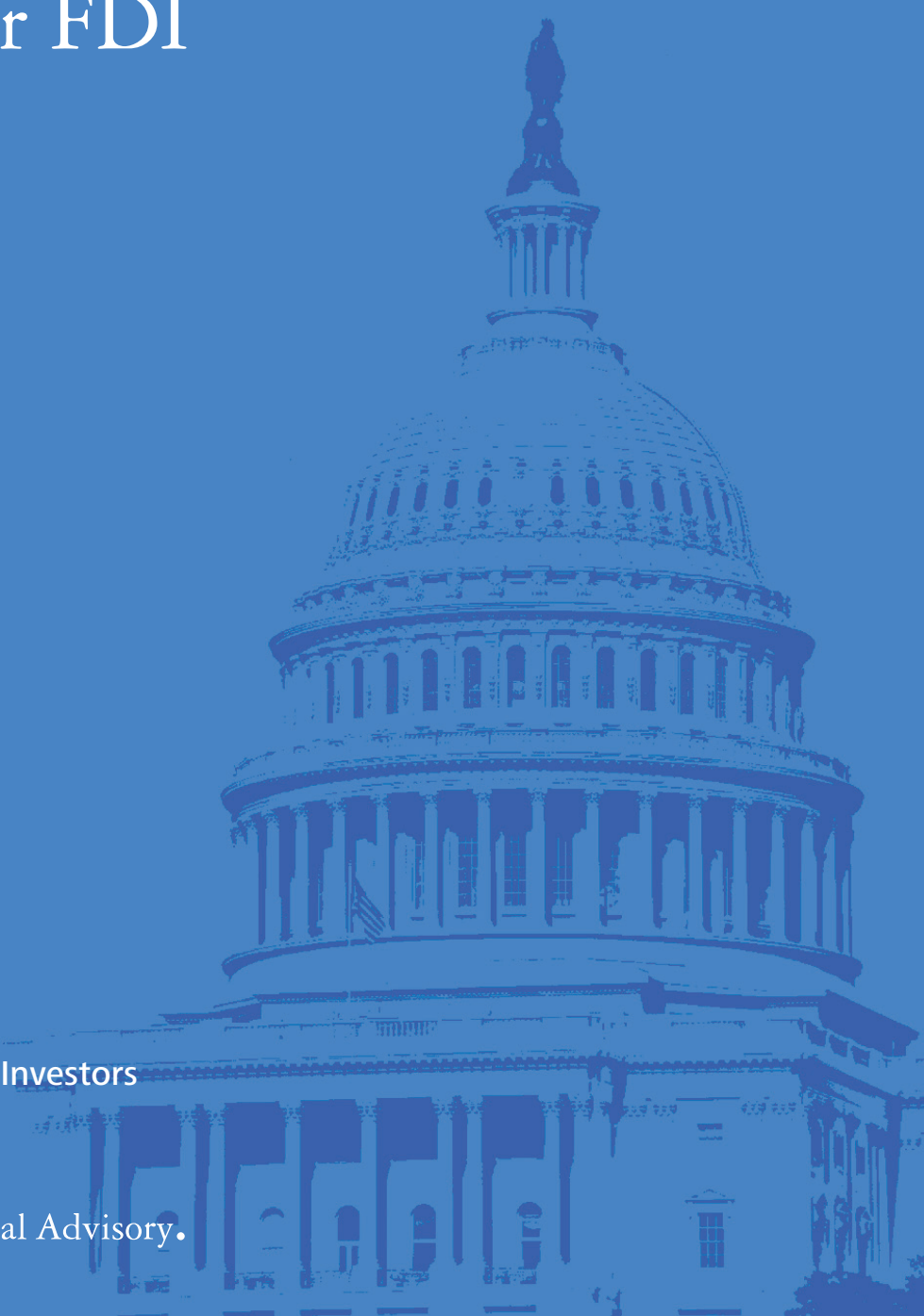




The U.S. Regulatory and Institutional Framework for FDI

David N. Fagan

Investing in the United States
A Reference Series for Chinese Investors
Volume 2



Investing in the U.S.: A Reference Series for Chinese Investors

Foreword

One of the world's most important bilateral relationships is that between China and the United States. An increasingly visible component of that relationship concerns foreign direct investment (FDI).

