security review regime.³⁸ China's State Council promulgated the "Circular on the Establishment of National Security Review System Pertaining to the Mergers and Acquisitions of Domestic Chinese Companies by Foreign Investors" of 2011 (hereinafter the "State Council National Security Review Circular").³⁹ The declaration was made as a notice (an executive order in effect), not as a formal regulation. In spite of pointing out a policy direction, the State Council National Security Review Circular has a weaker force and effect than a regulation because violators do not face legal liabilities. As a follow-on, MOFCOM subsequently promulgated the "Rules on the Implementation of National Security Review Regime Pertaining to the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" of 2011 (hereinafter the "MOFCOM National Security Review Rules").⁴⁰ China's national security review regime was finally launched.

³⁵ Denis McMahon, *Carlyle Agrees to Acquire Smaller Stake in Xugong*, WALL ST. J. (Mar. 26, 2007, 12:01 AM), <http://www.wsj.com/articles/SB117486672665348486>; Dinny McMahon, *Carlyle Moves on from Xugong Shadow*, WALL ST. J. (Jan. 12, 2010, 3:56 AM), <http://blogs.wsj.com/chinarealtime/2010/01/12/carlyle-moves-on-from-xugong-shadow>.

³⁶ By the time of the Carlyle-Xugong transaction, construction machinery had not been regarded as a sensitive sector in China. See *Chinese Companies: Over the Great Wall*, ECONOMIST (Nov. 3, 2005), <http://www.economist.com/node/5121635>.

³⁷ See Zhongguo Shi "Jingzheng" (中国式"竞争") [A Chinese-styled "Competition"], NEW CENTURY WKLY. (新世纪周刊) (Nov. 4, 2013),

<http://magazine.caixin.com/2013-11-01/100598261.html?p0#page2> (China); see also *Chinese M&A: Playing at Home*, ECONOMIST (Aug. 3, 2006), <http://www.economist.com/node/7258903>. Cf. Hairong Yu, *Waizi Binggou Anquan Shencha Chulu* (外资并购安全审查出炉) [Fresh out of the Oven: National Security Review in M&As by Foreign Acquirers], CAIXIN ONLINE (财新网) (Feb. 28, 2011), http://economy.caixin.com/2011-02-28/100229645_all.html#page2 (China).

³⁸ Following mentioning the need for accelerating the establishment of a national security review regime in M&A transactions by foreign investors in the State Council's work report for 2010 (national security review was never mentioned in the State Council's work report before), in a circular of the same year, the State Council reiterated the importance of establishing a national security review system to review the safety of mergers and acquisitions of domestic companies by foreign investors. See Guowu Yuan guanyu Jinyibu Zuohao Liyong Waizi Gongzuo de Ruogan Yijian (国务院关于进一步做好利用外资工作的若干意见)[Several Opinions of the State Council Regarding Further Improvement on the Utilization of Foreign Investments] (promulgated by the State Council, Apr. 6, 2010, effective Apr. 6, 2010), art. 3(12), http://www.gov.cn/zw/gk/2010-04/13/content_1579732.htm (China).

³⁹ Guowu Yuan Bangongting guanyu Jianli Waiguo Touzizhe Binggou Jingnei Qiye Anquan Shencha Zhidu de Tongzhi (国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知) [Circular of the General Office of the State Council on the Establishment of National Security Review Regime Pertaining to the Mergers and Acquisitions of Domestic Companies by Foreign Investors] (promulgated by Gen. Office of State Council, Feb. 3, 2011, effective Mar. 3, 2011) [hereinafter State Council National Security Review Circular], http://www.gov.cn/zw/gk/2011-02/12/content_1802467.htm (China).

⁴⁰ Shangwu Bu Shishi Waiguo Touzizhe Binggou Jingnei Qiye Anquan Shencha Zhidu de Guiding (商务部实施外国投资者并购境内企业安全审查制度的规定) [MOFCOM Rules on the Implementation

Since the implementation of national security review regime in 2011, there has not been any public information about its enforcement activities.⁴¹ In particular, no one single case is made public, indicating that MOFCOM (alongside other agencies involved in the enforcement of the regime) has ever exercised the power to impose mitigation measures or block any inbound M&A transaction based on national security grounds. In accordance with the author's informal survey with practitioners in China, four years into the enabling of national security review in China, the invoking of the regime is still sporadic: only on occasional cases do foreign investors make national security filings with MOFCOM. Most of the time, foreign investors will not take actions to file until local offices of MOFCOM mandate doing so.

The success of the modified national security review in the forthcoming Foreign Investment Law will largely hinge on whether it reverses its current image as a dormant regime. In other words, it is vital to ensure the regime will be actually enforced. In this regard, it is necessary to study why it has only been sporadically enforced so far. A convenient yet superficial excuse may be that it takes time for a regulatory mechanism to exert its full-fledged influence. CFIUS has been in existence for over four decades, during which transformations and evolvments phased in. China's scheme may likewise need time to develop after being fully exposed to political developments. But a more careful analysis shows the reasons go deeper than that. As further explored *infra*, China's national security review regime suffers several structural defects, creating an additional layer of approval requirements without properly securing national security.

C. Interplay of National Security Review with Other Foreign Investment Regulatory Regimes

To assess the practical implications of the Chinese and US national security regimes, it is helpful to view them through the lens of overall regulatory structure for inward foreign investments. This section assesses the purview of the regulatory framework governing foreign investments in the United States and China, putting national security review in context and examining its interplay with other regulatory apparatuses. One major difference in regulatory approach should be noted upfront: China is a regulatory state—its authoritarian government essentially regulates every aspect of economic activities until a

of National Security Review Regime Pertaining to the Mergers and Acquisitions of Domestic Enterprises by Foreign Investors] (promulgated by Ministry of Commerce, Aug. 25, 2011, effective Sept. 1, 2011) [hereinafter MOFCOM National Security Review Rules], <http://www.mofcom.gov.cn/aarticle/b/c/201108/20110807713530.html> (China).

⁴¹ No public information is available about the number of cases filed by parties in an inbound M&A transaction to the committee. MOFCOM does not make available the number of notices it receives to the public either.

deregulation initiative is launched, whereas in the United States, free entry into the market is the default unless a regulated industry is at issue.

1. China's Transition from a Catalogue System to a Negative List System, Merger Control, and National Security Review

China's regulatory apparatus governing inbound foreign investment is composed of a nexus of complicated rules and regulations. A foreign investor aspiring to acquire a Chinese target company needs to abide by (i) the Catalogue system (expected to be superseded by the Negative List system),⁴² (ii) the pre-approval requirements, and (iii) the merger control review, together with (iv) the new national security review regime. In a nutshell, Chinese authorities control the influx and outflow of foreign capital, and closely monitor the establishment, ongoing operation, and termination of foreign investment projects. Central to its regulatory philosophy is the pre-screening of foreign investments—foreign investments that are above specified value threshold⁴³ or fall into certain restrictive categories⁴⁴ require pre-approval. Commentators expect the new Foreign Investment Law to bring about an overhaul in the pre-screening process by levitating the pre-approval requirements in certain less critical sectors. But even with that, it will not be a full-blown free market access; access will be conditioned on monetary threshold and industrial sector.

So far, the substantial check on a foreign investor's entry into a domestic sector hinges on what is called the Catalogue system. The Catalogue system refers to the "Catalogue for the Guidance of Foreign Investment Industries,"⁴⁵ a catalogue promulgated by the NDRC and amended every few years (the 2015 version is hereinafter abbreviated as "2015 Catalogue"). The Catalogue lists the sectors in which foreign investment is "encouraged," "permitted," "restricted," or "forbidden." If the Catalogue specifies a sector as within the "encouraged" category, it is subject to relatively lenient approval requirements. And if one

⁴² See Guowuyuan Guanyu Shixing Shichang Zhunru Fumian Qingdan Zhidu de Yijian (国务院关于实行市场准入负面清单制度的意见) [Opinion of the State Council on the Establishment of a Negative List System Pertaining to Market Entry] (promulgated by the State Council, Oct. 19, 2015, effective Oct. 19, 2015), http://www.gov.cn/zhengce/content/2015-10/19/content_10247.htm (China).

⁴³ The Draft Foreign Investment Law is expected to alter the previous practice in foreign investment regulation that every aspect of foreign investment is regulated and subject to approval. Now a higher threshold is proposed for approval requirements, but it does not change the screening and pre-approval nature of foreign investment regulation in a fundamental way. See Draft Foreign Investment Law, *supra* note 24, at art. 26, 27.

⁴⁴ *Id.* at art. 26(2).

⁴⁵ Waishang Touzi Chanye Zhidao Mulu (2015 Nian Xiuding) (外商投资产业指导目录(2015年修订)) [Catalogue for the Guidance of Foreign Investment Industries (Amended in 2015)] (promulgated by Nat'l Dev. & Reform Comm'n and Ministry of Commerce, Mar. 10, 2015, effective Apr. 10, 2015) [hereinafter 2015 Catalogue], <http://www.sdpc.gov.cn/zcfb/zcfbl/201503/W020150402620481787669.pdf> (China).

falls within the “restricted” category, the Catalogue imposes more stringent approval requirements or conditions (e.g., shareholding limitation).

The pre-approval requirement kicks in after a transaction is characterized as falling into one of the “encouraged,” “permitted,” “restricted,” or “forbidden” categories. Depending on the specific industrial sector and the deal size concerning the transaction, foreign acquirers will have to make filings with multiple agencies at different levels for their sequential pre-approvals. Without obtaining the pre-approvals, no foreign investor is able to complete the transaction or gain market access.⁴⁶

In recent years, largely out of external pressure from counterparties to the negotiation of bilateral investment agreements (notably the United States and the European Union), China has committed to a negative-list approach for replacing the Catalogue system.⁴⁷ A “Negative List” is expected to list all sectors in two categories: (i) the “prohibited” category in which foreign investment is completely prohibited and (ii) the “restricted” category in which foreign investment will be subject to various restrictions. Market access approval would be required for any foreign investment in a restricted sector. Commentators also expect the Negative List to set out a monetary threshold over which investments would require market access approval, regardless of sector. Once the Negative List is put in place,⁴⁸ it will lift regulatory hurdles for a number of foreign investment projects for which foreign investment approval would no longer be necessary.⁴⁹

Another relevant regulatory regime is merger control. Merger control review in an M&A transaction focuses on concentration and the anti-competitive effects of such transaction. It therefore has its standalone economic justification for playing a role in the regulation of foreign investments.

Besides the Catalogue system (or the Negative List), the pre-approval scheme, and the merger control review, the last layer of regulation governing inward foreign investment is the national security review, a regime in its

⁴⁶ For a more detailed narrative of the pre-approval requirements, see Xingxing Li, *An Economic Analysis of Regulatory Overlap and Regulatory Competition: The Experience of Interagency Regulatory Competition in China's Regulation of Inbound Foreign Investment*, 67 ADMIN. L. REV. 685, 700-708 (2015).

⁴⁷ See MINISTRY OF COMMERCE, 2015 Nian Shangwu Gongzuo Nianzhong Zongshu, No. 1 (2015年商务工作年终综述之一) [2015 YEAR END SUMMARY ON COMMERCE-RELATED WORK] (Dec. 25, 2015), <http://www.mofcom.gov.cn/article/ae/ai/201512/20151201220159.shtml> (China).

⁴⁸ A nationwide Negative List has not been promulgated. One Negative List specifically applicable in China's pilot Free Trade Zones has taken effect. See Ziyou Maoyi Shiyuan Qu Waishang Touzi Zhunru Tebie Guanli Cuoshi (Fumian Qingdan) (自由贸易试验区外商投资准入特别管理措施(负面清单)) [Special Administrative Measures Applicable to Free Trade Pilot Zones in Respect of the Entry of Foreign Capital (Negative List)] (promulgated by Gen. Office of State Council, Apr. 8, 2015, effective May 8, 2015), http://big5.gov.cn/gate/big5/www.gov.cn/zhengce/content/2015-04/20/content_9627.htm (China).

⁴⁹ For such investments, the investor may directly proceed to register the business with the competent Administration for Industry and Commerce (AIC), the Administration of Foreign Exchange (SAFE) and the Tax Bureau.

infancy in China. As time has changed—free market entry by foreign investors has become the trend—policymakers seem to have an updated view toward national security review: to invoke it as a gatekeeper of foreign investments. This approach has its rationale—in any event, it is impossible for one host country to have full-fledged openness to foreign investments; at the minimum, it should strive to protect its national security. In this regard, while merger control has its standalone importance in the foreign investment regulatory framework, policymakers should deem national security review an indispensable supplement, particularly in the wake of removing entry barriers for foreign investment.

Further, a broader policy question regarding foreign capital is worth considering here. Since over three decades of openness to foreign capital, China has accumulated approximately \$3.7 trillion of foreign-exchange reserves. Its thirst for foreign capital—an important drive behind its commencement of open-door policy in the late 1970s—is now an obsolete argument in favor of more foreign capital. Instead, China is stumbling in making profitable use of its excess foreign reserves. Its foreign reserves have yielded far from satisfactory investment returns due to its unsophisticated management strategies. On the other hand, it has witnessed a deep entrenchment of foreign capital into almost every aspect of its economy, giving rise to the criticism that excessive foreign capital has put its national security in jeopardy and endangered its vulnerable domestic enterprises. Chinese policymakers may therefore wish to address the question of whether China should slow down its pace in introducing foreign capital before hastily overhauling its regulatory framework solely in response to external political pressures.⁵⁰

2. *United States' General Openness, Merger Control and National Security Review*

Similar to China, national security review is an integral part of the overall regulatory framework governing inward foreign investments to the United States. The United States is generally open to foreign investments, imposing few restrictions on potential foreign investors unless the investments concern regulated industries such as banking, insurance, and aviation.⁵¹ Unlike China, the United States does not require *ex ante* investment screening by regulatory

⁵⁰ The pressure for more openness to foreign capital is in part transmitted from negotiations of BITs between China and developed jurisdictions such as the United States and the EU. *See, e.g.*, Karl P. Sauvant & Huiping Chen, *A China – US Bilateral Investment Treaty: A Template for a Multilateral Framework for Investment?*, COLUM. FDI PERSP., Dec. 17, 2012, http://works.bepress.com/karl_sauvant/369/.

⁵¹ For a summary on the regulatory restrictions on foreign investment in the United States, see MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., RL33103, FOREIGN INVESTMENT IN THE UNITED STATES: MAJOR FEDERAL STATUTORY RESTRICTIONS (2013), <https://www.fas.org/sfp/crs/misc/RL33103.pdf>.

agencies, unless certain regulatory issues are concerned, such as antitrust,⁵² export control-related licenses,⁵³ environmental issues, or compliance matters (e.g. securities law compliance).⁵⁴ Taken as a whole, regulators have limited tools to employ against foreign takeovers of US firms other than a declaration of national emergency by the President and the invocation of the aforementioned regulatory measures. This provides the US Congress with motivation to package policy concerns—for instance, economic interests—beyond pure national security concerns in the CFIUS regime.

Merger control and national security review are two vital tools the regulators employ to scrutinize an inward M&A transaction in the United States.⁵⁵ Merger control focuses on the anti-competitive effects of concentration, i.e. monopoly, as a result of mergers and acquisitions. National security review, on the other hand, largely considers the impact of the transaction on US homeland security, acting as the last guard against detrimental inbound foreign investments. For example, when a specific country desires to curb foreign investment due to suspected espionage, the hope would therefore be pinned on the invoking of national security regime. However, another source of concern over a foreign investment project may be the US economy. In this case, while it is hard to justify the employment of other regulatory tools, it is relatively easy to channel the economic concern into an ambiguous national security review regime. The layout of foreign investment regulatory framework hence helps explain why agencies within the CFIUS would want to package certain considerations that are apparently unrelated to

⁵² See *Merger Review*, FTC, <https://www.ftc.gov/enforcement/merger-review> (last visited Apr. 8, 2016).

⁵³ See 50 U.S.C. app. §2170(f)(9)(C) (2015). A target company in an M&A transaction is required to comply with export-control laws and sanctions laws. After the transaction, the Bureau of Industry and Security within the Department of Commerce, the Directorate of Defense Trade Controls within the Department of State, and the Office of Foreign Assets Control within the Treasury Department may hold a foreign acquirer liable for the target company's prior export controls and sanctions violations. For acquirer's successor liability, see *Sigma-Aldrich Bus. Holdings, Inc.*, No. 01-BXA-06 (Aug. 29, 2002) (Fitzpatrick, A.L.J.) (Bureau of Industry and Security's approach); U.S. DEP'T OF STATE, BUREAU OF POLITICAL MILITARY AFFAIRS, GENERAL MOTORS CORPORATION CONSENT AGREEMENT (Oct. 22, 2004),

http://www.pmdt.state.gov/compliance/consent_agreements/pdf/GeneralMotorsCorp_ConsentAgreement.pdf (Directorate of Defense Trade Controls' approach); DEP'T OF THE TREASURY, OFFICE OF FOREIGN ASSETS CONTROL, ENFORCEMENT INFORMATION FOR SEPTEMBER 7, 2007 (2007), <http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Documents/09072007.pdf> (Office of Foreign Assets Control's approach).

