

National Security Review System in Cross-border Investment of China's Enterprises

Li Jie

School of Law, Postdoctoral Research Station, University of International Business and Economics, No.10 Huixin Street, Chaoyang District, Beijing, P.R.China

258378829@qq.com

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Abstract: The national security review, initiated by the host country, is a measure to examine, approve and supervise the entry of foreign capital. The national security review has a direct impact on whether the enterprises registered in our country can go abroad smoothly and carry out investment activities overseas. In recent years, western countries have begun to attach importance to China's growing economic strength, fearing threatens from China's strengthening of overseas M&A. Many countries have adopted amendments to laws, restricting foreign investment in the market access stage of national security. This paper introduces the legal system of national security review based on the historical evolution of basic theory and system, and studies the characteristics and common problems of the security review system of several sovereign countries with mutual investment activities with China. It also enumerates and analyses cases of national security review of overseas investment activities in recent years, and gives suggestions on the possible problems of cross-border investment in China.

1. Introduction

'Going out' is one of the important strategies that China has implemented since the end of 1980s. In this process, due to insufficient understanding of the basic laws in host countries, it is faced with potential legal risks from host countries' national security review. That is to say, whether Chinese enterprises can smoothly implement overseas M&A and whether the enterprises themselves can prevent or avoid the risk are closely related. Through the study of the national security review system, it is helpful to understand how to find a balance between promoting the opening of foreign capital and safeguarding national interests in the process of accelerating globalization.

2. Overview on the legal system of national security review

As a comprehensive concept, the meaning of 'security' is often not clear. First of all, it is a kind of value; and security means peace and the maintenance of peace. The author believes that 'security' is the state and goal that sovereign countries, especially for WTO members, which want to maintain in their international investment activities at the level of international law.

With the emergence of nations, the concept of national security has emerged as the times required. Any sovereign country regards it as the direction and goal of its efforts. The concept of national security refers to the military security of a sovereign state previously. Due to the changes of time and environment in different countries, the basic meaning of national security has changed. The object of national security also shows a diversified trend, not limited to the traditional level of national defense. The connotation and extension of national security have extended to non-traditional areas, and correspondingly to politics, economy and culture, and other fields. Particularly, since the September 11th terrorist attacks in the United States posed a major threat to international aviation security, the global community began to ensure the overall security of the international community through closer international cooperation (such as the conclusion of treaties); SARS spread throughout Asia in 2003, the Indian Ocean coast in 2004, and even the occurrence of the tsunami in China has also challenged the traditional concept of national security

from the practical level. Under the new concept of national security, economic factors are regarded as important factors affecting national security. In addition, non-traditional security issues such as 'terrorism, ethnic conflict, environmental degradation, food and energy shortage, drug trade, transnational crime, population growth and illegal immigration' have become the preconditions for countries to study and seek for reasonable solutions.

3. Research on extraterritorial national security review system

Based on political considerations such as safeguarding national economic security and industrial planning, protecting social and public interests, and guaranteeing national defense needs, governments often review foreign investors' M&A investments in key sensitive industries. Before planning cross-border investment to foreign sovereign countries, Chinese enterprise investors need to clearly and clearly grasp the security review system, characteristics and implementation status of target countries. This paper will select several sovereign countries which often have mutual investment activities with our country and conduct international trade for research.

In consideration of the United States of America, it is open to foreign investment and emphasizes national treatment for foreign investors, but the national security review system is an area of great concern and adherence. In addition, the U.S. government believes that in the process of global economic development, the investment mechanism constructed by the international investment system plays an irreplaceable role, and excessive government intervention in the field of investment will become a constraint factor for economic growth. The U.S. security review system was initially formed in the 1980s. The system hopes to enact special laws through the legislature to authorize the executive departments or relevant agencies to review overseas M&A projects and acts that may endanger national security on the basis of legal procedures and standards, and to adopt a series of corresponding measures, to ensure the resolution of national security threats. The general characteristics of the development of the US national security review system are as follows: Firstly, the foreign investment review system dominated by CFIUS is implemented in the United States; secondly, the focus of CFIUS is whether foreign investors constitute 'controlling' over the subject of acquisition. Thirdly, if an entity controlled by a foreign government or a foreign government intends to set up an investment in the United States, it is more likely to be considered as affecting the national security of the United States. In practice, CFIUS applies stricter censorship criteria for 'transactions subject to censorship' from a foreign government or a state-owned enterprise. Fourthly, the CFIUS Implementation Rules provide for several exceptions that do not belong to 'transactions subject to review'. According to CFIUS interpretation, any board seat, or the additional veto power enjoyed by minority shareholders beyond 'safe harbor matters' may lead to exceptions. The clause does not apply, so it requires CFIUS to conduct a case review to determine whether the relevant situation constitutes a 'transaction subject to review'. Fifthly, the application for transaction review to CFIUS shall be submitted to implement a voluntary declaration mechanism.