United States firms have invested in China for years — almost US\$60 billion since China opened to the world in 1978. They have been welcomed and play an important role in many sectors of that country's economy.

All indications are that a growing number of Chinese firms are interested in investing in the United States, and are prepared to allocate considerable resources for that purpose. Naturally, like all firms, they need to observe the regulatory framework of the United States, both when establishing themselves in that country and operating in it. They also need to become accepted insiders that contribute to their host country's economy and society. This raises an important question, however, namely: "Is the United States ready to receive foreign direct investment from China, including in the form of cross-border M&A?"

This booklet is part of a series entitled "Investing in the United States: A Reference for Chinese Investors." It is the result of a joint research project undertaken by the U.S. Chinese Services Group of Deloitte LLP and the Vale Columbia Center on Sustainable International Investment (VCC) of Columbia University. This series explores key topics associated with the receptivity of the United States business environment to future Chinese direct investment.

Booklets currently planned for this series include:

- Is the U.S. Ready for FDI from China? Lessons from Japan's Experience in the 1980s
by Curtis J. Milhaupt
- The U.S. Regulatory and Institutional Framework for FDI
by David N. Fagan
- International Investment Law Protections
by Mark Kantor
- The Politics of Chinese Investment in the U.S.
by Timothy Frye and Pablo M. Pinto

Anyone interested in Chinese direct investment in the United States — and, for that matter, investment by firms from other emerging market economies — will hopefully find these booklets useful, be it from a business, policy or academic perspective.

New York, November 2008



Karl P. Sauvant

Executive Director
Vale Columbia Center on Sustainable International Investment

The U.S. Regulatory and Institutional Framework for FDI

Preface

As China's leading companies continue to venture abroad, more are coming to recognize that a successful global company must compete effectively in the U.S. The large, lucrative markets of the U.S. represent substantial growth opportunities to intrepid Chinese investors capable of navigating their complexity. The regulatory system underpinning these markets is no less sophisticated and successful Chinese investors will need to overcome large differences in culture and business practice if they are to reap rewards over the long term.

This booklet, the second in a reference series for Chinese executives with global aspirations, provides an overview of the U.S. regulatory environment, particularly with regard to market entry, and identifies the key institutional actors that continue to shape it. It makes clear that while U.S. policy is largely welcoming of foreign investment, it is the product of an on-going trade-off between the desire to maintain an open investment environment and the need to address national security interests in a post-9/11 world. This booklet focuses on how the specific circumstances surrounding an inbound investment – i.e. mode of entry, investment location, sector and size – determines its formal treatment under the U.S. system and strongly influences the informal reception the investor receives from U.S. public opinion and the political establishment. Chinese executives will learn more about recent regulatory changes with a potential impact on their businesses in particular, including new measures regulating the treatment of state-owned acquirers. Throughout the booklet, case studies are used to explore various strategies employed by foreign investors to mitigate regulatory risk - successful as well as unsuccessful.

Whether contemplating market entry or managing day-to-day operations, even the most experienced foreign investor can find the U.S. regulatory environment daunting. The highly litigious nature of U.S. society and the pervasive role of the media only compound the challenges of compliance. Given the high stakes involved, we hope this booklet assists Chinese executives with the essential task of preparing their organizations for lasting success in the U.S. marketplace.