⁵⁴ For example, publicly traded companies must file Form 8-K with the SEC to disclose major events that may affect their businesses, which includes M&As. See *Fast Answers – Form 8-K*, SEC (Aug. 10, 2012), <http://www.sec.gov/answers/form8k.htm>; SEC, FORM 8-K: CURRENT REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 7, <http://www.sec.gov/about/forms/form8-k.pdf> (last visited Apr. 8, 2016).

⁵⁵ The United States has been persistent in including national security clauses when it enters into bilateral investment agreements with other countries. In its model bilateral treaty, the United States expressly reserves the right to scrutinize and invalidate a transaction through CFIUS by “applying measures that it considers necessary for . . . the protection of its own essential security interests.” OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2012 U.S. MODEL BILATERAL INVESTMENT TREATY art. 18 (2012), <http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf>.

genuine national security concerns into the grand basket of “national security review.”

II. SCOPE AND STANDARDS OF REVIEW IN THE UNITED STATES

A. *Predictability in the CFIUS Process: Rulemaking or Adjudication*

CFIUS is known for its broad power, secrecy, and unpredictability. These features are interlinked. Understanding these characteristics, their interplay, and their justifications is key to finding the right balance between clarity and flexibility.

CFIUS enjoys broad power because the “national security” that it is charged to protect is not defined: none of FINSA, the Exon-Florio Amendment, nor the CFIUS regulations⁵⁶ define “national security.” For example, the Exon-Florio Amendment construes “national security” tautologically: “those issues relating to ‘homeland security’.”⁵⁷ In lieu of defining “national security,” the Exon-Florio Amendment sets forth an illustrative list of the factors for CFIUS and the President to consider when assessing a transaction’s national security risks.⁵⁸ The listed factors raise interpretation issues, including overly broad and vague elements related to traditional military defense, to the technology the acquired business may possess, and to the effects of the acquisition on critical infrastructure, etc.⁵⁹ Further, by making these listed factors serve as non-exhaustive guidelines,⁶⁰ it leaves plenty of room for the President and CFIUS to consider other factors as deemed appropriate. The President and CFIUS therefore have considerable latitude in determining when to block or unwind an M&A transaction. To be sure, the Treasury Department published a “Guidance Concerning the National Security Review Conducted by CFIUS,”⁶¹ but in terms of the national security considerations of CFIUS, it uses either vague terms such as “facts” and “circumstances” or merely illustrative examples.⁶² For instance, the Treasury expressly articulates that regulators should consider the nature of the US business being acquired by a foreign investor, and it enumerates several examples about the “nature of business” (such as whether

⁵⁶ Exec. Order No. 11,858, 3 C.F.R. § 990 (1971–1975), *as amended* by Exec. Order No. 13,456, 3 C.F.R. § 4677 (2008). The Regulations include 31 C.F.R. pt. 800 (2015), *as amended* by Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 70,702 (Nov. 21, 2008).

⁵⁷ 50 U.S.C. app. § 2170(a)(5).

⁵⁸ 50 U.S.C. app. § 2170(f) (listing a total of eleven factors, and also noting these factors are merely guidelines and not intended to be conclusive).

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Office of Investment Security, Guidance Concerning the National Security Review Conducted by the Committee on Foreign Investment in the United States, 73 Fed. Reg. 74,567 (Dec. 8, 2008).

⁶² See U.S. DEP’T OF THE TREASURY, CFIUS REFORM: GUIDANCE ON NATIONAL SECURITY CONSIDERATIONS (Dec. 1, 2008), http://www.treasury.gov/resource-center/international/foreign-investment/Documents/GuidanceSummary_12012008.pdf (summarizing the Guidance).

the business has government contracts or whether it houses advanced technologies). However, an investor cannot rely on these examples to evaluate whether other occasions would similarly trigger the “nature of business” concern.

Secrecy marks the second feature of CFIUS. Information submitted to CFIUS is confidential.⁶³ Each CFIUS review—even the fact that a review is being conducted—is strictly confidential unless the transacting parties choose to disclose the information. This helps explain why CFIUS obstacles often are not widely known beyond the individual enterprises involved, let alone statistically computed.

The lack of clear definition, together with a secretive process in a black box exempt from judicial review, bring in vagueness and unpredictability, the third characteristic of CFIUS process. The CFIUS process shields the inner workings of its members from public knowledge, and therefore becomes purely case-by-case adjudication⁶⁴ and generates unpredictable review outcomes. The suboptimal level of clarity and predictability suggests the bolstering of CFIUS authority has outpaced the stifled definition. This may not be a huge issue in the old days when CFIUS merely assumed a monitoring function, but is no longer apt now that it has major impact on virtually every cross-border M&A transaction involving a US target.⁶⁵

1. *Negative Effects*

The combination of CFIUS’s broad power, secrecy, and unpredictability gives rise to a series of negative effects. An unpredictable process means a “lottery” for potential foreign investors. Foreign investors now deem the CFIUS process the ultimate and major hurdle to their investments in the United States.⁶⁶ The costs imposed on foreign investors are tremendous: Foreign investors are unable to ex ante discern the national security implications of their

⁶³ 50 U.S.C. app. § 2170(c).

⁶⁴ Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 70,702, 70,705 (Nov. 21, 2008) (discussing the case-by-case review approach as adopted in 31 C.F.R. § 800.101 (2015)).

⁶⁵ After enabling CFIUS’s function to block transactions, Congress complained that the CFIUS review process is not sufficiently transparent and that the White House has taken a hands-off approach, resulting in reviews that are not sufficiently detailed. See ALAN P. LARSON & DAVID M. MARCHICK, FOREIGN INVESTMENT AND NATIONAL SECURITY: GETTING THE BALANCE RIGHT 13-24 (2006).

⁶⁶ See, e.g., Harry L. Clark & Jonathan W. Ware, *Limits on International Business in the Petroleum Sector: CFIUS Investment Screening, Economic Sanctions, Anti-Bribery Rules, and Other Measures*, 6 TEX. J. OIL GAS & ENERGY L. 75, 84-91 (2010) (discussing various regulatory regimes’ impacts on inbound foreign investment in the United States and noting the particular challenges brought about by CFIUS’s process); see also Christopher F. Corr, *A Survey of United States Controls on Foreign Investment and Operations: How Much is Enough?*, 9 AM. U. J. INT’L L. & POL’Y 417, 456 (1993) (noting that “mandatory submission of reports” such as CFIUS filings “are to some extent burdens on foreign investment, and in certain cases may deter potential investors concerned about negative political reaction or press coverage given the sensitivity of foreign investment”).

potential transactions. This risks deflecting foreign investors from the United States to other jurisdictions.

To be sure, the case-by-case approach should not be confused with the common law adjudication process by judges. First, the judicial decisions are to a large extent open to the public, as are the reasons on which the rulings are based. Information about the rules or standards can therefore be summarized as doctrines and passed on to the public in the form of precedents. *Stare decisis* ensures that the court follows these doctrines, therefore promoting consistency between past and future cases.

Conversely, the black-box feature of the CFIUS works against the revelation and dissemination of information. On one hand, since CFIUS keeps its decision-making process strictly confidential, no reason will be offered when blocking or divesting a transaction. On the other hand, companies going through CFIUS have every incentive to keep to themselves even the fact that they make the filing. After completing its review, CFIUS passes little information revealing the review standards to future investors.

When secrecy is at play, foreign investors will pause in the face of the potential CFIUS challenge when considering whether to invest in the United States. Admittedly, the CFIUS process generates tremendous deterrence effects; however, foreign investors are lost as to *what* they are deterred from. Therefore, the deterrence effect is unlikely to be associated with improved national security review compliance: future investors do not have much more of a clue even after one transaction has been penalized for threatening to impair the US national security. An increase in the number of cases going through the CFIUS process over the years does not necessarily lead to an increase in the supply of information about the standards enforced. In this sense, the CFIUS process has the negative effect of deterring foreign investments that should generally be welcomed because it places the burden of uncertainty and unpredictability on a wide array of foreign investors.

Second, judicial decisions are delivered by politically impartial judges, whereas CFIUS rulings are made by a group of political administrators, and are thereby vulnerable to political influence. After all, CFIUS is an interagency committee comprised of administrative agencies. CFIUS is not authorized to take into account either political opposition or public opinion regarding a transaction.⁶⁷ But the institutional setting of CFIUS reflects that immunity from politics may merely be a hollow declaration; CFIUS's secrecy adds to the difficulty of monitoring the performance of CFIUS to make sure that it is competent and honest. The black-box process makes it possible for CFIUS to

⁶⁷ A CFIUS decision "shall be based on a risk-based analysis, conducted by the Committee, of the threat to national security of the covered transaction." FINSA sec. 5, § 721(1)(1)(B), 121 Stat. at 254. Commentators interpret that "[n]ational security should be the prime consideration, presumably rather than political or diplomatic considerations, although the statute is not entirely clear on this score." Zaring, *supra* note 3, at 70, n.72.

conceal political factors behind the mask of its broad mandate without having to expose its inner workings to the public.

Therefore, arguments in favor of case-by-case adjudication in the judicial process, as well as some conventional arguments in connection with rules versus standards, should not be applied in the context of CFIUS process by analogy. While as a general theory, a case-by-case adjudication process embraces more flexibility, the seemingly appealing rationale is a deceptive argument when applied to the CFIUS process.

2. *Some Justifications for Flexibility and Secrecy*

Admittedly, some justifications may exist for the flexible definition of national security and for preserving secrecy. For one, Congress may not want to expressly define the criteria for the CFIUS decisions in order to enable flexibility with an evolving concept of national security.⁶⁸ But it remains hard to justify such an extremely broad and vague mandate, especially if the general welcome of foreign investment is one of the stated policy goals.⁶⁹ The lack of any specific definition of what constitutes national security, as well as any standard of review, means that CFIUS can (and does) review many aspects of a transaction which may seem quite far strayed from accepted notions of national security.

As for secrecy, a few rationales may be offered. The CFIUS process involved classified and proprietary information. On the part of CFIUS, the agencies utilizing classified information in decision-making would not want to fully disclose their internal process. Specifically, the “risk-based analysis”—the report prepared by the agency with an equity interest in the transaction which forms the basis for mitigation conditions imposed on the parties—has its legitimacy in not being shared with the transacting parties. On the part of transacting parties, as CFIUS notices contain a great deal of private and proprietary information from both buy and sell sides of the transaction, the parties do not wish to make their submissions publicly accessible. Moreover, at times the parties may even prefer to keep the fact that the transaction is going through the CFIUS process, realizing any publicity could potentially invite political intervention in the CFIUS process.

⁶⁸ See 134 Cong. Rec. S4833 (1988) (statement of Sen. Exon) (noting that “national security” was “to be read in a broad and flexible manner”).

⁶⁹ There is criticism that the broad and vague mandate of CFIUS, in combination with its secrecy, is an impediment to trade liberalization and a threat to economic productivity, and potentially in an arbitrary and capricious manner. See, e.g., Joseph Mamounas, *Controlling Foreign Ownership of U.S. Strategic Assets: The Challenge of Maintaining National Security in a Globalized and Oil Dependent World*, 13 LAW & BUS. REV. AM. 381, 393 (2007).

3. *A More Plausible Approach*

That said, in light of the broad (and seemingly infinite) reach of the CFIUS process and the high costs incurred to evaluate the CFIUS impacts on a specific transaction, promotion of clarity and predictability should be a goal. To achieve the proper balance between easing the undue burden on potential foreign investors and safeguarding national security, US policymakers should not pin hope on case-by-case adjudication of CFIUS. Instead, they should favor a direct regulation approach, meaning more clear-cut ex ante rulemaking.

For a completely secretive process like the CFIUS process, a case-by-case adjudication process is particularly unable to shed light on the review scope and standards. The case-by-case adjudication does not help potential foreign investors to better assess the national security consequence of their investments ex ante, so as to adjust their behavior to ensure compliance.

In order to increase clarity and predictability, the CFIUS regime should lay out more black-letter rules or guidelines—it is time for CFIUS to adjust its regulatory approach. To facilitate predictability is to ensure continuity in the scope and standards of review enforced by CFIUS, and direct regulation in this sense should be a better candidate for the regulatory machinery.⁷⁰ CFIUS possesses proprietary knowledge and expertise in defining the elements that threaten to impair national security—it has accumulated sufficient information about inbound M&A activities and has the competence to tender a universal application now that it has been in operation for four decades.

B. Due Process: The Ralls Case and the Role of the Judiciary in National Security Issues

The frustrations from lack of clarity and unreviewability have led some foreign investors to challenge CFIUS on due process grounds, alleging that the secretive CFIUS process is in violation of the Fifth Amendment. For example, in *Ralls Corp. v. CFIUS*,⁷¹ Ralls Corporation, a US company owned by two Chinese nationals (who are affiliated with a Chinese construction equipment company that manufactures wind turbines) acquired ownership interests in four Oregon wind farms as wind turbine demonstration projects.⁷² The four wind farms were near a military training installment.⁷³ Ralls did not make a voluntary notification of the transaction to CFIUS prior to closing.⁷⁴

⁷⁰ See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 493 (9th ed. 2014) (pointing out that direct regulation is continuous).

⁷¹ 758 F.3d 296 (D.C. Cir. 2014).

⁷² *Id.* at 304.

⁷³ *Id.*

⁷⁴ *Id.* at 305.

After the transaction closed, CFIUS requested that Ralls file a notice regarding the transaction.⁷⁵ With little or no advance notice or opportunity for discussion or negotiation of mitigating conditions, CFIUS ordered Ralls to cease all construction, sell the properties to a buyer that CFIUS would approve, remove all equipment on the properties, and destroy any construction that had been completed.⁷⁶ In 2012, based on the recommendation of CFIUS, President Obama issued an order unwinding the transaction.⁷⁷ Ralls filed suit against CFIUS. On appeal, the D.C. Circuit validated the Fifth Amendment due process claim of Ralls,⁷⁸ but left the *ultra vires* claim and other claims intact.⁷⁹ In October 2015, Ralls and the US government reached a settlement, putting an end to the continued litigation.⁸⁰

According to the description of CFIUS's annual report to Congress, the important reason for the prohibition was that "[t]he wind farm sites are all within or in the vicinity of restricted air space at Naval Weapons Systems Training Facility Boardman in Oregon."⁸¹ An often overlooked fact, however, is that in the same restricted military area, there had already been a number of wind farms installed, some of which were owned by foreign entities, which nobody challenged on the basis of national security impacts.⁸²

One should not read too much into the *Ralls* decision, or hope *Ralls* would help alleviate the secrecy clouding over the CFIUS process. The *Ralls* decision, in its essence, ruled that a foreign investor should be given the procedural protection to be notified of (a) the official action, (b) the unclassified evidence on which the decision relies, and (c) an opportunity to rebut the evidence.⁸³ What *Ralls* does not alter, however, is more important: a CFIUS or Presidential determination of national security risk, which deprives foreign investors of significant property interests, remains judicially unreviewable.⁸⁴

⁷⁵ A different version is that Ralls "submitted a CFIUS notice only after being told that the Department of Defense was preparing to file its own notice of the transaction and trigger review if Ralls did not." Ivan A. Schlager et al., *Court Finds CFIUS Violated Ralls Corporation's Due Process Rights*, SKADDEN (July 17, 2014), <http://www.skadden.com/insights/court-finds-cfius-violated-ralls-corporations-due-process-rights>.

⁷⁶ CFIUS further prohibited Ralls from undertaking the equipment removal and demolition itself, but instead ordered that only outside firms approved by CFIUS could do so.

⁷⁷ The order directed Ralls Corporation to divest its interest in the wind farm project companies that it acquired in 2012, and to take other actions related to the divestment.

⁷⁸ *Ralls Corp.*, 758 F.3d at 319-21.

⁷⁹ *Id.* at 307 n.9 (noting that "Ralls [did] not appeal the dismissal of its *ultra vires* and equal protection challenges to the Presidential Order.").

⁸⁰ Stephen Dockery, *Chinese Wind Company Settles with U.S. in CFIUS Battle*, WALL ST. J. (Oct. 9, 2015, 6:45 PM), <http://blogs.wsj.com/riskandcompliance/2015/10/09/chinese-wind-company-settles-with-u-s-in-cfius-battle/>.