In recognition of related Canadian investment act, as the definition of investment review criteria is very vague, it has not been clear to the political and business circles to implement them in specific cases in Canada. According to the Canadian Investment Act, when the proportion of organizational form and voting rights involved in the acquisition of the host country's enterprises exceeds a certain standard, the acquisition is regarded as a 'controlling right' acquisition, then the acquisition constitutes a 'review transaction'. In addition, foreign investors 'directly' acquire the ownership, all or all of the Canadian enterprises. Where the value of the assets of the acquired Canadian enterprise exceeds 344 million Canadian dollars, all of the substantive business assets constitute 'transactions subject to review'. In addition, regardless of the size of the transaction or the size of the trader, and whether the transaction has been completed, if the Ministry of Industry of Canada has reasonable grounds to believe that a foreign investor's transaction in Canada will be harmful to Canada's national security, the Ministry of Industry has the right to conduct a national security review. It should be noted in particular that in Canada, the Ministry of Cultural Heritage has the right to examine whether a transaction involving foreign investors' mergers and acquisitions of cultural enterprises can bring net benefits to Canada from a cultural perspective, in addition to

the review power of the Ministry of Industry. On December 7th, 2012, the Federal Government of Canada promulgated the revised Guidelines on Investment in Foreign State-owned Enterprises and issued a related policy statement. Overall, Canada will apply a stricter investment review system for investments from foreign state owned enterprises than non-state-owned enterprises, including relatively lowering the threshold for foreign state-owned enterprises to trigger investment reviews, requiring foreign state-owned enterprises to make binding commitments in compliance, transparency and business orientation. Under the new Act, the Federal Ministry of Industry can consider all investment projects involving state-owned enterprises (even minority equity investments), and then decide whether the transaction is actually controlled by state-owned enterprises, and ultimately require the application of the net interest audit procedure under the Canadian Investment Act.

In Australia, its position on foreign investment is welcomed and encouraged, but it still retains a complete legal system for national security review of foreign investment. Australia adopts 'case review system' for foreign investment. According to the foreign takeover law, the finance minister has the final say in the investment application. In practice, the Australian Foreign Investment Review Committee was established in 1976. Its main task is to receive and examine applications for foreign investment, and to give recommendations for approval or rejection of applications, and to submit the recommendations to the Australian Finance Minister. At the end of 2015, Australia has revised the relevant laws and regulations on foreign investment, and made a great change in its foreign investment review system. The new act divides foreign mergers and acquisitions activities governed by Australia's foreign investment review system into 'important activities' and 'compulsory declaration activities'. In practice, in order to reduce the legal risk, applicants usually analyze whether the M&A bill is an important activity or a compulsory declaration activity to determine whether it is necessary to declare the proposed transaction to FIRB. Australia's new act applies stricter declaration standards to foreign government investors than ordinary foreign investors, including lower acquisition ratio requirements and cancellation of minimum transaction amount requirements. The new act raises the standard of substantive rights and interests from 15% to 20%. The standard of identifying foreign government investors is relatively loose compared with the original system. However, when it comes to the merger calculation of 'affiliates' involving foreign government investors, the relevant provisions of the new law have greatly increased the burden of foreign government investors. With regard to the review period, the new law has not substantially amended the statutory review period for FIRB's foreign investment review. The Australian government has further strengthened its supervision of foreign investment by substantially amending its foreign investment review system; as a result, foreign investors including China will also have a certain negative impact.