New York, March 2009



Clarence Kwan

National Managing Partner
U.S. Chinese Services Group

The U.S. Regulatory and Institutional Framework for FDI

by David N. Fagan*

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Executive Summary

This booklet addresses the regulatory and institutional framework that influences and, in some instances, may restrict foreign direct investment (“FDI”) in the United States (“U.S.”), with a particular focus on investment from China. As described further herein:

- **There is a basic framework for assessing legal and regulatory risk for market entry in the United States.**

However, the precise legal and institutional framework for any given investment depends highly on the facts and circumstances of the particular investment. A critical factor in this regard is the form and nature of the transaction. Regulatory and institutional risks may vary depending on whether a transaction is an acquisition by merger, an acquisition of assets, a greenfield investment, or an acquisition of a majority or minority of shares. Other factors that may impact the legal risk and strategy for market entry include:

- The location of the investment (which may influence what local laws or institutional actors can impact prospects for success);
- The sector or industry of the investment;

- The size of the investment; and
- The specific facts of a particular transaction and the characteristics of the transaction parties, such as the legal compliance reputation of the buyer and U.S. target and the potential broader legal liabilities of the U.S. target.

- **Foreign investors that engage in merger and acquisition (“M&A”) activity in the United States must pay particular attention to the national security review under the Exon-Florio Amendment to the Defense Production Act (“Exon-Florio”), as now modified by the Foreign Investment and National Security Act of 2007 (“FISIA”).** The Exon-Florio review process — which is also known as the “CFIUS” process, after the regulatory body that administers the statute, the Committee on Foreign Investment in the United States — has received increased attention from investors considering acquisitions in the United States in the wake the Dubai Ports World case in 2006, and it often is among the first regulatory-related items a Chinese investor will or should consider when assessing a merger or takeover of a U.S. company. There are three fundamental aspects of the Exon-Florio law that Chinese investors should bear in mind:
 - The law applies only to controlling investments in existing U.S. businesses, such as mergers, acquisitions, takeovers, or significant share purchases of such businesses. It does not apply to greenfield investments.
 - The underlying U.S. business and assets at issue in an investment also matter, since the ultimate test under Exon-Florio is whether a particular transaction may threaten to impair U.S. national security. Thus, not all outright acquisitions — or even the majority of foreign acquisitions in the United

* This booklet was prepared in the context of the Deloitte-Vale Columbia Center on Sustainable International Investment project on “Is the U.S. ready for FDI from China?”. For their insights and guidance throughout this project, I would especially like to thank Karl Sauvart, Clarence Kwan, Wendy Cai-Lee, and Kris Knutsen, as well as the other authors in the project. I owe a special gratitude for the support and guidance of Mark Plotkin, and for the opportunity provided to me in this booklet by David Marchick. I also am grateful to those who were patient enough to read all or part of this booklet and to offer their precise and constructive comments, including Todd Malan, Louis Brenner, Christopher Simkins, Stuart Stock, Ellen Eliasoph, Cao Yu, Alan Larson, Stuart Eizenstat, Mace Rosenstein, Peter Trooboff, Peter Flanagan, Corinne Goldstein, Derek Ludwin, Kerry Burke, Don Ridings, Damara Chambers, Adam Smith, and Anna St. John. Finally, my love to Marnie, Chloe, and Ian for tolerating the late nights and much more.

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States — will necessarily be subject to Exon-Florio. For example, a foreign acquisition of an ice cream company or a sporting goods retailer would generally not require a review by CFIUS.