⁸¹ See CFIUS ANNUAL REPORT 2013, *supra* note 1, at 2.

⁸² Corrected Brief for Appellant Ralls Corporation at 6, *Ralls Corp.*, 758 F.3d 296 (No. 13-5315).

⁸³ *Ralls Corp.*, 758 F.3d at 319.

⁸⁴ *Id.* at 320 ("Our conclusion that the procedure followed in issuing the Presidential Order violates due process does not mean the President must, in the future, disclose his thinking on sensitive questions related to national security in reviewing a covered transaction. We hold only that Ralls must receive the

The ruling of unreviewability is in line with the general *Chevron* deference to agencies based on their relative competence and the recognition of the institutional limitations of the courts.⁸⁵ Eric Posner and Cass Sunstein have noted that the *Chevron* deference is particularly apt in the domain of foreign affairs.⁸⁶ Courts have legitimate grounds for refraining from intervening in CFIUS substantive rulings and the Presidential orders: the relative competence of courts and executive officials to deal with national security issues.⁸⁷ Courts have limitations in their intellectual capacities to take sides in highly contested political issues such as national security. Judges should intervene in such areas as national security only if utterly convinced of the completely unreasonable character of the act or practice that they are asked to prohibit—a realism principle based precisely on the institutional limitations of the courts. As put by Judge Richard Posner, “those of us who argue that courts should be extremely cautious about checking presidential initiatives in the current emergency do so in part at least on the basis of our assessment of the relative competence of courts and executive officials to deal with national security issues.”⁸⁸ Exactly because of the judicial passivity and self-restraint toward national security issues, the behavior of CFIUS should be better guided by having more black-letter legislation and regulations. As the judicial branch refrains from intervening in national security review, when lack of certainty and predictability has taken a toll on potential foreign investors, more direct regulation becomes the most feasible option.

C. *The Market’s Ability to Help*

While the *Ralls* decision on unreviewability is justifiable on *Chevron* grounds, the unpredictability of the CFIUS process remains unresolved. Whether CFIUS cloaks protectionism in the guise of national security in its adjudication becomes an open question. However, an important potential

procedural protections we have spelled out before the Presidential Order prohibits the transaction.”). The *Ralls* decision made clear that although the statutory bar of judicial review does not preclude judicial review of due process challenge under the Fifth Amendment, the “final ‘action[s]’ the President takes ‘to suspend or prohibit any covered transaction that threatens to impair the national security of the United States’” are barred from judicial review. *Id.* at 311 (quoting 50 U.S.C. app. § 2170(d)(1) (2015)).

⁸⁵ See The Honorable Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 DUKE L.J. 511, 511-12, 514 (1989) (noting one justification for *Chevron* deference is the expertise and competency of agencies); see also, Cass R. Sunstein, *Law and Administration After Chevron*, 90 COLUM. L. REV. 2071, 2083-84 (1990) (discussing the *Chevron* principle and deference to agency’s relative competence in fact finding); Robert M. Chesney, *National Security Fact Deference*, 95 VA. L. REV. 1361, 1404-19, 1434 (2009) (exploring “the judiciary’s reluctance to overstep its bounds” in fact findings in such contested areas as national security, because of the executive branch’s “comparative institutional accuracy”).

⁸⁶ See Eric A. Posner & Cass R. Sunstein, *Chevronizing Foreign Relations Law*, 16 YALE L.J. 1170, 1170 (2007) (arguing for *Chevron* deference to the executive interpretation “in the domain of foreign affairs”).

⁸⁷ See RICHARD A. POSNER, *LAW, PRAGMATISM, AND DEMOCRACY* 292-321 (2003).

⁸⁸ See Richard A. Posner, *Reply: The Institutional Dimension of Statutory and Constitutional Interpretation*, 101 MICH. L. REV. 952, 957 (2003).

counter-argument is that market participants (intermediaries such as law firms, consulting firms, lobbying firms) can help bridge the information gap and bring a certain degree of predictability by collecting and analyzing precedents. This way, it may not be necessary for CFIUS to formulate, *ex ante*, the definition of national security or the scope and standards of review.

Law firms, lobbying firms, and consulting firms do come up with some generalizations as to the scope, the standards, and priorities of CFIUS review. In practice, firms have distilled some important elements as a rule of thumb: (a) nationality of acquirer,⁸⁹ (b) extent of foreign government's involvement in acquirer,⁹⁰ (c) industry sector,⁹¹ (d) particular products or services involved,⁹² (e) types of assets involved,⁹³ (f) contracts with the US government,⁹⁴ (g) potential vulnerability of business,⁹⁵ (h) defense-related issues,⁹⁶ and (i) implicit political factors,⁹⁷ alongside some miscellaneous factors.⁹⁸

Reliance on the interpretation furnished by the market has several inherent flaws, however. Above all, they are mostly rules of thumb, largely drawn from

⁸⁹ The identity and the home country of an acquirer loom large in a CFIUS review process. Countries posing political or security challenges to the United States receive enhanced scrutiny. The home country's record on non-proliferation, counter-terrorism, and export controls is examined as well. A related issue is that during the CFIUS review process, one common request addressed by CFIUS to foreign buyers is for a record of sales or other relationships involving countries on which the United States imposes trade restrictions. A combination of a suspect home country and physical proximity to sensitive US installations will magnify the chance of a transaction being closely scrutinized.

⁹⁰ A related concern of CFIUS has been foreign governments' involvement in the buyer. This factor also marks the importance of the buyer's home country. Whether the entity is privately or publicly controlled is sensitive, and government-controlled entities receives heightened scrutiny.

⁹¹ Transactions involving the defense, energy, information and communications technology, financial markets and credit operations, and transportation sectors are more likely to raise CFIUS concerns.

⁹² More specifically, if CFIUS decides there is any critical technology involved, or transactions involving export-controlled products or nuclear related products, the transactions will be evaluated closely.

⁹³ If the business being acquired controls technologies that are considered important to US strategic interests, CFIUS will usually closely scrutiny the transaction.

⁹⁴ When the business being acquired does substantial business with the US government—especially when some of that business is classified—CFIUS will usually take a close look, and may even seek to put conditions on the transaction.

⁹⁵ CFIUS assesses potential vulnerabilities and whether the nature of the business creates susceptibility to the impairment of national security. This often involves asking whether the United States would face a critical shortage or emergency situation in a particular sector, should the foreign parent decide to shut down or transfer its US operations abroad.

⁹⁶ Other intelligence or defense-related issues include whether there is proximity to strategic US operations—"persistent co-location," e.g., military base. In recent years, the question of cybersecurity has also loomed large in CFIUS reviews.

⁹⁷ Besides legitimate national security concerns, political considerations are embedded in CFIUS decisions. See discussion *infra* note 104 and accompanying text.

⁹⁸ See e.g., Jeffrey R. Keitelman et al., *What Real Estate Cos. Need to Know About CFIUS Reviews*, LAW360 (Jan. 5, 2016, 3:44 PM), <http://www.stroock.com/siteFiles/Publications/WhatRealEstateCos.NeedToKnowAboutCFIUSReviews.pdf> (enlisting such elements as the targeted asset's proximity to government facilities and accommodation of sensitive government tenants as some of the many factors that will draw CFIUS's attention). There are numerous publications and newsletters alike released by third-party intermediaries, summarizing their views on the elements that CFIUS is likely to consider based on their respective experiences.

the law firms' past deal experiences. Individual firms may have some sample CFIUS cases as their knowhow, but they are no more than sneak peeks at the scope or standards of review.⁹⁹ Such information in the possession of individual intermediaries is bound to be incomplete. Generally, it is very difficult to draw statistical inference from these cases scattered in separate law firms.

Still further, law firms, lobbying firms, and consulting firms have the incentive to keep confidential their proprietary analyses of the scope and standards of review enforced by CFIUS. They gained such knowhow through their clientele relationship with foreign investors, their experience before CFIUS, or their employees who were previous CFIUS staff. They want to charge a high premium on the knowhow next time when they advise new clients. The cost of information dissemination is therefore high.

More importantly, if one intends to apply knowledge gained from the past to predict the future, the premise is that all events (be it in the past or in the future) follow the same pattern, i.e., the scope and the standards of review are actually the same the whole time. But we are unable to ascertain whether the scope or the standards of review have remained the same throughout the history of CFIUS. Indeed, given its broad and vague mandate, CFIUS is under no obligation to ensure continuity or consistency in its decisions. In other words, CFIUS is *not statutorily required* to follow a consistent standard. If CFIUS is expected to play a dynamic role in national security review, it is implied that it will employ drifting and discriminative enforcement criteria over time. And we do see an expanding scope of "national security" purview: emphasis of hard assets in CFIUS review has given way to a close scrutiny on technology; proximity to strategic US operations had not become a salient issue until the *Ralls* decision. Last but not least, the information collected and revealed by market participants through private channels is at best helpful in shedding light on what kind of *information* is sought by CFIUS, not what kind of *standards* CFIUS is likely to implement.

D. The Value of Available Data

On a related subject, one may wonder whether empirical studies by scholarship or think tanks might lend a helping hand. Academics endeavor to

⁹⁹ Almost all firms with international trade divisions have national security/CFIUS practices, and more than a handful of firms claim they have leading practices in the area. The market for CFIUS practice is fragmented and proprietary information about CFIUS is disseminated within numerous firms. For a glimpse of leading players, see, for example, *Foreign Investment in the US (CFIUS)*, WILMERHALE, <https://www.wilmerhale.com/trade/cfius>, (last visited Apr. 8, 2016); *Nationale Sicherheit/CFIUS*, KAYE SCHOLER, http://www.kayescholer.com/de_DE/legal-services/national_security_cfius, (last visited Apr. 8, 2016); *CFIUS*, COVINGTON & BURLING, <https://www.cov.com/en/practices/international/cfius-exon-florio>, (last visited Apr. 8, 2016); *CFIUS and National Security*, WILEY REIN LLP, <http://www.wileyrein.com/practices-cfius-national-security.html>, (last visited Apr. 8, 2016); *Economic Sanctions and Foreign Investments*, CLEARY GOTTlieb, <http://www.cgsh.com/services/servicedetail.aspx?service=83&subservice=85> (last visited Apr. 8, 2016).

decipher the standard of review through empirical studies, by collecting data on CFIUS filing cases and conducting regression analyses.¹⁰⁰

Valuable as they are, this strand of research similarly faces difficulty in overcoming the limitation on the source of data. First, the secrecy of the CFIUS process makes data collection a particularly challenging task. Second, researchers are prone to systemically underestimate the array of M&A transactions that are affected by CFIUS. Those companies that do not end up filing CFIUS notices, but nevertheless incur high costs (attorney fees, lobbying efforts, etc.) in assessing the implication of CFIUS process on their specific transactions, comprise a much larger population compared to what the datasets may represent. Essentially every cross-border M&A transaction involving a US target is covered by the CFIUS regime.¹⁰¹ In contrast, the datasets compiled in researches tend to be comprised of observations collected from publicly available information.¹⁰² The selection bias is twofold. One is public M&As are overrepresented—information about public companies with SEC filing obligations is relatively easy to track down—whereas private M&A information is much harder to obtain. Another bias exists in that even for those private M&As reflected in the datasets, they tend to be high-profile cases that drew media attention. They are merely the tip of the iceberg and may not be representative of those medium or small-sized M&As that particularly suffer from the CFIUS process.¹⁰³

Third, available data likely overestimates the success rate of CFIUS process. A large proportion of companies, deterred by the contingency of the CFIUS process, refrained from entering into a transaction with their desirable US target companies after assessing the CFIUS consequences.¹⁰⁴ Some other

¹⁰⁰ See, e.g., Dustin H. Tingley et al., *The Political Economy of Inward FDI Flows: Opposition to Chinese Mergers & Acquisitions*, 8 CHINESE J. INT'L POL. 27 (2015); Paul Connell & Tian Huang, Note, *An Empirical Analysis of CFIUS: Examining Foreign Investment Regulation in the United States*, 39 YALE J. INT'L L. 131 (2014).

¹⁰¹ There is no specific data in direct support of this allegation, but given the broad and vague coverage of CFIUS notification requirements, it is expected that a wide array of parties to M&A transactions would have to conduct CFIUS impact analyses even though they do not end up making the actual filings.

¹⁰² See, e.g., Connell & Huang, *supra* note 100, at 135 (using dataset compiled of seventy-six transactions that underwent CFIUS review); Tingley et al., *supra* note 100, at 27 (using “dataset of 569 transactions that occurred between 1999 and 2014 involving Chinese” investors’ attempted acquisitions of US targets).

¹⁰³ For example, one of the datasets was compiled from Bloomberg M&A database and newsletters of law firms (largely high-profiled cases) and the SEC EDGAR database (public companies). See Connell & Huang, *supra* note 100, at 152-53.

¹⁰⁴ See, e.g., Joshua W. Casselman, Note, *China’s Latest ‘Threat’ to the United States: The Failed CNOOC-UNOCAL Merger and Its Implications for Exon-Florio and CFIUS*, 17 IND. INT’L & COMP. L. REV. 155, 161-64 (2007) (noting that in CNOOC’s failed attempt to acquire Unocal, CNOOC withdrew its bid due to “mounting” political pressure before completion of the CFIUS process).

companies chose to withdraw after preliminary contacts with CFIUS or throughout the review phases and never made it to the finishing line.¹⁰⁵

Last, the regression analysis may be useful in explaining past development as covered in the time span of their datasets, but may not be as helpful when making predictions. Again, when CFIUS is not bound by its past decisions or required to maintain consistency in its adjudicating process, a summary on the past behavior of CFIUS does not do much help to shed light on CFIUS's behavior in the future, providing foreign investors with limited guidance.

E. Vulnerability to Politicization and Protectionism

With no helping hands from the judiciary, the broadly mandated and highly secretive CFIUS process is vulnerable to political influence. National security has always been a profoundly contested political issue.¹⁰⁶ It is no surprise that high-profile M&A transactions feature politicization and media sensationalism, and the national security review regime adds to the politicization concern.¹⁰⁷

National protectionism, a barrier to free trade, often fosters politicization. Openly advocating protectionism is sure to provoke protectionist backlashes in other countries, creating incentives to cloak their protectionist actions in the guise of other more glamorous claims. National security review regime is the perfect mechanism for that.

US economic interests have clouded the legislative history of the national security review regime. The possible economic protection function of CFIUS was raised as early as in 1979. In a congressional hearing, one legislator commented:

“the Committee has been reduced over the last 4 years to a body that only responds to the political aspects or the political questions that foreign investment in the United States poses and not with what we really want to know about foreign investments in the United States, that is: Is it good for the economy?”¹⁰⁸

¹⁰⁵ See CFIUS ANNUAL REPORT 2013, *supra* note 1, at 20 (noting the parties' withdrawal from the CFIUS process for various reasons); see also DICK K. NANTO ET AL., CONG. RESEARCH SERV., RL33093, CHINA AND THE CNOOC BID FOR UNOCAL: ISSUES FOR CONGRESS 14 (2006), <https://www.hsdl.org/?view&did=460852>.

¹⁰⁶ See Posner, *supra* note 88, at 957.

¹⁰⁷ CFIUS has been criticized as being unduly politicized. See, e.g., Maira Goes de Moraes Gavioli, *National Security or Xenophobia: The Impact of the Foreign Investment and National Security Act ("FINSA") in Foreign Investment in the U.S.*, 2 WM. MITCHELL L. RAZA J. 1, 33-36 (2011). Among the political considerations are the preservation of jobs, espionage of the home country of the acquirer, economic distress of the United States, and retaliation. Also, in recent years, inbound investment from China has become a particular target susceptible to political concerns. Hostility against acquirers from China is in the rise. Investment from China is treated as largely to transfer technology and knowhow to Chinese firms, but do little to help the US economy. See WAYNE M. MORRISON, CONG. RESEARCH SERV., RL33536, CHINA-U.S. TRADE ISSUES 17, 24 (2015).

¹⁰⁸ *The Operations of Federal Agencies in Monitoring, Reporting on, and Analyzing Foreign Investments in the United States (Part 3—Examination of the Committee on Foreign Investment in the United States, Federal Policy Toward Foreign Investment, and Federal Data Collection Efforts) Before*

As of today, legislators have not formally addressed this concern in the national security regime, but the ambiguity in rules gives rise to the notion that the commercial nature of investment transactions is among CFIUS considerations in deciding on the fate of these cases.