4. Cases analysis on cross-border investment in national security review of China's enterprises

In recent years, more and more security reviews have been encountered in China's foreign investment. Take the events in the United States as an example. From 2005 to 2014, the number of Chinese enterprises investigated in the United States increased from one to 24, and the proportion of Chinese enterprises in the total number of cases examined in the United States increased sharply from 1.56% to 16.32%. In 2012-2014, CFIUS reviewed 68 Chinese transactions; in 2016, CFIUS reviewed more than 80 Chinese transactions. From the point of view of the object of national security review, the cases of overseas investment of Chinese enterprises mainly include the following types:

First of all is the safety review of contact sensitive information. It is universally acknowledged that Lenovo acquired IBM personal computers in 2004; in this case, American politicians are more opposed, because they think that the Lenovo Group, which is owned by the Chinese Academy of Sciences, is a state-owned enterprise, while the computer business involved by IBM includes government services. Through the acquisition of IBM, Lenovo has the possibility of obtaining sensitive information. CFIUS investigated the acquisition case and made a preliminary decision,

which forced the two groups to reach a settlement agreement.

The second is safety review of potential threats to sensitive areas. BEIDA Jade Bird Group began to build the Canadian Production and Research Center in Quebec Province in 2014 and started construction in San Bruno, Quebec Province in August. The project, which invests 30 million Canadian dollars, aims to provide high-quality automatic fire alarm equipment for China, the United States and Western European cities. The workshop will have six production lines after completion. The automatic fire alarm products manufactured will supply high-end markets. However, despite the approval of the federal government, the previous opinion was overturned after a more in-depth review of national security factors. According to media reports, the Canadian Ministry of Industry, after examining the project in particular, considered that the project was only 1.7 kilometers away from the Canadian Space Agency and formed a national security issue under the Investment Canada Act, thus changing the original decision.

The third is safety review for sensitive industries. China National Offshore Oil Corporation (CNOOC) has planned to acquire U.S. Unocal Oil Company into CNOOC, the head company, with more than \$18 billion in funds between 2004 and 2005. Unocal is one of the most recognized companies in the United States. It is a well-known company that mainly produces petroleum and natural gas. Prior to that, Chevron Corp. from the United States also wanted to buy Unocal and gave the purchase price, which was lower than CNOOC's offer. The Senate and the House of Representatives jointly passed a resolution to reject the acquisition, in which 'the 9-58 Energy Bill' from the House of Representatives was upgraded to law, which does not require the Ministry of Defense and national security to investigate the current situation of China's energy demand and to study whether the increase in energy demand is related to the country's politics and economy.

The fourth is the safety review of sensitive technology. Last year, Reuters had reported on June 14th that the United States is strengthening China's review of mergers and acquisitions of sensitive industries such as artificial intelligence (AI), semiconductor, chip and advanced materials companies in the United States. In the same year, on September 13th, U.S. President Trump has issued an executive decree banning the purchase of Lattice Semiconductor Corporation, Oregon, by the Canyon Bridge Fund I (LP) on national security grounds. The United States is concerned that the sophisticated technology developed by the United States may be used by China to improve its military capabilities and surpass the United States in strategic areas.

The fifth is the security review of investors' military background. Huawei's acquisition of American Trifoliate Systems Technologies Company is mainly planned to acquire the company's cloud computing related patented technology. In November 2010, HUAWEI submitted an application to CFIUS to allow safety review. In February of next year, HUAWEI received a notice from CFIUS, which asked HUAWEI to withdraw and abandon merger and acquisition. At first, Huawei refused to accept the proposal, so the final decision was transferred to President Barack Obama. A few days later, because of pressure from the government, HUAWEI had to accept the decision of CFIUS.

The sixth is the safety review of equity allocation and source of funds. In 2008, China Aluminum Limited by Share Ltd bought Rio 9% only \$14 billion. In the following year, Rio Tinto faced huge debts and its share price continued to decline as the financial crisis broke out. At that time, Chinalco threw olive branches at it, saying that it could inject 19.5 billion yuan to help defuse its risks, even at the expense of nearly 70% of its investment losses, but ultimately it was not accepted by Rio Tinto's board. Chinalco ended up with only 195 million dollars in compensation. One of the main reasons Rio Tinto's board refused to accept the capital injection was that the second round of capital injection would lead to an increase in Chinalco's share-holding ratio as the largest shareholder to 18%.