- For investments in certain sectors, however, Exon-Florio may be especially important for Chinese investors — and potentially can be a bar to Chinese investment, as evidenced by the 2008 experience of Huawei Technologies.
- **Among the key institutional actors in the United States for FDI is the U.S. Congress.** For certain Chinese transactions, the political ramifications of the investment, including whether the U.S. Congress could take any action to prevent an investment, will be an important consideration. In focusing on the political landscape for FDI, certain high-profile prior investments or proposed investments from mainland China and Hong Kong, such as transactions involving China National Offshore Oil Corporation (“CNOOC”), China Ocean Shipping (“COSCO”), and Huawei Technologies, may be instructive.
- **For Chinese investors in particular, there may be certain characteristics that impact U.S. regulatory and political considerations.** These include potential ownership and governance structures of Chinese companies, sources of funding for Chinese investment, U.S. law and regulatory compliance challenges that have been associated with Chinese investors, and U.S. military strategic considerations.
- **To the extent the prior experiences and characteristics of Chinese investors in the United States provide a lesson to future investors and potential U.S. transaction parties about the U.S. regulatory and political environment for Chinese investment, it is this: the U.S. is generally open to investment and has the policy and regulatory tools in place to welcome and promote investment, but certain investments may not be open to Chinese companies, and, in all events, there are certain heightened risks for Chinese investors that require thoughtful strategies to avoid and manage.**
- **Finally, Chinese investors may wish to take certain measures to enhance the likelihood of regulatory approval**

and manage the potential for political risk. Depending on the circumstance, these measures can include:

- Developing a public affairs and regulatory and political engagement strategy outside the context of any particular transaction to raise the profile of the investor in the United States and to assist and inform transactions when they occur;
- Conducting regulatory and political risk due diligence before entering into a transaction, and, on the basis of such a risk assessment, being strategic about the sectors and U.S. businesses in which to invest;
- Adhering to transparent business practices and using standard sources and vehicles for financing, including, to the extent possible, financing from Western financial institutions;
- Committing to strong regulatory compliance programs; and
- Partnering with well-respected U.S. business.



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Introduction

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

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

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

President Bush's statement affirming the importance of foreign investment to the United States was not ground-breaking. On the contrary, it followed a long line of Administration policy

pronouncements expressing openness to foreign investment.² The significance of President Bush's statement on "Open economies" was that it explicitly linked the policy of open investment to U.S. national security interests. This basic policy framework — recognizing the benefits of open investment, but also emphasizing the importance of national security — is especially important when considering FDI from China. Indeed, not by coincidence, the issues presented by FDI from China in many respects embody the balance set forth in the Bush Administration's statement on "Open economies."

China has the potential to be a tremendous source of FDI for the



United States. At the same time, the history of Chinese investments in the United States tells us that, from the perspective of U.S. regulators and policymakers, Chinese FDI can present unique considerations, especially in the area of national security. As described further below, of the United States' ten largest trading partners, China is the only one not considered an ally³; key institutions, including the Department of Defense, the U.S. intelligence and law enforcement agencies, and Congress view certain Chinese investments with great suspicion; and U.S. concerns over the unlicensed transfer of dual use technologies are especially acute with China. In fact, the only transaction ever formally blocked under Exon-Florio was an

¹ President George W. Bush Statement on Open Economies (May 10, 2007), available at <http://www.whitehouse.gov/news/releases/2007/05/20070510-3.html>.

² In 1977, the Carter Administration had issued a policy statement recognizing that "international investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces," and "the United States has an important interest in seeking to assure that established investors receive equitable and nondiscriminatory treatment from host governments." James Jackson, "Foreign direct investment: current issues," Congressional Research Service Report to Congress, April 27, 2007, at 6 (internal citation omitted). In 1983, President Reagan issued a statement welcoming foreign investment, and clarifying the U.S. government's "neutrality" position on international investment to include three objectives: liberalization of barriers to international investments abroad, encouraging FDI to assist in the economic development of developing countries and maintaining an open U.S. economy to contribute to FDI. *Id.* at 7 (internal citation omitted). The Administration of George H.W. Bush then issued a statement promoting foreign investment in 1991. The Clinton Administration, while not formally adopting a policy statement, sought the development of a Multilateral Agreement on Investment (MAI) among OECD countries that would have formally addressed various issues that hamper the free flow of investments, such as discriminatory treatment and creating dispute settlement mechanisms. *Id.* (internal citation omitted).

³ Edward M. Graham and David M. Marchick, U.S. National Security and Foreign Direct Investment 103 (Institute for International Economics 2006).