Protectionism, be it in the open or hidden form, would greatly hamper the attractiveness of the host country. The CFIUS process is particularly vulnerable to abuse as a protectionist instrument.¹⁰⁹ Scholarship has long argued that overall protectionism is inefficient.¹¹⁰ By raising the costs of entry in a domestic market for a subset of foreign firms and thereby putting them at a comparative disadvantage, protectionist measures leave the relatively high-cost players in the market. Deadweight loss is therefore present.¹¹¹ Empirical evidence has generally established that protectionism causes a series of adverse consequences that weaken the spillover effects—the positive outcomes—the host countries may have from foreign investment.¹¹² For fear of protectionism, foreign investors steer away their investment and look for possible substitute host countries.¹¹³

National security review can easily become a facially neutral, yet practically protective, regulatory instrument. Its secrecy may shield the selective protection of a certain group of investors from public scrutiny. If economic interests beyond national defense were involved in national security review, turning down certain group of investors may provide other groups of investors a competitive edge in winning over a desirable transaction.¹¹⁴ The problem is the winner is not necessarily the most efficient acquirer.

If policymakers genuinely desire to eliminate protectionism or the criticism it facilitates protectionism from CFIUS review, they should aim to promote transparency in the decision-making process. Such an improvement would help

the Subcomm. on Commerce, Consumer, & Monetary Affairs of the H. Comm. on Gov't Operations, 96th Cong. 5 (1979) (statement of Mary P. Azevedo, M.A., M.A.L.D., Ph. D., & J.D. Candidate, the Fletcher Sch. of Law & Diplomacy, Tufts Univ.).

¹⁰⁹ See W. Robert Shearer, Comment, *The Exon-Florio Amendment: Protectionist Legislation Susceptible to Abuse*, 30 HOUS. L. REV. 1729, 1732-35 (1993) (discussing the danger that Exon-Florio Amendment may be abused for protectionist purposes).

¹¹⁰ See generally Alan O. Sykes, *Regulatory Protectionism and the Law of International Trade*, 66 U. CHI. L. REV. 1 (1999).

¹¹¹ *Id.* at 5.

¹¹² See Magnus Blomström et al., *The Determinants of Host Country Spillovers from Foreign Direct Investment: Review and Synthesis of the Literature*, in INWARD INVESTMENT, TECHNOLOGICAL CHANGE AND GROWTH 34 (Nigel Pain ed., 2001).

¹¹³ The fear for protectionism is genuine. See, e.g., Nagesh Kumar, *Multinational Enterprises, Regional Economic Integration, and Export-Platform Production in the Host Countries: An Empirical Analysis for the US and Japanese Corporations*, 134 WELTWIRTSCHAFTLICHES ARCHIV 450, 478-79 (1998) (discussing the scenario of multinational corporations' utilization of host countries as platforms for export-oriented production—production made in the host countries will be shipped back to the multinational corporations' domestic markets).

¹¹⁴ See, e.g., CFIUS ANNUAL REPORT 2013, *supra* note 1, at 147-50 (empirically showing that CFIUS decisions have significant positive effects on the stock prices of domestic companies in such sectors that may benefit from the denial of entry by foreign investors).

confer more legitimacy on the national security review regime and reduce retaliation from other countries when its own enterprises seek to invest in other countries.¹¹⁵ Indeed, countries may implement their own national security review programs as retaliation instrument against the protectionism they experienced in the CFIUS process in the United States.¹¹⁶ Retaliation will not only tarnish a country's reputation for openness to foreign investment but also distract the attention of policymakers from building the infrastructure for a genuine national security review.

III. HOW TO APPROACH A REVIEWABLE TRANSACTION IN CHINA: DIFFERENCES AND DEFECTS IN THE REVIEW STANDARDS OF TWO SYSTEMS

In contrast with an undefined rubric of national security in the CFIUS context, Chinese policymakers adopt a categorical list (albeit a very broad one) in an effort to narrow down the factors to be considered in a national security review.¹¹⁷ In accordance with the list, regulators may review inward foreign investment transactions (not restricted to M&As) relevant to (i) national defense, (ii) critical technology, (iii) critical infrastructure, (iv) energy and other resources, and (v) economic safety.¹¹⁸ However, such a broad and ambiguous list is, in effect, equivalent to the US approach of not furnishing a definition of national security. By the same token, the unpredictability of the Chinese system is equal to that of its US counterpart. What is worse, while each categorical element is broad and ambiguous, the list is far from a comprehensive one; for instance as discussed *infra*, the financial sector is completely missing. It unreasonably narrows the coverage of national security review and mistakenly renders large subsets of transactions immune from national security scrutiny.

Given the simultaneous narrowing and ambiguity in the list of reviewable transactions, it would be useful to understand policymakers' reasoning behind the list. The various regulations and rules possess striking inconsistencies in their wordings of reviewable transactions.¹¹⁹ This indicates Chinese

¹¹⁵ See Georgiev, *supra* note 3, at 126 (“If the United States is seen as using national security review to engage in protectionism, this could provoke a protectionist backlash in other parts of the world and hurt U.S. companies.”). For some examples of retaliation by the United States against its international trade partners, see generally THOMAS O. BAYARD & KIMBERLY ANN ELLIOTT, *RECIPROCITY AND RETALIATION IN U.S. TRADE POLICY* (1994).

¹¹⁶ See, e.g., DAVID M. MARCHICK & MATTHEW J. SLAUGHTER, *GLOBAL FDI POLICY: CORRECTING A PROTECTIONIST DRIFT* 12 (2008), http://www.cfr.org/content/publications/attachments/FDI_CSR34.pdf (“[India] has considered creating new national security–related screening in the telecoms field—in part in reaction to a CFIUS review of an Indian company undertaking a U.S. acquisition . . .”).

¹¹⁷ Draft Foreign Investment Law, *supra* note 24, art. 57.

¹¹⁸ *Id.*

¹¹⁹ Compare *id.*, with State Council National Security Review Circular, *supra* note 39, at art. 1(1), and Ziyou Maoyi Shiyuan Qu Waishang Touzi Guojia Anquan Shencha Shixing Banfa (自由贸易试验区外商投资国家安全审查试行办法) [Interim Measures on National Security Review Pertaining to Foreign

policymakers are undetermined as to what should be included in the list and what should be left out. One may therefore wonder where the list came from and whether there is a solid ground for it. Unfortunately, when retracing the steps, one would not be able to find any publicly available resources concerning the basis for such a list. Rather, the Chinese policymakers seemed to draw from a handful of salient US and Chinese cases while overlooking the danger that a salient-case approach is doomed to be under-inclusive and cannot evolve over time. For example, “in the proximity of critical or sensitive military installations”¹²⁰ is likely a reciprocal provision in light of the *Ralls* decision in the United States. Recall that proximity to military installations was not a salient element in the CFIUS process until the *Ralls* acquisition. And “engaging in critical construction machinery industry”¹²¹ looks like a lesson drawn from the contested Xugong Machinery case (discussed *supra*).

Such a piecemeal list may suffer the deficiency of heuristic reasoning. China has long been criticized for, and has admitted, the poor quality of its legislation.¹²² Empirical evidence supports the suspicion that a sizeable number of legislations were promulgated without prudent deliberation.¹²³ The rulemaking concerning foreign direct investment regulation was similarly based on the limited experience that China’s top leadership had, and the legislative process was *ad hoc*.¹²⁴ Policymakers drafted the legislation largely by way of “water testing,” wherein a legislative initiative is first rolled out despite lacking substantiated evidence in support of the legislation and is subsequently adjusted based on the lessons learned from the small-scale experiments.¹²⁵ When policymakers determine legislation by the views of individual leaders without prudent deliberation or rigorous empiricism, heuristic reasoning becomes a real danger. The issues spotted in national security legislation seem to suggest that Chinese policymakers have very limited experience regarding national security review. When first crafting the legal framework, Chinese policymakers chose the convenient way of directly borrowing from a sophisticated jurisdiction like

Investments in Free Trade Pilot Zones] (promulgated by General Office of State Council, Apr. 8, 2015, effective May 7, 2015), art. 1(1) [hereinafter Free Trade Zone National Security Review Rules], http://www.gov.cn/zhengce/content/2015-04/20/content_9629.htm (China).

¹²⁰ State Council National Security Review Circular, *supra* note 39, art. 1(1); *see also*, Free Trade Zone National Security Rules, *supra* note 119, art. 1(1). In Draft Foreign Investment Law, the language has been modified to be “the impact on the safety of critical or sensitive military installations.” *See* Draft Foreign Investment Law, *supra* note 24, art. 57(1).

¹²¹ State Council National Security Review Circular, *supra* note 39, art. 1(1); *see also* Free Trade Zone National Security Rules, *supra* note 119, art. 1(1).

¹²² *See* Yahong Li, *The Law-Making Law: A Solution to the Problems in the Chinese Legislative System*, 30 HONG KONG LJ 120, 122 (2000).

¹²³ *See* PENG HE, CHINESE LAWMAKING: FROM NON-COMMUNICATIVE TO COMMUNICATIVE 21 (2014).

¹²⁴ For an authoritative historical narrative of the legislative process of China’s foreign investment regulatory apparatus, *see* Ping Jiang (江平), Wei “Waiguo Touzi Fa” Shuo Jiju (为《外国投资法》说几句) (A Few Words on the Foreign Investment Law), Keynote Speech at the 2015 China International Investment Law Forum (Sept. 17, 2015), http://blog.sina.com.cn/s/blog_9223c60d0102wcos.html (China).

¹²⁵ *Id.*

the United States—convenient in a sense that it does not require cost-benefit analysis, data collections, or empiricism, a tradition lacking in China’s policymaking process.¹²⁶

The result is that Chinese policymakers have indeed transplanted many rules and structural arrangements from that of CFIUS. When it comes to the catalog of sectors that are reviewable, which should tailor to the Chinese conditions and is hard to copy (recall the United States does not promulgate a categorical list), the policymakers fell on the salient cases that came readily to mind and the availability heuristic then kicked in.¹²⁷ When the availability heuristic is at play, more concrete and vivid events tend to be perceived as more likely to occur.¹²⁸ Events that are not visible or salient to the policymakers are then systemically underestimated for their probability to occur. Systemic biases in the evaluation of possible cases that threaten to impair national security emerge.

To overcome the erroneous and dangerous reliance on heuristics, Chinese policymakers should get a helping hand from rigorous empiricism—an area under-appreciated in China¹²⁹—so as to expand the canvas for the list by correctly assessing the probabilities of possible scenarios wherein foreign investment may hamper national security. It would be a huge project; however, it is a path the policymakers have to go down if the categorical list is the suitable approach in the context of China. Only in this way can they engage in a knowledgeable and informed rulemaking process.

¹²⁶ China’s rule-making process is more a top-down implementation of the intention of the leadership, rather than derived from empiricism or cost-benefit analysis. For an authoritative summary, see Dehuai Ma, *Woguo Lifa de Xianzhuang, Wenti yu Yuanyin Fenxi (我国立法的现状、问题与原因分析) [The Current State of China’s Legislation, the Problems, and the Reasons Analyzed]*, PEOPLE’S DAILY – CHANNEL THEORY (Jul. 8, 2008), <http://theory.people.com.cn/GB/68294/120979/124345/7481139.html> (noting the lack of cost-benefit analysis in rule-makings, the absence of procedural due process, and the top-down rule-making process in which the drafters merely carry out the superior’s will without scientific reasoning) (China). For a vivid illustration of China’s legislative process, see Ta-kuang Chang, *The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process*, 28 HARV. INT’L. L.J. 333, 336-54 (1987), which discusses a Chinese bankruptcy law case. The legislative process for other legislations is analogous throughout the years. For a summary of the interest parties that exert influence over the legislative process, see Stanley Lubman, *Introduction: The Future of Chinese Law*, 141 CHINA Q. 1, 3-4 (1995).

¹²⁷ Availability heuristic refers to judgments on the accessibility or ease with which specific instances are brought to mind. For the classic paper on availability heuristic, see Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207 (1973).

¹²⁸ See, e.g., Ben R. Newell, Chris J. Mitchell & Brett K. Hayes, *Getting Scarred and Winning Lotteries: Effects of Exemplar Cuing and Statistical Format on Imagining Low-Probability Events*, 21 J. BEHAV. DECISION MAKING 317, 320 (2008); Steven J. Sherman et al., *Imagining Can Heighten or Lower the Perceived Likelihood of Contracting a Disease: The Mediating Effect of Ease of Imagery*, 11 PERSONALITY & SOC. PSYCHOL. BULL. 118 (1985); Paul Slovic, John Monahan & Donald G. MacGregor, *Violence Risk Assessment and Risk Communication: The Effects of Using Actual Cases, Providing Instruction, and Employing Probability Versus Frequency Formats*, 24 L. & HUM. BEHAV. 271 (2000).

¹²⁹ See Ma, *supra* note 126.

The arbitrary rulemaking process invites two critical problems: (1) some critical sectors are missing from China's national security review, and (2) the regulations are a mixture of under-inclusive and over-inclusive rules.

A. *The Missing Critical Sectors: Financial Sector as an Example*

One of the systemic errors in the list is the omission of certain critical sectors. Hard assets are the foci of the categorical list; services sectors, especially the financial services sector, are left out of the picture.¹³⁰ The Draft Foreign Investment Law briefly mentions national security in financial services sector, but fails to recognize it as an imperative issue that warrants being included in the Foreign Investment Law.¹³¹ Another deficiency in the salient-case approach: a lack of vision that foresees the trend of the Chinese economy.

The utter absence of the financial services sector from the categorical list is at odds with the sector's strategic importance and sensitiveness in Chinese economy. China's financial services sector experienced substantial growth in the recent years.¹³² Along with that came foreign investors' strong interests in the sector. Of the \$79 billion in foreign investment China received in 2005, around \$12 billion "was for foreign banks' purchases of stakes in large state-owned commercial banks."¹³³ Since 2009, foreign investment in the financial services sector has experienced a steady annual growth rate of 50 percent.¹³⁴ Figure 1 below illustrates the exponential growth of foreign investment in the financial services sector in China. As of 2014, China's financial services sector has emerged to be one of the most active areas for M&A transactions.¹³⁵ A

¹³⁰ See Draft Foreign Investment Law, *supra* note 24, art. 57; Free Trade Zone National Security Review Rules, *supra* note 119, art. 1(1).

¹³¹ The Draft Foreign Investment Law sets out that the national security review regime in financial services sector is to be formulated later, which usually means in an indefinite period. See Draft Foreign Investment Law, *supra* note 24, art. 74.

¹³² See KPMG, MAINLAND CHINA BANKING SURVEY 2015 4-6 (2015), <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/Mainland-China-Banking-Survey-201507-low.pdf> (citing CBRC's reports on the performance of China's banking industry); KPMG, MAINLAND CHINA SECURITIES SURVEY 2015 26-33 (2015), <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/China-Securities-Survey-201510.pdf> (discussing the securities sector's rapid development); see also Gabriel Wildau, *China Services Sector Key to Growth*, FIN. TIMES (Dec. 6, 2015), <http://www.ft.com/intl/cms/s/0/0f6f0018-9817-11e5-bdda-9f13f99fa654.html#axzz3y44874HP> (discussing the rally of the services sector in China's GDP, with major contributions from the financial services sector, and foreign investor's zeal in investment in China's financial services sector).

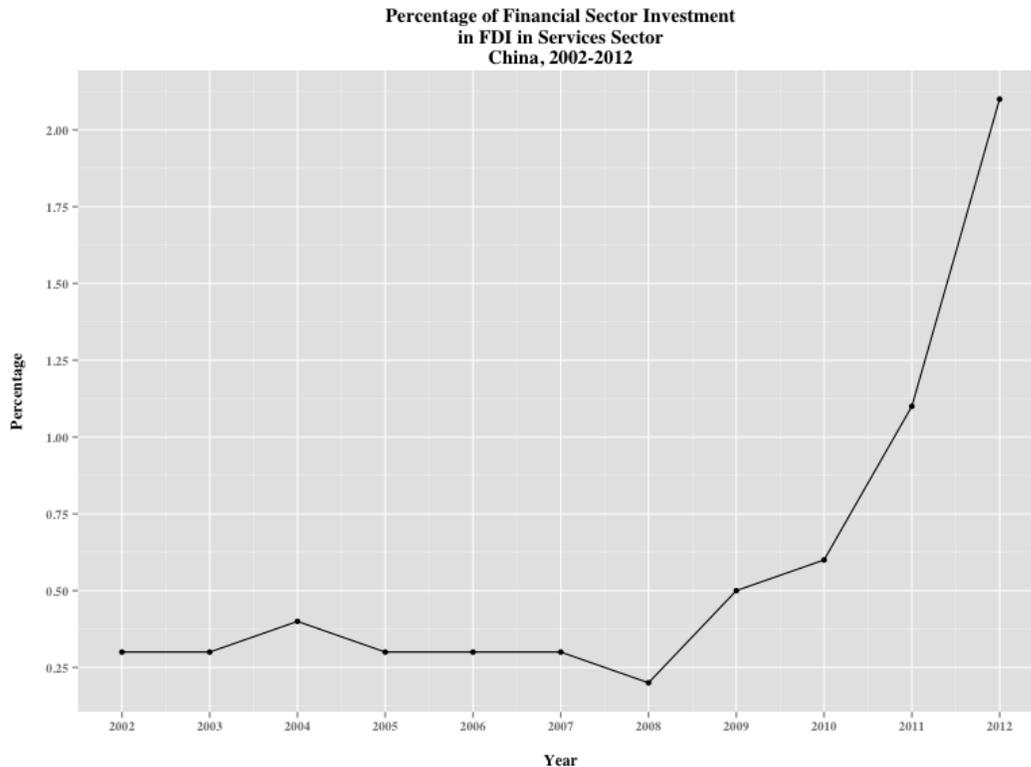
¹³³ *China's Economy: China Wants Higher-Quality Foreign Investment*, ECONOMIST (Nov. 13, 2006), <http://www.economist.com/node/8162102>.