It is not difficult to find that the cross-border investment of Chinese enterprises is easy to face the national security review of the host country from various perspectives and contents. It is helpful to formulate countermeasures for Chinese enterprises to invest overseas by drawing lessons from the comparatively advanced system design abroad and analyzing the existing risks.

5. Risks and Countermeasures for cross-border investment of Chinese enterprises in safety review

On one hand, it is necessary to correct challenges faced by China's enterprises in cross-border investment under the background of security review. Firstly, Chinese enterprises lack of understanding of the host country's censorship system and coping strategies. Although some Chinese enterprises have rich experience in the process of direct investment in the United States, they do not attach importance to the security censorship system in the United States. Among them, nearly 50% of Chinese enterprises do not know much about foreign investment in the United States, and less than 10% have applied for national security. Secondly, many countries around the world have successively established a national security review system for foreign capital to carry out economic activities within their jurisdiction. By contrast, China's legislation in this regard started relatively late, Chinese enterprises are vague about the concept of national security, and the nature of relevant legal provisions in some countries is no longer pure. We should safeguard national security and transform it into an aggressive strategic weapon. Moreover, due to the particularity of the form of enterprise ownership in our country, the security review links for our enterprises often include political factors, especially the state-owned enterprises in our country suffered heavy losses. Therefore, if the enterprises invested abroad are state-owned enterprises, the background of enterprises in developed countries will be highly valued, which invisibly increases the difficulty of enterprise investment. Before weighing the interests, the host Congress had doubts about this background, and considered it politically. For the sake of national security, most transactions would not be approved.

On the other hand, it is significant to find out countermeasures for China's enterprises with risks in host country's safety review. Firstly, before planning to invest abroad, China's enterprises should attach importance to the national security review of the target country. Generally, national security review of foreign countries is an inescapable key issue for China's enterprises to invest abroad, but it is also not an insurmountable gap to invest abroad. Meanwhile, it is not an insurmountable gap for them to cope with it, because there are still many problems in China's national security review, and there is a lot of undertaking to be done. Secondly, the government background has become an important element of the security review for the host country. China's enterprises should rationally avoid the attributes of state-owned companies and optimize the way of corporate governance to maintain fairness. The principle of openness, transparency, democracy and accountability can weaken the government background and eliminate the host country's concerns about Chinese government's overseas acquisitions. Thirdly, when China's enterprises make cross-border investments in their equity plans, an expert team should be formed at the very beginning. The members of the expert team should not only have a clear division of labor, but also cooperate with each other fully. Fourthly, throughout the legislation of various countries, there are basically provisions or practices on conditional permission, which give enterprises greater flexibility when they make cross-border investments in response to the other party's national security review. When faced with security review, enterprises can change in time according to the reasonable requirements of the host country of investment. Investment conditions or partial changes in investment details to ensure that through the national security review, improve the pass rate of investment activities. Fifthly, when China's enterprises invest overseas, developed countries attach great importance to the identity of enterprises. Thus, in the process of going out, China's enterprises should study the relevant elements of the review, and adopt appropriate methods to lobby reasonably on the modernization of China's enterprises with the help of favorable public opinion environment. The corporate governance structure is explained and explained. Finally, if an enterprise encounters unfair review abroad and draws a conclusion that the merger and acquisition request is negated by the foreign party, the enterprise should immediately use the existing laws of the host country to defend itself, or use relevant rules such as WTO dispute settlement mechanism to defend its own interests.

6. Conclusion

In international investment law, the host country is uneasy because of the activities of a large number of foreign capitals in its own territory. It does not want to threaten its national security, political security and economic security. In order to maintain its own economic order and even the development of international economic integration and capital globalization, the safety review system came into being. For China's investors, especially CFIUS review is a decision-making process with great uncertainty and lack of predictability and transparency. Therefore, when Chinese enterprises invest across borders, they should carefully design investment plans, avoid sensitive industry enterprises or assets as far as possible, or strip off the sensitive parts of assets in advance, and follow the CFIUS game rules for projects that cannot exclude the risk of CFIUS approval. And it is necessary to maintain continuous communication and dialogue with the relevant departments of the host government, and try to communicate to them clearly the intention and business positioning of financial investors.

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