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investment by a Chinese company⁴. More recently, in early 2008, the U.S. private equity firm Bain Capital Partners and the Chinese technology firm Huawei Technologies were forced to drop their bid for the U.S. computer communications equipment manufacturer 3Com Corp. after they were unable to address the national security concerns of the United States government⁵. Sensitivities over Chinese investment can extend to the state level as well, as demonstrated when the 1990s sale of the Indiana-based magnet company Magnaquench to an investment group that included Chinese state-owned companies belatedly became a political issue in the 2008 Democratic party primary campaign in Indiana⁶.

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

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

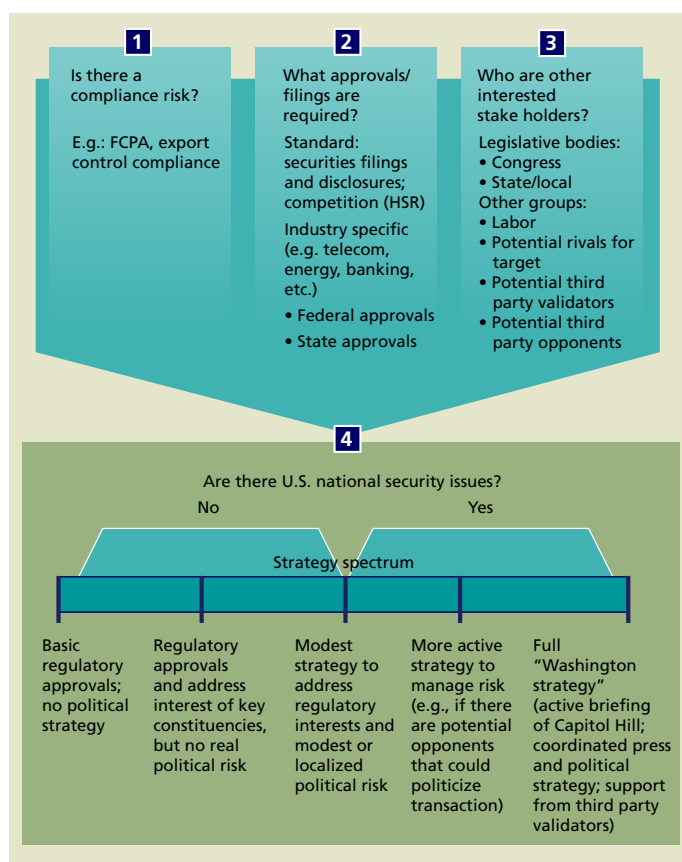
The U.S. regulatory landscape for FDI from China and considerations for investors

The legal and corporate due diligence evaluation for any particular investment can be a complex exercise, touching on a wide range of laws, regulations and other issues. On the legal side alone, a due diligence review typically will encompass, among other elements, a review of material contracts, supply and licensing agreements, pending and ongoing litigation, intellectual property portfolios

and potential liabilities, labor and employment issues, insurance coverage, and environmental issues. Such a due diligence review also must encompass three fundamental issues: (1) What, if any, regulatory compliance issues will be implicated by the investment? (2) What, if any, regulatory approvals are required to complete the investment? (3) What other stakeholders, such as legislative bodies or other third parties, may be interested in the transaction? For certain foreign investors, including in particular Chinese investors, there is an additional consideration that pervades each of these issues: whether the transaction implicates — in fact or in perception — U.S. national security considerations.

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

Figure 1: U.S. regulatory and strategic due diligence flow chart.



Source: the author, copyright Covington & Burling LLP

⁴ See infra note 36 and accompanying text.

⁵ See infra notes 89–90 and accompanying text.