¹³⁴ See MINISTRY OF COMMERCE, *2013 Zhongguo Waishang Touzi Baogao [2013 中国外商投资报告] (China Foreign Investment Report 2013)* 151 (Dec. 13, 2013) [hereinafter Chinese Foreign Investment Report], http://www.fdi.gov.cn/1800000121_35_166_0_7.html.

¹³⁵ See PRICEWATERHOUSECOOPERS, *GOING FOR GROWTH IN ASIA: NAVIGATE THE WAY — FINANCIAL SERVICES M&A — CHINA* 1-2 (2008), http://www.pwchk.com/webmedia/doc/633495680611482048_m&a_fs_asia_jun2008_cn.pdf; PRICEWATERHOUSECOOPERS, *M&A 2014 MID YEAR REVIEW AND OUTLOOK PRESS BRIEFING* 31 (Aug. 26, 2014), http://www.pwccn.com/webmedia/doc/635446471209602513_ma_press_briefing_aug2014.pdf.

series of factors play a role in foreign investors' enthusiasm in the Chinese financial services sector, including the high profitability of the sector and the increasingly wider openness of the sector to foreign investment in recent years.¹³⁶

Figure 1



Source: MOFCOM

Interagency political bargaining and compromise may account for the absence of the financial services sector from the list.¹³⁷ But the bureaucracy should by no means become any excuse for the insufficient attention to national

¹³⁶ See Zhong Nan, *China's Service Sector Clears a Path for FDI*, TELEGRAPH (Apr. 25, 2015), <http://www.telegraph.co.uk/sponsored/china-watch/business/11563044/china-service-sector-fdi.html> (discussing China's provision of more foreign access to its financial sector).

¹³⁷ One explanation may be that due to the jurisdictional divisions between the NDRC, MOFCOM, and the financial regulators—e.g., the Ministry of Finance, CBRC, CSRC, CIRC, or China's central bank, the People's Bank of China—the NDRC and MOFCOM do not wish to intervene on the turfs of the financial regulators when it comes to national security review. But that argument has no merit. National security review, by its nature, is cross-sectorial. That is why there is need for an interagency committee to pool and harness the collective wisdom of various agencies in the enforcement. There is no excuse why, at the rule-making process, one critical sector, as well as its regulators, is left out.

security in the financial services sector. Policymakers should be alert to the possible catastrophic consequence: China may quickly lose the momentum, and the optimal timing, in systematically evaluating the national security risks of foreign investments in its financial services sector and consequently fail to safeguard its national security. It will be too late to reflect on the national security review policy once foreign investments have entrenched the financial sector. This is a high price to pay.

Put more generally, a heavy emphasis on the status quo—that manufacturing is by far the mainstream of foreign investments into China—leads to a focus on hard assets in China’s categorical list for national security review.¹³⁸ With service sectors such as financial service sector becoming pillars in attracting foreign investment in China going forward, it would be a dangerous inertia if policymakers fail to develop a forward-looking vision. Chinese policymakers should not overlook that a transition from an industrial society to a service economy is the trend of China’s economic development,¹³⁹ and should factor this unavoidable trend in the formulation of the categorical list. The fragmentation of regulatory power should in no event constitute an excuse for an incomplete categorical list. A thoroughly deliberated list would create a truly uniform platform on which each ministerial-level regulatory agency could, as mandated, diligently perform its duty to assess the national security impacts, based on its unique expertise. This is key to the success of national security review regime.

In the case of the United States, in spite of criticism over an undefined “covered transaction,” at least critical sectors are not inadvertently filtered out. FINSAs merely requires assessment of the effect of covered transaction on US critical infrastructure,¹⁴⁰ energy assets, and critical technologies.¹⁴¹ The effect is that the transactions filed with CFIUS involve a wide range of industrial sectors, as shown in Figure 2 below.

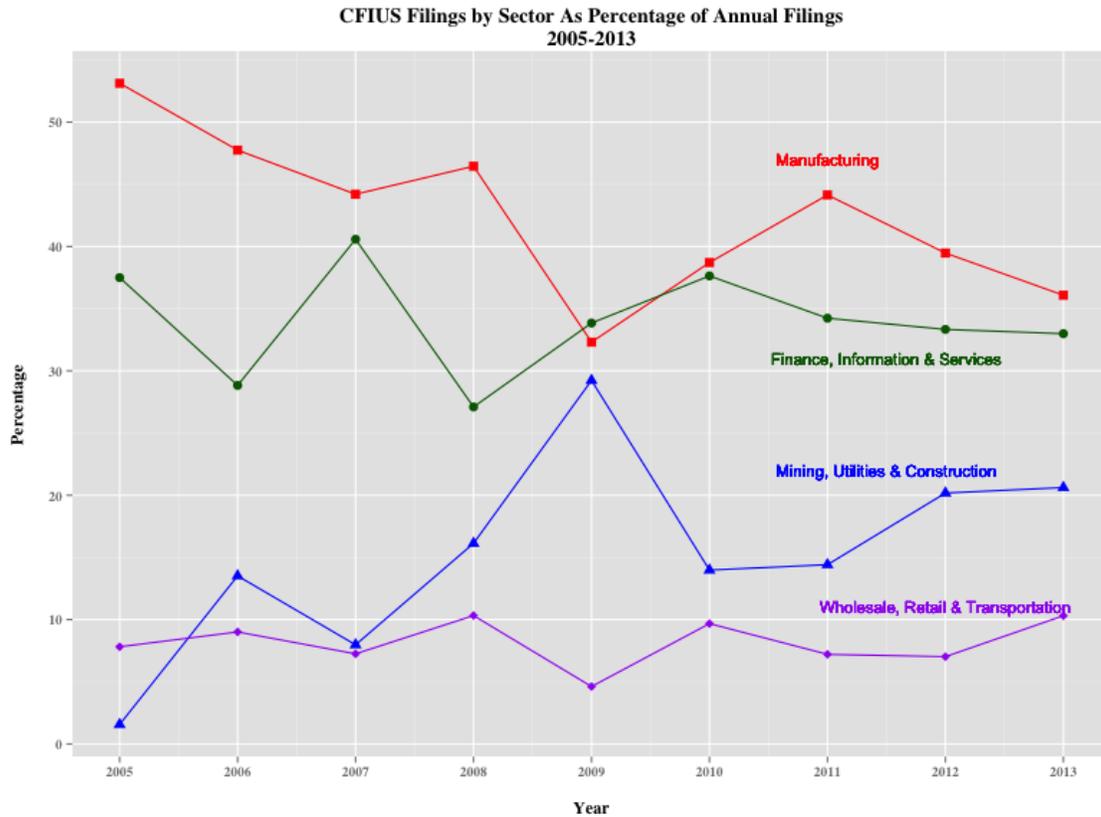
¹³⁸ For the sectorial distribution of foreign investment in China in the early days during the 1980s and 1990s, see Harry G. Broadman & Xiaolun Sun, *The Distribution of Foreign Direct Investment in China*, 20 *WORLD ECON.* 339, 355-59 (1997) (“At the same time, the Chinese manufacturing sector [was] fast becoming the most important field to foreign investors.”).

¹³⁹ China Foreign Investment Report 2013, *supra* note 134, ch.4.

¹⁴⁰ See 50 U.S.C. app § 2170(a)(6) (2014).

¹⁴¹ *Id.* § 2170(f)(6)&(7).

Figure 2



Source: CFIUS

During the 2008-2012 period, although more than one-third of CFIUS notices were in the manufacturing sector (223, or 41 percent), comprising of the largest sector, another one-third of the notices were in the finance, information, and services sector (175, or 33 percent).¹⁴² It covers a much wider spectrum of sectors compared to what is required under the Chinese categorical list.¹⁴³ Therefore, an incomplete coverage of sectors eligible for national security review is not a legitimate criticism on the CFIUS process.

¹⁴² CFIUS ANNUAL REPORT 2013, *supra* note 1, at 4 (“The remainder of notices were in the mining, utilities, and construction sector (96, or 18 percent) or the wholesale, retail, and transportation sector (44, or eight percent).”).

¹⁴³ Compare Draft Foreign Investment Law, *supra* note 24, art. 57, with Free Trade Zone National Security Review Rules, *supra* note 119, art. 1(1).

B. Under-Inclusive versus Over-Inclusive: The Definition of “Control”

In addition to the exclusion of the services sector from the list, another issue is the under-inclusiveness of China’s definition of “control.” To put the importance of defining control in context, a reviewable “covered transaction” should be one that may result in control of a US business by a foreign person, and so “control” becomes central to the definition of covered transaction.¹⁴⁴ The contour of “control” defines the threshold for national security review notices.¹⁴⁵ When using the term “control,” on the one hand, no dollar threshold is set out for a covered transaction eligible for CFIUS review.¹⁴⁶ No matter how small the deal size, as long as “control” is found, an investor must file notice with CFIUS. On the other hand, CFIUS interprets “control” far more broadly than traditional corporate governance concepts.¹⁴⁷ By such standard, even foreign ownership of less than 10 percent in a US business may constitute foreign control unless it is “solely for the purpose of passive investment” with no elements of control (the safe harbor offered in the CFIUS regulation).¹⁴⁸

The sweeping definition of “control,” with no monetary threshold or shareholding percentage threshold for a transaction, results in overly broad coverage of CFIUS review. A drawback of the expansive coverage is that it does not work to effectively filter out the chunk of transactions that are unlikely to pose national security risks; it is an over-inclusive list. Over-inclusiveness would not be a huge deficiency in the early era when CFIUS did not have its real teeth. In its nascent stage, its monitoring role did not add substantial burden on foreign investors. But times have changed. Now, because of the review’s influential power to block or unwind M&A transactions, the delay as a result of the common heightened scrutiny,¹⁴⁹ and the global prominence of its increasing high-profile decisions, an over-inclusive list may not be justifiable anymore.

By contrast, the definition of “control” in the context of China is under-inclusive. China adopts a cutoff line of 50 percent equity interests as its national security review threshold: “control” is found where one or more foreign investors¹⁵⁰ hold more than 50 percent interests in a target company.¹⁵¹

¹⁴⁴ A “covered transaction” is defined as a transaction, “by or with any foreign person, which could result in control of a U.S. business by a foreign person.” 31 C.F.R. § 800.207 (2015).

¹⁴⁵ 50 U.S.C. app. § 2170(a)(3).

¹⁴⁶ *Id.* § 2170(a)(2).

¹⁴⁷ For instance, “control” can be identified if a foreign investor (a) has the ability to determine or block important business matters, or (b) has representation on the board of directors.

¹⁴⁸ 31 C.F.R. § 800.302(b).

¹⁴⁹ See Tipler, *supra* note 3, at 1283-84.

¹⁵⁰ By itself, or through its parent holding company or its controlled subsidiary, individually or jointly with other foreign investor(s).

¹⁵¹ State Council National Security Review Circular, *supra* note 39, art. 1(3)(1)-(3). The Draft Foreign Investment Law is completely silent on the definition of control, which means one may need to fall back on the old rule—i.e., the State Council National Security Review Circular—when looking for a definition of “control.”

The 50 percent-ownership threshold is documented in the rules promulgated by China's State Council, and as discussed *infra*, collides flagrantly with the Catalogue system which is primarily formulated by the NDRC. The failure to reconcile the national security review threshold with the Catalogue system may be a result of lack of prudent consideration of all possible consequences of a nexus of regulations.

The 50 percent ownership threshold is arbitrary notwithstanding additional catchall provision where "control" may be found, including (i) where a foreign investor's equity interest is less than 50 percent, but equity interest voting rights exert substantial influences shareholders' meetings or the board of directors,¹⁵² and (ii) a de facto control transfer from the target company (i.e., management decisions, finance, personnel, or technology) to foreign investors.¹⁵³

At the outset, with the catchall provision in place, it seems not to make a substantial difference whether the threshold for national security review is a 10 percent or 50 percent equity interest. But the provision should not be understood in isolation. The catchall provision does not touch on the ownership threshold for "control," leaving it highly likely that the committee in its enforcement activities nevertheless relies on the 50 percent-ownership threshold as its benchmark for national security review.

The consequence of the legal rule is apparent when checking against the rules governing inward M&A activities. It is worrisome that the 50 percent threshold indeed functions to automatically filter out a subset of critical sectors—those sectors in which foreign ownership is restricted to minority interest such as financial service and telecommunication—granting them immunity from national security review.

Revisiting China's Catalogue system, we see a series of "sensitive" sectors of the Chinese economy have restrictions on foreign shareholding. In the telecommunications industry, basic telecommunications business (i.e., infrastructures or facilities of networks, data transmission), there is a cap on foreign shareholding of not exceeding 49 percent.¹⁵⁴ Likewise, in value-added communications business, foreign shareholding is capped at 50 percent.¹⁵⁵ In the financial services sector, foreign shareholding in banks is not allowed to exceed 25 percent;¹⁵⁶ in life insurance companies not to exceed 50 percent;¹⁵⁷ in

¹⁵² State Council National Security Review Circular, *supra* note 39, art. 1(3)(3).

¹⁵³ *Id.* at art.1(3)(4).

¹⁵⁴ 2015 Catalogue, *supra* note 45, art. 6(20).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at art. 8(24). Shareholding of one individual foreign investor (including its affiliates) is limited to 20 percent in a Chinese bank. The aggregate shareholding of multiple foreign investors investing in one Chinese bank is limited to 25 percent.

¹⁵⁷ *Id.* at art. 8(25).

securities companies not to exceed 49 percent;¹⁵⁸ in futures companies, foreign shareholders have to be minority shareholders.¹⁵⁹ In a nutshell, the Catalogue system enforces a different 50 percent-ownership threshold: In some of the most sensitive sectors, foreign shareholding should *not* exceed 50 percent.¹⁶⁰

If we consider both the Catalogue system and the national security review regime as a whole, the over-50 percent-equity threshold renders the most critical sectors—those that are so vital that the Catalogue system imposes a cap on foreign shareholding—off the radar of scrutiny for national security threats. This is largely because a foreign investor has to *concurrently* abide by several layers of regulations. If it falls into a reviewable category according to the Catalogue system, it will have to comply with the shareholding limitation; meanwhile if it intends to invest in a restricted sector, it will also have to file a national security notice. The collision between these two regimes leads to the doomed ineffectiveness of a national security review in certain sectors. Logic then implies that in these critical sectors, as long as a foreign investor complies with the shareholding restrictions, the regulators do not have to assess the national security consequences of their investment. The seemingly neutral over-50 percent-equity threshold deflects the correct focus of a national security review regime: The more critical one sector is, the more heightened scrutiny a foreign investment in it the regulators should give.

Hence there is a misplacement of regulatory resources. The over-50 percent-equity approach shifts the regulators' attention to less critical sectors—those that are fully open to foreign investors with no shareholding limits, while systematically steering the regulators away from the most crucial ones in their screening process—those that are so vital as to worth placing a restriction on shareholding. A collision in legal rules risks nullifying the very purpose of national security review regime.

IV. SUBSTANTIVE DIFFERENCES IN SEEMINGLY SIMILAR REVIEW PROCESSES

United States. Overall, the CFIUS process resembles the two-stage Hart-Scott-Rodino merger review process,¹⁶¹ though it is less transparent. In the preliminary Hart-Scott-Rodino review phase, parties to certain M&A transactions meeting the filing thresholds file premerger notifications with both

¹⁵⁸ *Id.* at art. 8(26).

¹⁵⁹ *Id.* at art. 8(27).

¹⁶⁰ While the Catalogue system is expected to phase out of the foreign investment regulatory framework and superseded by a Negative List, the fact that the 2015 Catalogue was promulgated most recently indicates that the Catalogue system will not disappear at least in the short term.

¹⁶¹ See Hart-Scott-Rodino Antitrust Improvements Act, 15 U.S.C. § 18a (2015). Under the Hart-Scott-Rodino Act, parties to certain large mergers and acquisitions must file premerger notifications and go through the merger review process. For more explanations on the merger review program, see *Premerger Notification and the Merger Review Process*, FTC, <https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/mergers/premerger-notification-and-merger> (last visited Apr. 8, 2016).

the FTC and the DOJ and wait for a thirty day waiting period to expire.¹⁶² During the preliminary clearance period, the agencies decide whether to allocate the case to the FTC or the DOJ for a thirty day second-phase review.¹⁶³ In the second-phase review, the assigned antitrust agency will make additional “Second Requests” to the parties and determine whether to clear the transaction.¹⁶⁴

By contrast, the CFIUS process begins well before foreign investors file formal notices with CFIUS. Before entering into definitive agreements, the parties already need to consider the possibility of a CFIUS filing and allocate the responsibility between them.¹⁶⁵ Next comes the parties’ informal contact with CFIUS staff, which usually takes place after the signing of definitive transaction documents.¹⁶⁶ Following the informal contact is a pre-filing process. This process, in which CFIUS will provide comments and feedback regarding the pre-filing,¹⁶⁷ typically occurs five business days prior to the formal filing.

Next is a thirty day initial review, and if necessary, a forty-five day investigation.¹⁶⁸ During this initial review stage, lawyers at the Treasury Department undertake jurisdictional analysis to determine if the transaction is a covered transaction. This is usually completed within approximately fifteen days. If it is a covered transaction, the Treasury determines whether it is a foreign-government controlled transaction. Approximately twenty days into the initial review period, CFIUS receives a “threat assessment” report from the national security agencies (including the Central Intelligence Agency, National Security Agency, Federal Bureau of Investigation) on the transaction, the parties, and the individuals.¹⁶⁹ CFIUS then proceed to conduct its formal due diligence.¹⁷⁰

¹⁶² *Premerger Notification and the Merger Review Process*, *supra* note 161.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ The parties would consider CFIUS notification as one of the key factors for whether to proceed with the transaction. In negotiations, they allocate between themselves the responsibility to make CFIUS notice. Usually, the acquirer assumes the responsibility.

¹⁶⁶ Specifically, the regulations rewritten following the enactment of FINSA explicitly encourage transacting parties to consult with CFIUS in advance of filing a notice. *See* 31 C.F.R. §800.401(f) (2015). Before and after the final agreement, the parties are able to give preliminary informal “heads up” to CFIUS, usually by phone. Besides informal contacts with CFIUS, the parties can, and are usually advised by their legal advisors, to address specific national security considerations with government agencies that may have specific jurisdiction over the particular industry sector, products, or services involved.

¹⁶⁷ *Id.* §800.401(f).

¹⁶⁸ *Id.* §800.503.

¹⁶⁹ 50 U.S.C. app. §2170(b)(4)(A) and (B) (2014).

¹⁷⁰ CFIUS may address questions or requests for additional information to the parties regarding the transaction or any aspect of their operation or corporate structures. Questions posed by CFIUS would usually need to be answered within three business days.

If there are unresolved national security concerns at the end of the initial review period, CFIUS will open an “investigation.”¹⁷¹ The investigation phase has no substantive or procedural difference from the review phase; the former is just an extension of the latter, allowing additional time for CFIUS to deal with national security issues if necessary.¹⁷²

On rare occasions where national security issues are not resolved during the forty-five day investigation phase, or the situation is sensitive enough that CFIUS agencies believe that the President should make the requisite national security determination, the Exon-Florio Amendment provides the President with an additional fifteen days to issue a final determination.¹⁷³ When CFIUS cannot determine that the transaction lacks unresolved national security concerns, it refers the matter to the President for a decision, and at times includes a recommendation that he suspend or prohibit the transaction. The President’s decision is likely to rely on CFIUS’s opinion, as the President acts only after reviewing the record compiled by CFIUS and CFIUS’s recommendation.¹⁷⁴ The CFIUS process triggering a presidential review is rare, and such cases usually draw heightened attention on an international scale. In the history of CFIUS, so far there have only been two incidents of presidential review, one of which being the *Ralls* case (discussed *supra*). The other incident traces back to 1990, when President George H. W. Bush unwound the sale of MAMCO Manufacturing to a Chinese agency, ordering China National Aero-Technology Import & Export Corporation to divest its interest in Seattle-based MAMCO on the grounds of national security threat.¹⁷⁵

CFIUS has authority to take action to mitigate a threat posed by the covered transaction, but only the President has the authority to prohibit or unwind a transaction. If after going through the CFIUS process, CFIUS or the President determines that there is national security concern, either could ask the transacting parties to agree to conditions on a transaction to mitigate the national security concern. Mitigation agreement is a commonly used tool for

¹⁷¹ *Id.* § 2170(b)(2)(A). Although the decision to open the investigation is largely at the discretion of CFIUS, the Exon-Florio Amendment requires that transactions involving foreign governments or vital infrastructures be subject to a mandatory forty-five day investigation period. This relates to the presumption of investigation for foreign government transactions and transactions involving critical infrastructure, unless senior CFIUS officials sign off that no investigation is necessary. *See Id.* § 2170(b)(2)(C).

¹⁷² If the cabinet or sub-cabinet level representatives of the Treasury Department and the head of any lead agency or agencies agree that a foreign government controlled purchase will not threaten national security, or that a vital infrastructure is not at risk, they may waive the mandatory investigation. *See* 31 C.F.R. § 800.503(c).

¹⁷³ 50 U.S.C. app. § 2170(d)(2).

¹⁷⁴ 31 C.F.R. § 800.506(b)-(c).

¹⁷⁵ *See* GEORGE BUSH, MESSAGE TO THE CONGRESS ON THE CHINA NATIONAL AERO-TECHNOLOGY IMPORT AND EXPORT CORPORATION DIVESTITURE OF MAMCO MANUFACTURING, INCORPORATED (Feb. 1, 1990), <http://fas.org/nuke/guide/china/contractor/90020112.html>.

CFIUS to address national security concern that it finds.¹⁷⁶ If an agency proposes mitigation, CFIUS will, by statute, prepare a confidential “risk-based analysis” describing the threat, vulnerability and consequences, and identify the risks that arise from the transaction.¹⁷⁷ The mitigation conditions imposed on the parties are negotiable. If approved by all of CFIUS, Treasury and lead agency will negotiate with the parties. Although more likely than a Presidential block, mitigation can undermine the business rationale for the transaction, as the parties may be required to restructure the transaction in question.¹⁷⁸

China. National security review process in China resembles that of the United States. The review is carried out by an inter-ministerial joint committee chaired by both the NDRC and MOFCOM, and allegedly includes other ministries in charge of the industries and sectors related to the proposed foreign acquisition.¹⁷⁹

There is a general review phase (analogous to the initial review phase in the CFIUS process), which is completed within thirty working days.¹⁸⁰ If there is no national security concern found, the transaction is cleared.¹⁸¹ Otherwise, the review enters a special investigation phase (analogous to the special investigation phase in the CFIUS process), to be completed within sixty working days.¹⁸² Before the conclusion of the special investigation, to avoid posing a national security risk, a foreign investor may propose mitigation measures,¹⁸³ or the joint committee may recommend the State Council to make the final decision, including blocking the transaction (analogous to the presidential review phase in the CFIUS process).¹⁸⁴ Similar to the black-box process of CFIUS, there is essentially no public information about the inner

¹⁷⁶ For a content analysis of mitigation agreements in the telecommunications sector between 1997 and 2007, see Zaring, *supra* note 3, at 110-16.

¹⁷⁷ For example, DoD may furnish CFIUS with the “risk-based analysis” which assesses “threat, vulnerability, and overall risk including proposals to mitigate risks.” See INSPECTOR GENERAL, DOD, ASSESSMENT OF DOD PROCESSES IN SUPPORT OF COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) DETERMINATIONS AND FOREIGN OWNERSHIP, CONTROL, OR INFLUENCE (FOCI) MITIGATION, <https://www.fas.org/sgp/othergov/dod/cfius.pdf> (Jun. 10, 2014), at 2.

¹⁷⁸ For a summary of mitigation measures adopted between 1997 and 2007, see THEODORE H. MORAN, THREE THREATS: AN ANALYTICAL FRAMEWORK FOR THE CFIUS PROCESS 42-43 (2009). See also BAKER BOTTS LLP, A GUIDE TO DEMYSTIFY THE CFIUS PROCESS 7, http://www.bakerbotts.com/~media/files/brochure-attachments/cfiusbookletenglishversion_000.pdf?la=en; CFIUS ANNUAL REPORT 2013, *supra* note 1, at 20 (noting some parties withdraw their notices with CFIUS altogether because they “[did] not want to abide by CFIUS’s proposed mitigation”).

¹⁷⁹ Draft Foreign Investment Law, *supra* note 24, art. 49.

¹⁸⁰ *Id.* at art. 61.

¹⁸¹ *Id.* at art. 62.

¹⁸² *Id.*

¹⁸³ *Id.* at art. 65.

¹⁸⁴ *Id.* at art. 64.

workings of the inter-ministerial committee. Overall, the processing of filing is convoluted, making it susceptible to abuse and manipulation.¹⁸⁵

A. Similar Delays in Both the CFIUS and China's Process

Practitioners have been complaining about the unreasonable delay caused by the pre-filing communications with CFIUS. The rationale behind such pre-filing process is that the parties now have the opportunity to submit their notice in draft form before the statutory time periods begin. In this way, CFIUS may determine early on whether they need more basic information for its review. Additionally, informal contacts with CFIUS staff before the official notice show an informal gesture of goodwill and avoid surprising the CFIUS staff with the submission of an unexpected notice.¹⁸⁶ Because of this, parties sensitive to their transaction's Exon-Florio implications routinely incorporate a pre-filing engagement strategy into their timetable and basic agreement.¹⁸⁷ On the part of CFIUS, it reduces its workload in reviewing the notices in the formal review stage (there is no evidence, however, that CFIUS is now overloaded; CFIUS typically reviews less than 150 filings per year, as depicted in Figure 3 below).

But pre-filing contacts also cause unreasonable delays. For instance, energy sector is hit hard by the delay in the prolonged review process. This is in part because FINSA broadened the scope of national security to explicitly include "critical infrastructure, including major energy assets."¹⁸⁸ Energy assets are the only subcategory expressly mentioned in "critical infrastructure," and are therefore especially vulnerable to national security red flags if the parties choose not to file a CFIUS notice. In a sense, such spotlighting of energy assets forced more energy-related transactions to go through the CFIUS process—and more energy-related transactions became exposed to the delay problem. Moreover, the pre-notice process prolongs the CFIUS process because although it is "encouraged" by CFIUS, it has in practice turned into a "functionally

¹⁸⁵ When a foreign investor intends to merge with or acquire a domestic enterprise, the investor is required to file an application with MOFCOM. *Id.* at art. 50. The modification under the Draft Foreign Investment Law is that, screening and pre-approval are required only if the sectors that foreign investors invest in fall into the Negative List. *Id.* at art. 27. If it deems the proposed transaction falls within the scope of a national security review, MOFCOM requests national security review to be initiated within five days. State Council National Security Review Circular, *supra* note 39, at art. 4(1).

¹⁸⁶ In such an informal contact, usually the parties introduce themselves and their companies, describe the nature of their business, indicate whether the U.S. business being acquired has government contracts and if so whether any classified information is involved, describe the transaction (stock or asset deal, merger, etc.), and note the estimated timetable for filing the draft CFIUS notice and for closing (subject to government approval).

¹⁸⁷ On the side of foreign investors, it has been advised that foreign investors should aim to build relationships with key regulators and ensure adequate and practical disclosures are made to regulators to increase the prospects of a positive reception.

¹⁸⁸ 50 U.S.C. app. § 2170(a)(5), (f)(6) (2014).

mandatory” process.¹⁸⁹ Once an additional phase is introduced, along come new and unpredictable delays. Now, in addition to reviewing formal notices, CFIUS reviews draft notices—another round of review is added. To transacting parties, whether it is called a draft or a formal notice, it does not make a difference—both require the same level of care given they are under scrutiny by regulators.

Internally within CFIUS, new formality requirements and the bureaucratic process add to the time lag. Practitioners reported on CFIUS’s slow pace of review.¹⁹⁰ This is understandable—policy-level approvals are bound to come slow, when there are multiple agencies at work within CFIUS. In addition, the Executive Order adopted by the Bush Administration to implement FINSA,¹⁹¹ while established a more rigorous internal process that CFIUS must follow before adopting a mitigation measure, creates an additional layer to the regulatory approval process.¹⁹²

B. Deterrence Effects on Foreign Investors

Although the majority of CFIUS inquiries are completed in the thirty-day initial review period, an increasing portion of filings have to go through the second investigation phase. As illustrated in Figure 3 below (the red curve depicts the percentage of notices to CFIUS that underwent the second investigation phase), prior to the enactment of FINSA in 2007, only a negligible portion of notices was required to proceed to the investigation phase. By 2008, among a total of 155 notices filed with CFIUS, approximately 15 percent of them underwent the additional forty-five-day investigation process. Since then, there has been a surge in the percentage of filings being investigated. Between 2009 and 2013, approximately 35-40 percent of all notices had to enter the investigation stage.¹⁹³ This percentage peaked at almost 50 percent in 2013. It has become routine for CFIUS to exceed the statutory time periods for its inquiry, and to request that the parties accept such further delays before receiving a resolution and clearance. While this reflects the escalated importance of CFIUS process in recent years since the enactment of FINSA, it is an indication of delay in CFIUS review in addition to the delay in pre-notice consulting process.

¹⁸⁹ For a description and criticism of the technically voluntary yet “functionally mandatory” pre-notice process, see Joshua C. Zive, *Unreasonable Delays: CFIUS Reviews of Energy Transactions*, 3 Harv. Bus. L. Rev. 169, 173-174 (2013).

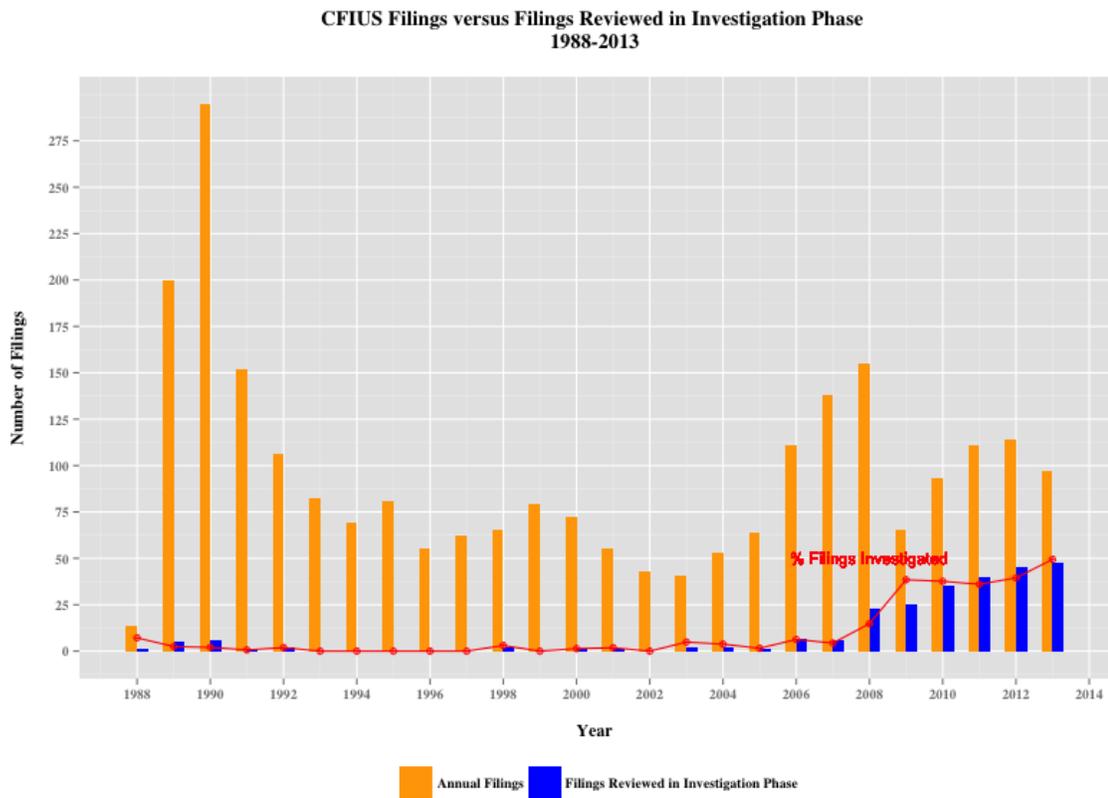
¹⁹⁰ See Mark E. Plotkin & David N. Fagan, *Foreign Direct Investment and U.S. National Security: CFIUS Under the Obama Administration*, COLUM. FDI PERSP., 2, June 7, 2010, http://ccsi.columbia.edu/files/2014/01/FDI_24.pdf.