⁶ Hillary Clinton Press Release, “Hillary Clinton Promotes Plan for Strong Defense and Good Jobs in Indiana,” Apr. 12, 2008 (claiming that Indiana lost 225 jobs when “Chinese investors moved the operations of Magnaquench to China” and, as a result, “today the U.S. military buys ‘neo’ magnets from China.”); see also Jake Tapper, “Hoosier Responsible? Clinton Decries China’s Acquisition of Indiana Company — Ignoring Her Husband’s Role in the Sale,” ABCNews.com (Apr. 30, 2008), available at <http://abcnews.go.com/Politics/Vote2008/story?id=4757257>.

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1. Ongoing regulatory compliance considerations

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

a. Foreign trade controls compliance

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

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

There are three programs that principally comprise the U.S. foreign trade controls regime.⁹ First, U.S. Commerce Department regulations, known as the Export Administration Regulations (“EAR”), apply to so-called “dual-use items” — i.e., products and technologies that may have both military and commercial applications. The EAR specifically provide restrictions on the export of commercial products (including software) and technologies from the United States and on the re-export between foreign countries of U.S.-origin (including foreign-made items with more than de minimis U.S.-origin content) commercial products (including software) and technologies.¹⁰ The degree to which a particular item is controlled (e.g., whether export or re-export is prohibited or subject to specific licensing requirements) under the EAR depends upon the (i) technical capabilities and performance specifications of the product, software or technology involved (according to a classification list maintained by the Commerce Department); (ii) the country of destination; and (iii) in certain circumstances, the actual end-user and end-use of the item.

Second, the State Department administers the International Traffic in Arms Regulations (“ITAR”),¹¹ which control the export or foreign transfer of any defense article or service. In general, defense articles are products, software or technical information that are specially designed, modified or configured for military or intelligence uses, as defined on the U.S. Munitions List.¹² Defense services include any support or training for design, production, repair or use of defense articles, whether in the U.S. or abroad.¹³ The State Department requires specific licensing authorization for the export of all defense articles and services to virtually any country. Under current U.S. legislation, export or re-export to China of U.S. Munitions List products, software or technical information subject to the ITAR is prohibited.

Third, the U.S. Treasury Department’s Office of Foreign Assets Control (“OFAC”) administers certain sanctions programs that generally preclude export-import transactions and other business and financial dealings with targeted countries (e.g., Cuba and Iran) and parties (e.g., terrorist organizations and drug kingpins and narco-traffickers) for U.S. national policy and security reasons. These restrictions apply quite broadly to U.S. persons, which include not only entities organized under the laws of the United States but, depending on the program, also their foreign subsidiaries (e.g., Cuba). In addition, “U.S. person” includes any individual or legal entity physically in the United States or any U.S. citizen or permanent resident wherever located or employed.¹⁴ Thus, no foreign national in the United States and no U.S. citizen located abroad, including as an employee of a

⁷ 15 U.S.C. §§ 78m, 78dd.

⁸ Department of Commerce, Bureau of Industry and Security, Revisions and Clarification of Export and Reexport Controls for the People’s Republic of China (PRC); New Authorization Validated End-User; Revision of Import Certificate and PRC End-User Statement Requirements, 72 Fed. Reg. 33646 (June 19, 2007).

⁹ For a thorough overview of the basics of the U.S. foreign trade control regime, see Peter L. Flanagan and Eric D. Brown, “Foreign trade controls,” in *E-Commerce Law & Business* (Plotkin, Wells, and Wimmer, eds., 2003); see also GAO, “Export controls: agencies should assess vulnerabilities and improve guidance for export-controlled information at universities” (Dec. 2006), available at <http://www.gao.gov/new.items/d0770.pdf> [hereinafter “GAO Report on Export Controls”].

¹⁰ 15 C.F.R. Parts 730 to 774.

¹¹ 22 C.F.R. Parts 120–130.

¹² 22 C.F.R. Pt. 121.

¹³ Flanagan and Brown, *op. cit.*, pp. 15–16.

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

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foreign company, may take action to facilitate trade or other financial transactions with an OFAC-sanctioned country or party.