¹⁹¹ Exec. Order No. 13,456, 3 C.F.R. § 4677 (2008).

¹⁹² For the “heightened formality of the internal mitigation process,” see Plotkin & Fagan, *supra* note 190, at 2 (noting the “trade-off between fewer mitigations agreement but longer CFIUS reviews”).

¹⁹³ U.S. DEP’T OF THE TREASURY, COVERED TRANSACTIONS, WITHDRAWALS, AND PRESIDENTIAL DECISIONS 2008-2012, <http://www.treasury.gov/resource-center/international/foreign-investment/Documents/CFIUS%20Stats%202008-2012.pdf> (last visited Apr. 8, 2016).

Figure 3

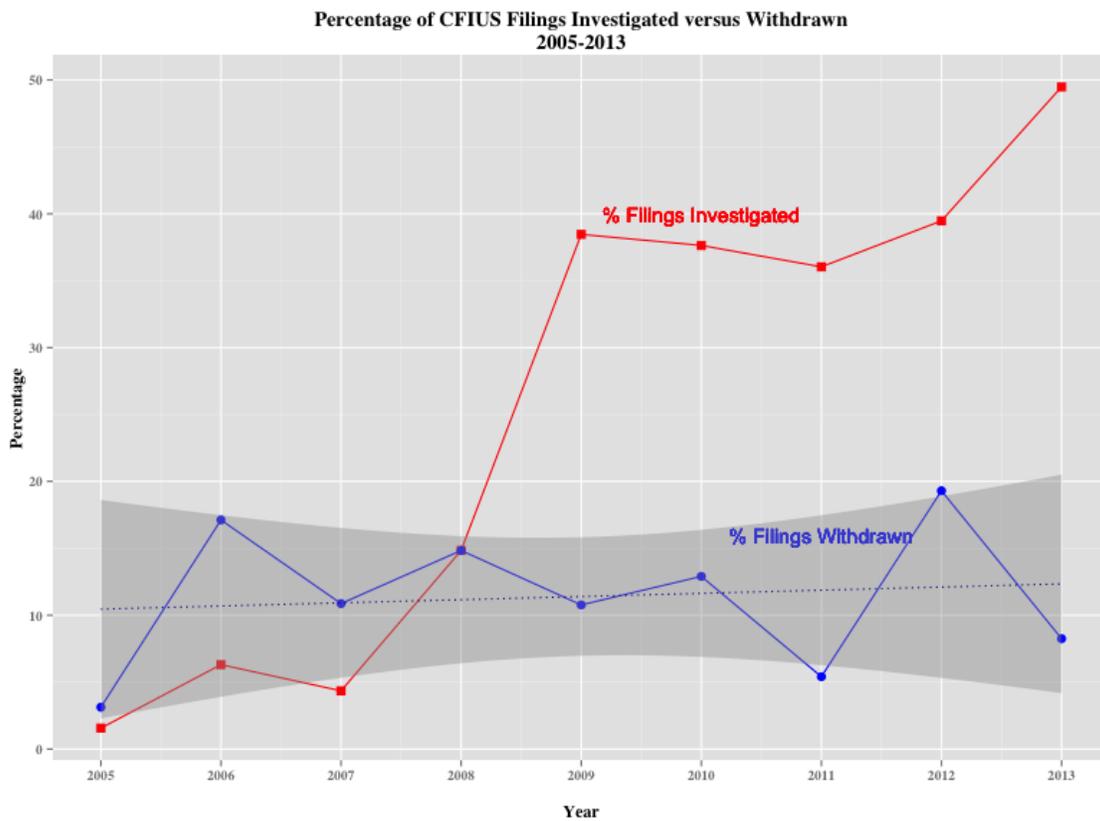


Source: CFIUS

Moreover, a sizeable number of withdrawn cases signify the amplified impact of CFIUS process on inbound M&A transactions in the United States. It is more than fear for delay in the withdrawn cases. Foreign investors may be deterred and choose to withdraw due to fear for reputation damages, the potential difficulties associated with completing the CFIUS process, and the

cost of the process. As shown in Figure 4 below, in one of the peak years such as 2012 alone, 19 percent of the filings made were subsequently withdrawn. Although Figure 4 depicts that the withdrawal rate varies from year to year, in a typical year one would expect a median of 10 percent of the filings end up being withdrawn.

Figure 4



Source: CFIUS

Withdrawals include two types of cases: those that withdraw in order to re-file while having more time preparing for the answers, and those that withdraw because of high risk of rejection. The two types of cases both reflect the concerns of the parties regarding potential difficulties in passing the CFIUS

clearance process. In cases where the parties are unable to address all of CFIUS's outstanding national security concerns within the prescribed time frame, the parties might request to withdraw and refile their notice to provide themselves more leeway for addressing the remaining national security concerns.¹⁹⁴ In other cases, "the parties might request to withdraw their notice because they are abandoning the transaction for commercial reasons, or in light of a CFIUS determination to recommend that the President suspend or prohibit the transaction."¹⁹⁵ From the business perspective, withdrawing a case after becoming aware of the high rejection risk does less reputational damage to a business than rejection in the later stage. Although a substantial part of the withdrawn cases would later be refiled with CFIUS after modification of transaction terms and conditions, the fact that an increasing number of parties choose to withdraw their cases suggests that CFIUS is having greater influence on the cross-border transactions and the parties are experiencing greater difficulties and need to put more efforts regarding national security reviews.

As with all transactions reviewed by CFIUS, all but a very few of these cases completed the process successfully. Generally eighty to ninety percent of cases were approved without a mitigation agreement.¹⁹⁶ But one should read the clearance rate in conjunction with the withdrawal rate. Researchers tend to ignore the fact that there is a high clearance rate because a sizeable number of acquirers withdraw their filings, with or without subsequent re-filings. Merely looking at clearance rate of the cases that complete the whole CFIUS process can be misleading.

Although the increased percentage of investigated cases may be explained in part by the new presumption of CFIUS investigation extended beyond a preliminary review phase under FINSAs for foreign government transactions and transactions involving critical infrastructure, the statistics suggest the CFIUS process has generated much greater impacts than before. To foreign investors, cross-border M&As in the United States become more difficult and more costly. It captures a broader array of foreign investors: Absent clear definition, when in doubt, investors have to file. And the statistics do not reflect those investors deterred from investing; they spend considerable time and resources to weigh CFIUS implications and ultimately decide to invest elsewhere in light of the uncertainty posed. For those who nevertheless decide to make investments, it takes toll on the investors' investment costs—uncertain of CFIUS's reach, investors will have to file. Along the way of the CFIUS

¹⁹⁴ The parties may also request to withdraw and refile their notice because a material change in the terms of the transaction warrants the filing of a notice. CFIUS ANNUAL REPORT 2013, *supra* note 1, at 19.

¹⁹⁵ *Id.*

¹⁹⁶ See COMM. ON FOREIGN INV. IN THE U.S., ANNUAL REPORT TO CONGRESS 23 (Feb. 2016), <https://www.treasury.gov/resource-center/international/foreign-investment/Documents/Annual%20Report%20to%20Congress%20for%20CY2014.pdf> (noting from 2012 through 2014, on average only 8 percent of cases were subject to a mitigation agreement).

process, a sizeable group of investors withdraw their cases, which explains the high clearance rate for those who complete the long journey of review amid the delay and the deterrence effects.

As China's national security review mimics that of CFIUS, it is foreseeable that the delay derived from multiple bureaucratic layers would take a similar form in China. China already has a bloated bureaucratic structure in its administration, and an addition of three-tiered national security review will only deteriorate the problem. In this sense, the downsides of the three-tiered review such as more delay are likely to outweigh the potential benefits such as the arguably meaningful checks on national security threats. It is more worthwhile for Chinese policymakers to ponder on *what* exactly will national security review add to China's foreign investment regulatory regime, before rushing to build up more layers of approvals.

C. The "Two Lead Agencies" Schemes in Divergence

A few deviations of the Chinese national security review process from the CFIUS model are very puzzling, giving rise to suspicions about the existence of political compromises in the policymaking process. China's State Council designates both the NDRC and MOFCOM as standing lead agencies in the joint committee.¹⁹⁷ But why do we need two lead agencies in an interagency committee, if the purpose of having a lead agency is to coordinate among multiple agencies? When two standing lead agencies are in place, which has the say on coordination if they are at odds with each other? If the lead agency were a decision-maker having a say on which joint committee agency should handle a specific case, two parallel decision-makers would inevitably result in conflicts. Unnecessary complications and inefficiency therefore arise in the Chinese "two lead agencies" scheme.

The redundant "two lead agencies" scheme may be a result of political bargaining and compromise. The NDRC and MOFCOM are known to be in fierce jurisdictional competition. Long before the emergence of national security review as a regulatory regime up for grab by the agencies, the NDRC and MOFCOM had engaged in a long-lasting regulatory competition to fight for jurisdiction over foreign investment.¹⁹⁸ The outcome is the inefficient stacking of agencies; instead of being alternatives to each other, the NDRC and MOFCOM became additives to one another, each with veto power in signing

¹⁹⁷ State Council National Security Review Circular, *supra* note 39, art. 3(2). An interesting contrast is that, in the subsequent MOFCOM National Security Review Rules, no reference is made to the NDRC as lead agency. See MOFCOM National Security Review Rules, *supra* note 40. The inconsistency in language was not reconciled until the Draft Foreign Investment Law was made public, in which it is reiterated that the NDRC and MOFCOM jointly act as lead agencies. See Draft Foreign Investment Law, *supra* note 24, art. 49.

¹⁹⁸ See Xingxing Li, *supra* note 46.

off a foreign investment project.¹⁹⁹ For the regulated firms, it means onerous sequential approvals rather than an option to choose a preferred regulatory agency.

Such competition of power is common in China's legislative history. The difference this time seems to be that the State Council indulges the self-interested behaviors of the NDRC and MOFCOM by authorizing both of them to be lead agencies in the joint committee. This approach of reconciling the disputes between the two agencies is erroneous and likely furthers the agency turf warfare.

The harm goes beyond the tolerance of agency turf warfare at the price of efficiency in the regulatory structure. The rationale for an interagency committee in the national security review regime in the first place is the need for pooling relative institutional competence of multiple agencies. By reinforcing the dominant position of the NDRC and MOFCOM in the joint committee, other agencies are deprived of the opportunity to be designated to be a lead agency. Their opinions become less determinative and prone to be neglected.

When the decisive power belongs only to the two leading agencies and no other agencies is specifically referred in a list, it is hard to get the true opinions from other more informed and qualified agencies according to the specific circumstance. The reason is twofold. First, when a subset of agencies in the joint committee is identified to be "lead agencies," essentially it forms a core group of decision-makers. A hierarchical structure is hence formed, and voices from other agencies will be peripheral; the NDRC and MOFCOM as lead agencies have the option of excluding agencies at their discretion when deciding on which agencies the joint committee would consult. Further, other than the NDRC and MOFCOM, no specific agencies are listed to be members to the joint committee—a signal that other agencies are likely to play a peripheral role in offering opinions when consulted. The pooling of comparative expertise from multiple agencies may be an institutional design on paper, but it is not so in action.

Second, in contrast with the process by which the CFIUS determines lead agencies in the CFIUS process (as described *infra*), the predetermined lead agencies take up the spot that should have been taken by other agencies on a case-by-case basis. The role that other agencies can play in the national security review process is doomed to be limited if the NDRC and MOFCOM are always the lead agencies despite the circumstances of individual transactions.

Having the NDRC and MOFCOM as predetermined lead agencies results in the over-representation of these two agencies and under-representation of other agencies (e.g., the Ministry of Science and Technology, the Ministry of

¹⁹⁹ *Id.* at 730-34.

National Defense). It creates a hierarchy among the agencies in the national security review process, which risks circumventing or sidelining of inputs of agencies other than the NDRC and the MOFCOM. If agencies other than the NDRC and MOFCOM are deprived of the opportunity to be designated lead agency and to play any decisive role in evaluating the national security impact of individual cases, the national security review regime essentially converges on other existing gate-keeping regulatory schemes and becomes a repetitive and useless layer of regulation. Ultimately, the dominance of one or two agencies in the decision making process, questions the credibility of the representative intent of the inter-agency involvement. The goal of having an inter-agency committee is severely undercut.

The determination process of lead agencies in the CFIUS process in the United States follows a more reasonable regulatory design. CFIUS is chaired by the Treasury Department. There is criticism that the Treasury Department acting as the chair renders economic concerns prevailing over national security concerns, but the scheme of co-lead agencies helps ease the potential defect.

While the Treasury Department acts as the standing chair, a co-lead agency is designated for each individual transaction filed with CFIUS.²⁰⁰ Once a CFIUS notice is filed, the Treasury Department makes the decision as to which agency will join it as co-lead agency.²⁰¹ Such an agency generally has equity in the transaction. In practice, lead agencies are most common DoD and DHS when filings involve military-related equities or critical defense technology is at stake.²⁰² The lead agencies generally assume the obligation of monitoring the mitigation measures imposed on the transaction later on.²⁰³ While there are a limited number of voting members of CFIUS, generally it operates on consensus, such that if one participant strongly objects to a transaction or seeks conditions, those demands are usually respected.²⁰⁴ This is understandable, as CFIUS will wish to speak with the same voice.

²⁰⁰ 31 C.F.R. § 800, *as amended by* Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 70,702 (Nov. 21, 2008).

²⁰¹ *Id.*

²⁰² *For example, see* INSPECTOR GENERAL, *supra* note 177, Appendix B (setting out the internal CFIUS timeline and the internal working procedure when DoD acts as co-lead agency). For the active role of DoD in CFIUS, see OFFICE OF UNDER SECRETARY OF DEFENSE FOR ACQUISITION, TECHNOLOGY AND LOGISTICS, ANNUAL INDUSTRIAL CAPABILITIES REPORT TO CONGRESS 12 (2006) (statistics of 2005); OFFICE OF UNDER SECRETARY OF DEFENSE FOR ACQUISITION, TECHNOLOGY AND LOGISTICS, ANNUAL INDUSTRIAL CAPABILITIES REPORT TO CONGRESS 45-47 (2013) (statistics of 1996 through 2012).

²⁰³ 50 U.S.C. app. § 2170(k)(5) (2014) (addressing actions the co-lead agency should take).

²⁰⁴ For a glimpse over the inner workings of CFIUS, see Plotkin & Fagan, *supra* note 190, at 2 (noting the trend to streamline inner-agency process within CFIUS); 153 CONG. REC. 4800-01 (2007) (statement of Rep. Bachus); STEWART A. BAKER & STEPHEN R. HEIFETZ, ADDRESSING NATIONAL SECURITY CONCERNS 21-22 (Sept. 2010), <http://www.stepto.com/assets/attachments/4149.pdf> (the authors, as former officials of DHS, describing the weekly interagency discussions within CFIUS). *Cf. A Review of the CFIUS Process for Implementing the Exon-Florio Amendment: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 2-5 (2005) (statement of Katherine Schinasi, Managing Director, Acquisition and Sourcing Management; noting the existence of significant disagreements between CFIUS agencies in certain scenarios).

By comparison, we can see that although the CFIUS process embraces the concept of two lead agencies, only the Treasury Department acts as the standing lead agency, playing the role of a coordinator in the interagency committee. The other spot for the lead agency is not predetermined; instead, it is assigned on a case-by-case basis. This way it adequately harnesses the expertise of agencies other than the Treasury Department. Moreover, unlike in the case of China where in theory an infinite array of agencies may be consulted in the national security review process—which ironically may imply that no agencies other than the NDRC and MOFCOM are consulted, the seven member agencies in the CFIUS committee are announced, adding clarity to the CFIUS process.

Therefore, the similarity of “two lead agencies” in the context of the CFIUS process and China’s national security review regime is deceptive. In terms of the effects, the scheme of two predetermined lead agencies in China bears no resemblance to the two-lead-agency scheme in the CFIUS review. The former nullifies the very purpose of creating a national security review regime and in turn renders the regime a useless repetition of existing regulatory structure. The latter, in contrast, has merits from an institutional design perspective.

D. Who Can Institute a Review Process? The Substantive Impacts of a Procedural Setting

Even nuances in procedural settings, such as how the national security review process can be initiated, may generate contrasting effects in the United States and China. The incentive structures in these two jurisdictions are indeed distinct from each other.

United States. In the United States, a national security review process is invoked mainly by voluntarily filing initiated by the transacting parties, in practice usually the acquirer.²⁰⁵ Unlike Hart-Scott-Rodino antitrust clearance, CFIUS clearance is not a legal precondition to closing, nor is it mandatory. Neither the Exon-Florio Amendment²⁰⁶ nor the CFIUS regulations²⁰⁷ require that the parties to a covered transaction notify CFIUS of that transaction prior to closing.

²⁰⁵ See 31 C.F.R. §§ 800.401(a), 402 (2015). Because the characteristics of the foreign acquirer, for example, its nationality, are usually key determinants in whether a transaction poses threat to national security, in practice it is more often the acquirer that makes the voluntary filings. See, e.g., Chelsea Naso, *5 Tips For Ensuring a Smooth CFIUS Review*, LAW360 (Nov. 10, 2015, 3:54 PM), <https://www.mayerbrown.com/files/News/236d1cd1-552e-43cf-8cb4-c3d7e851a2ee/Presentation/NewsAttachment/be204a87-3d57-4d67-a08a-c3eb5a7935f5/5TipsForEnsuringASmoothCFIUSReview.pdf>.

²⁰⁶ 50 U.S.C. app. § 2170.

²⁰⁷ *Supra* note 200.

But the voluntary filing mechanism functions well in encouraging CFIUS filings, and CFIUS employs a few tools to ensure this happens. First, under the Exon-Florio Amendment, CFIUS can initiate its own review and investigation of a covered transaction.²⁰⁸ CFIUS personnel “routinely review the press and trade journals for transactions that have not be [sic] filed.”²⁰⁹ Second, if CFIUS, in its review and investigation, determines that there is national security concern in a transaction, it can impose conditions on a transaction even after it is closed by demanding mitigation agreements or even ordering divestment to unwind the entire transaction.

In the face of the possibility that CFIUS undertakes reviews and investigations on its own initiative, parties that choose not to notify CFIUS are thus taking the risk that, either before or after closing, CFIUS will contact them and request that they submit information. Given CFIUS’s authority to stop a transaction or even require divestment of US operations, the parties are not in a position to refuse such a request. The real danger of costly penalties is that it has deterrence effects and prompts the transacting parties to make the notification. Though CFIUS ultimately approves most investments that it reviews, at times investors have to accept significant conditions to obtain CFIUS approval.

Moreover, parties to a cross-border M&A transaction are usually prominent businesses. They risk their reputation if they choose not to voluntarily file and are subsequently chased by CFIUS. Also, by failing to voluntarily inform CFIUS, the parties have almost certainly forfeited the goodwill and cooperative climate that may result from a decision to fully engage with CFIUS in the first place (recall the *Ralls* scenario discussed *supra*). It will not be clear whether CFIUS will allow the transaction even if the parties file voluntarily, but it is certain that whatever the resolution CFIUS makes, it will probably be far less chaotic for the parties than an after-the-fact divestment. The aggregate effect is that transacting parties tend to file with CFIUS when there is a glimmer of doubt about whether to file.

China. Unlike the structural arrangement of CFIUS that induces transacting parties to file when in doubt, the incentive structure in China is the opposite: “when in doubt, do not file.” The nuance lies in the identity of parties who can initiate a national security review process. If local MOFCOM branches decide the transaction in question involves national security concerns, the branches shall require transacting parties to make the filing with central MOFCOM when

²⁰⁸ *Id.* § 800.401(b)-(c).

²⁰⁹ Stephen Heifetz, *A Brief History of the Committee on Foreign Investment in the United States* 1, STEPTOE & JOHNSON LLP (2011), <http://www.steptoel.com/assets/htmldocuments/Heifetz%20Brief%20History%20of%20CFIUS%202011.pdf>. The author served as Deputy Assistant Secretary for Policy Development at the Department of Homeland Security and handled CFIUS issues before working as partner at a law firm in DC.

making approval decisions with respect to a proposed M&A transaction.²¹⁰ As background information, inbound M&A transactions need to be pre-approved by *local* offices of MOFCOM in the locality of the target company,²¹¹ while a national security review filing is made with the *headquarter* of MOFCOM at the central ministerial level. The new Draft Foreign Investment Law removes pre-approval requirements for investments below a certain value threshold but nevertheless keeps pre-approval requirements for those above a value threshold irrespective of sector.²¹²

Since local MOFCOMs can make judgments as to whether transactions are “covered transactions” or not during their pre-approval screenings, the dominant strategy of foreign investors would be to piggyback on the decision of local MOFCOMs. That is, they are reluctant to voluntarily make national security review filings until local MOFCOMs require so.

If in the pre-approval process with local MOFCOM, a foreign investor is not required to make a separate national security review filing with the central MOFCOM, it can claim that it has received endorsement from the authorities. The argument is this: local MOFCOM, as the approval authority, does not think my transaction triggers any national security concern, so why should I bother to make a national security review notification with central MOFCOM? Local MOFCOMs are then making decisions *for* transacting parties as to whether a national security filing needs to be made, and they affix their red stamps on such decisions. As a result, adding local MOFCOMs as possible requestors disincentives the parties from making voluntarily filings.

There is more danger to this. The approval authority for a transaction and the power to conduct a national security review lie in different branches of MOFCOM: the former with local MOFCOM and the latter central MOFCOM. The consideration behind such division of authority lies in the importance of national security review, and a realistic recognition of divergent incentives of local and central MOFCOMs. Local MOFCOMs align more with local governments with respect to the attraction of foreign investment in the locality. They are inclined to excessively focus on trivial details in a transaction so as to assert their authority and seek rents from the foreign investors. They are unlikely to turn down an incoming foreign investment project on the ground of national security concern, as that implies steering foreign investment away

²¹⁰ MOFCOM National Security Review Rules, *supra* note 40, art. 2; *see also* Draft Foreign Investment Law, *supra* note 24, art. 34.

²¹¹ The specific local office of MOFCOM—county-level, city-level, or provincial-level—is mainly determined based on the deal size and the subcategory—“permitted,” “encouraged,” or “forbidden”—within which the transaction is characterized to fall. *See* Shangwu Bu guanyu Xiafang Waishang Touzi Shenpi Quanxian youguan Wenti de Tongzhi (商务部关于下放外商投资审批权限有关问题的通知) [Circular of MOFCOM Concerning the Delegation of Pre-approval Authority in Respect of Foreign Investments] (promulgated by Ministry of Commerce, Jun. 10, 2010, effective Jun. 10, 2010), <http://www.mofcom.gov.cn/aarticle/h/redht/201006/20100606965687.html> (China).

²¹² *See* Draft Foreign Investment Law, *supra* note 24, art. 26(1).

from their locality. By bestowing local MOFCOMs the authority to provide a de facto safe harbor to foreign investors as to the question of whether there is a potential national security concern in a specific transaction, central MOFCOM is in fact delegating the power of judgment call to local MOFCOMs.

Even assuming local MOFCOMs are able to take a neutral stand on whether one individual transaction threatens to impair national security, they do not have the capacity or information advantage to do so. This is an example of over-regulation—the under-staffed MOFCOM branches are screening massive transactions in the market and make decisions for market participants that are better off making judgment calls on their own. What is more, the ability of local MOFCOMs to hand pick winners (i.e., the foreign investors who need not go through the additional expensive national security review process) and losers (i.e., those investors who will have to), creates ample room for rent seeking. Also, the capabilities of MOFCOM branches vary to a great extent in China, and therefore one would expect great disparity in the decision-making process.

Nor do local MOFCOM branches have the information advantage in making the decision for the transacting parties. Note that the local MOFCOM branches would make the judgment call as to whether the parties should make a filing *prior to* the revelation by the investors of comprehensive information about its national security implications. That is to say, foreign investors do not have to disclose their proprietary information about the possible national security impacts of their transaction, while they pass the obligation to decide whether to make a filing on to local MOFCOMs. The regulators, who have the least information and high costs in obtaining the information, are bestowed with the power to make the decision on behalf of market participants.

In China, wide arrays of administrative agencies are able to request the institution of a national security review,²¹³ an arrangement distinctive from the CFIUS process in the United States. Above all, the determination of whether a transaction is a “covered transaction” has already taken place when such “other agencies” make requests, well before the thirty-business-day clock begins to tick. The introduction of agencies outside of the joint committee adds another layer of review, which means more delay. Also, if one agency requests that a national security review process be instituted, it is signaling to other agencies that may later involve in the review that *it* believes the transaction poses national security risks. The signal may affect the behavior of other agencies. What is worse, subsequently if the NDRC and MOFCOM actually consult the same agency that instituted the review process in the first place, such agency’s opinion may be biased. It is predictable that the preoccupation of such agency may lead it to leaning toward imposing mitigation conditions on the transaction, or even proposing to block the transaction. Otherwise it would

²¹³ *Id.* at art. 55.

have concerns over justifying the administrative costs and regulatory resources involved in the national security process, both internally in its institution and externally in other agencies involved in the review process.

Several other third-party requestors, such as competitors, upstream companies, or downstream companies, could initiate a national security review process.²¹⁴ The problem with these third-party requestors is that they have conflicting business interests that induce them to abuse the right. Policymakers may have good intentions in laying out such a structural arrangement: they hope to expand the pool of entities that keep an eye on any national security risks posed. This whistle-blowing setting borrows from its counterpart in Chinese antitrust enforcement, where regulators almost exclusively rely on whistleblowing of disgruntled competitors, purchases and employees to decide on the antitrust cases to bring.²¹⁵

As much as whistle-blowing helps mitigate the information asymmetry problem faced by national security reviewers and eases enforcement burdens on regulators, rival businesses in the marketplace are not the optimal parties to have the power of initiating national security reviews. The motivation of a competitor in instituting a national security review is likely to deter the potential entry by its rivals in the market, and it tends to abuse the right by strategically filing frivolous cases. It means substantial costs on the part of potential foreign investors and a deflection of regulatory resources on the part of the agencies.

Analogy can be drawn to sham litigation, i.e., anticompetitive litigation brought about by competitors with the purpose of imposing additional costs on the incoming entrant. Sham litigation, in particular in the areas of intellectual property and antitrust, is notably costly for defendants. In the antitrust realm, plaintiffs are prone to use antitrust litigation to exclude competitors or to extract a wrongful settlement payment.²¹⁶ The ability for a competitor to institute a national security review process, which is usually lengthy, is equivalent to imposing an injunction on the incoming foreign investors. It will be a good way to delay or deter entry, a result the competitor would like to see. What is worse, unlike litigation, which incurs costs (e.g., attorney fees) on the part of plaintiff competitors while taking a toll on the defendants, the institution of a national security review process essentially requires zero cost of competitors. That is to say, the competitors can easily trap their rivals in the lengthy national security review process by nothing more than simply making a request to institute the national security review. Thus, the stake is high for

²¹⁴ *Id.*

²¹⁵ See PARR GLOBAL, PARR SPECIAL REPORT: ABA ANTITRUST IN ASIA 21 - 23 MAY 2014 3 (2014), <http://www.parr-global.com/wp-content/uploads/2014/06/ABA-antitrust-in-asia-special-report.pdf>.

²¹⁶ See William J. Baumol & Janusz A. Ordover, *Use of Antitrust to Subvert Competition*, 28 J.L. & ECON. 247, 250-51 (1985). Cf. Frank H. Easterbrook, *Detrebling Antitrust Damages*, 28 J.L. & ECON. 445, 461 n.31 (1985).

foreign investors, while the bar is low and pay-off high for their competitors as requestors; the system is inclined to induce competitors' opportunistic petitions.

Also, there is little benefit associated with bestowing competitors with the right to initiate the national security review process against their rivals. They lack superior information. Transacting parties usually keep private M&A transactions highly confidential before closing. And in China, a national security review process needs to be completed before a transaction is closed.²¹⁷ Furthermore, cross-border public M&As are rare in China.²¹⁸ Even in the case of public M&As, as the relevant information would become available to the public, it does not justify why the competitors need to be singled out as good candidates to kick-start the national security review process; the whole market then has the information.

To sum up, in the national security review process in China, bringing in more parties as possible requestors for the institution of a national security review process creates misplaced incentives. It would work as a better mechanism to encourage voluntary filings by transacting parties, who have the best information about the transaction's national security implications, while deterring filing by other third parties with their own divergent goals to pursue and who are prone to engage in self-interested, potentially egregious behaviors.

V. CONCLUSION

Walking a fine line between openness to foreign investment and the protection of national security is at the core of designing a foreign investment regulatory framework. While scholarship unanimously recognizes the delicate balance between free trade and the protection of national security, without a satisfactory certainty on what "national security" is and what the scope and the standards of national security review are, such a declaration merely pays lip service to the glorious notion.

When we look at the real-life national security programs in action, while it appears that the Chinese counterpart of CFIUS resembles that of CFIUS, they

²¹⁷ See MOFCOM National Security Review Rules, *supra* note 40, art. 6. The Draft Foreign Investment Law contains strong wording on the penalty the foreign investors may face if they complete the investment projects without prior national security clearance and are subsequently found to impair national security. See Draft Foreign Investment Law, *supra* note 24, art. 72.

²¹⁸ Foreign investors were not permitted to purchase "A" shares, the most common types of shares listed on the two Chinese stock exchanges—i.e., Shanghai Stock Exchange and Shenzhen Stock Exchange—until the publication of Waiguo Touzi Zhe dui Shangshi Gongsi Zhanlve Touzi Guanli Banfa (外国投资者对上市公司战略投资管理办法) [Measures for the Administration of Strategic Investments in Listed Companies by Foreign Investors] (promulgated by the Ministry of Commerce et al., Dec. 31, 2005, effective Jan. 30, 2006), <http://www.mofcom.gov.cn/article/swfg/swfgbl/201101/20110107349072.shtml> (China). Prior to that, the door for public M&As of Chinese A-listed companies by foreign investors was essentially shut, with a minor exception of QFII. Even after the promulgation of rules enabling public M&A by foreign investors in China, the qualification requirement is stringent. Foreign investors are subject to a three-year lock-up period, a minimum 10 percent shareholding in the listed company, and stringent approval requirements, making public M&A an unattractive option for foreign investors.

are indeed two very different regimes with contrasting consequences. In the United States, while the CFIUS process sets the benchmark for national security review internationally and the degree of openness in foreign investment regulation, some reflections are necessary. CFIUS has experienced an expansion in its mandate (from “monitoring” to “blocking” or “unwinding” M&A transactions), an expansion in its scope of “national security” purview (all industries, all sectors, no dollar amount threshold), and has no obligation in assuring the continuity of its standard of review (drifting standards of review over time, unreviewability of decisions)—all of which make the CFIUS especially challenging and unpredictable to potential foreign investors. The swift expansion of CFIUS power and its greatly heightened impact on companies has made it no longer apt to maintain a national security review system without a concrete definition of “national security,” scope of review, or specific standards of review. As it stands, the CFIUS process does not facilitate compliance by foreign investors and generates negative consequences, including increased costs and undesirable deterrence effects on investors (yet the foreign investors are not entirely certain what they are deterred from). In light of the judicial self-restraint and deference to CFIUS as an interagency committee, as well as the inefficiency of case-by-case adjudication in shedding light on the criteria for review, policymakers should consider more direct regulation as a feasible regulatory approach to refine the CFIUS process. Otherwise, CFIUS will remain vulnerable to criticism that it may be abused for protectionist or political purposes.

In the case of China, while it strives to establish a national security review regime by modeling it on that of the United States, several structural and institutional loopholes lead to a failure in properly safeguarding national security. Above all, the poor draftsmanship implies difficulty in implementation. It does not factor in the institutional considerations that make the regime work in the United States; the twists and selective application due to unsophisticated draftsmanship, political compromises, and agency self-interested behaviors undermine the regime. Instead, China’s regime becomes another layer of regulation that burdens the incoming foreign investors with no plausible positive effects. A more worrisome phenomenon is that it does not devote the appropriate proportion of regulatory resources to the critical sectors that are in the most need of national security review. This leads to a more profound question regarding the timing of its implementation of national security review program. Its national security regime came into place too little too late: the sweeping wade of foreign investments in hard assets (including many of the valuable resources) has shown the trend of quieting down after foreign capital’s wide penetration in a wide spectrum of economy.

As a broader lesson from legal transplantation in general, legal proposals to the Chinese national security review regime should embrace a presumption of

skepticism over the institutional competence of regulatory agencies. The presumption should be different from that of general deference to administrative agencies deriving from the *Chevron* doctrine. Meanwhile legal framers should caution against the obsession with copying rules or procedures from developed jurisdictions, while disregarding the system-level effects and the institutional setting in which these rules and procedures operate.