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

[T]echnology is ‘released’ for export when it is available to foreign nationals for visual inspection (such as reading technical specifications, plans, blueprints, etc.) even if such release occurs in the United States. This same interpretation applies to technology that is exchanged orally with a foreign national or technology that is made available by practice or application under the guidance of persons with knowledge of the technology.¹⁵

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

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



b. FCPA

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

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

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

¹⁵ U.S. Department of Commerce Bureau of Industry and Security, “Deemed export questions and answers,” available at <http://www.bis.doc.gov/deemedexports/deemedexportsfaqs.html#1> (citing 15 C.F.R. § 734.2(b)(3)). For additional background on deemed export control rules, see Larry E. Christensen, “Technology and software controls,” in *Coping with U.S. Export Controls*, at pp. 673–674 (Practising Law Institute 2001).

¹⁶ *Id.*

¹⁷ GAO on Export Controls, p. 8.

¹⁸ For a thorough overview of the FCPA’s criminal provisions and pitfalls, see Jacqueline C. Wolff and Jessica A. Clarke, “Liability under the Foreign Corrupt Practices Act,” 40 *Review of Securities and Commodities Regulation* 13 (Jan. 17, 2007).

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

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

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



2. Required regulatory approvals

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

a. Standard approvals and disclosures

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

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

- Registered U.S. entities must make Form 8-K filings with the SEC to provide prompt disclosure of certain events, which would include a change of control of the entity and any material definitive merger, asset purchase or other business combination agreements.²²
- Persons who acquire beneficial ownership interest of more than five percent of a class of voting equity securities registered

under the Securities Exchange Act of 1934 (“1934 Act”) must file with the SEC a form addressing, among other things, the shareholder’s intent with respect to the target (including plans or proposals with regard to future actions), the percentage of ownership, the source and amount of any financing and an explanation of the transaction.²³

- For exchange offers, issuers must submit a form addressing, among other things, the bidder’s financial condition and results of operations, the reasons for the transaction, the shareholder’s financing and prior material contacts with the company being acquired.²⁴
- Tender offers for publicly held stock must comply with the SEC’s tender offer rules, which include filing a schedule with the SEC describing the tender offer and providing substantive disclosures.²⁵
- Shareholder votes required under state corporate law or stock exchange rules for mergers, asset sales, issuances of stock or similar transactions involve the filing of a preliminary proxy statement with the SEC followed by a definitive proxy statement when it is delivered to shareholders.²⁶

The SEC will review, and may provide comments on, certain of these filings, and the parties will not be permitted to complete the transaction until the SEC confirms that it has no further comments on such filings.

In addition to these federal filing requirements, the various exchanges (NYSE, AMEX, Nasdaq) have certain requirements, such as disclosure and notification requirements for material events that may affect the value of a company’s stock.²⁷ Many states also have anti-takeover laws that govern acquisitions of stock of companies incorporated in their jurisdictions. These state laws may impose requirements for shareholder or board approval for acquisitions of stock above a certain threshold (e.g., 10 or 15%).²⁸

In addition to securities-related disclosures and filings, the other standard federal review in connection with M&A activity is a competition review conducted by the U.S. Federal Trade Commission (“FTC”) and the Department of Justice (“DOJ”). The U.S. antitrust laws prohibit acquisitions of interests or assets of a party engaged in interstate commerce where the “effect of such acquisition may be substantially to lessen competition” in a relevant U.S. product market.²⁹ To provide the FTC and DOJ with an opportunity to review proposed acquisitions in advance, the Hart-Scott-Rodino Antitrust

²² Jack Levin, “Structuring venture capital, private equity, and entrepreneurial transactions”, at ¶ 503.3.2.1 (Ginsburg and Rocap, eds., 2007).

²³ Id. at ¶ 503.3.2.2; see also Ethiopas Tafara, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs (Apr. 24, 2008).

²⁴ See Form F-4, Registration Statement Under the Securities Act of 1933, available at <http://www.sec.gov/about/forms/formf-4.pdf>.

²⁵ Levin at ¶ 503.3.2.4.

²⁶ Id. at ¶ 503.3.2.7.

²⁷ Id. at ¶ 503.2.1.

²⁸ Id. at ¶ 503.3.3.

²⁹ 15 U.S.C. § 18.

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Improvements Act of 1976 (“HSR”)³⁰ requires parties to submit a premerger notification for most significant acquisitions. The HSR notification requirements apply if the transaction meets certain thresholds based on the value of the transaction and the parties’ sizes, or if, regardless of the parties’ sizes, the transaction will result in the acquirer receiving at least \$260.7 million of the target’s interests and assets.

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

b. Industry-specific requirements

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

First, with respect to transactions in the telecommunications sector, Section 310 of the Communications Act of 1934 restricts foreign ownership of broadcast, common carrier and aeronautical radio station licensees. Section 310 expressly prohibits a foreign corporation or “alien” from holding any broadcast, common carrier or aeronautical radio station license, but, as interpreted by the Federal

Communications Commission (“FCC”), it does not prohibit indirect foreign control of certain licensees.³¹ Section 310 also prohibits foreign governments, individuals and corporations from owning more than 20% of the stock of a broadcast, common carrier, or aeronautical radio station licensee. Yet, as the FCC has noted, most foreign investments occur through intermediate companies organized in the United States. Section 310 provides a presumptive 25% ownership limitation for foreign investment in entities that in turn control U.S. broadcast, common carrier and aeronautical radio licensees. However, Section 310 also grants the FCC discretion to allow higher levels of foreign ownership at the holding company level unless it finds that such ownership is inconsistent with the public interest. Thus, foreign entities may acquire, directly or indirectly, up to 100% of the stock of a U.S. company owning or controlling an FCC licensee if the FCC does not find the foreign ownership to be inconsistent with the public interest.³² Although the FCC has frequently exercised its discretion under Section 310 to permit foreign investment in excess of the 25% limitation with respect to non-broadcast licensees, historically it has declined to do so in the broadcast context.

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

Second, with respect to banking transactions, the U.S. system of financial institution regulation involves multiple regulators, including at the federal and state level, and, in turn, may require multiple approvals for M&A transactions. As presently constituted, commercial banking in the United States is principally overseen by four primary federal regulators — the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. In addition, states have laws and regulations that govern the business of banking within the state, including in some cases mergers and acquisitions. Most foreign banks elect to enter the United States through the establishment of their own branches or other offices in the U.S.;³³ however, the federal and state regulators have ample authority to review M&A activity, whether it is the initial avenue for a foreign bank to enter the U.S. market or involves a foreign bank that already has existing branches in the United States.

In particular, at the federal level, the federal Bank Holding Company Act (“BHC Act”) requires the Federal Reserve Board to review and either approve or disapprove any proposed transaction that would result in any company, foreign or domestic, acquiring control of a banking holding company or certain types of banks. This includes, among other

³¹ FCC, Foreign Ownership Guidelines for FCC Common Carrier and Aeronautical Radio Licenses, DA 04-3610, at 7 (Nov. 17, 2007) (hereinafter “FCC Guidelines”).

³² *Id.* at 10.

³³ Carl Felsenfeld, *Banking Regulation in the United States* (Second Edition) 396 (Juris Publishing 2006).

³⁰ 15 U.S.C. § 18a.



things, the acquisition of 25% or more of any class of voting securities of a bank or bank holding company. The Federal Reserve also can find control where an investment would result in a lower percentage (down to 5%) of ownership over voting securities, if other indicia of control are also present. In considering whether control is present, the Federal Reserve “considers the size of the investment, the involvement of the investor in the management of the bank or bank holding company, any business relationships between the investor and the bank or bank holding company, and other relevant factors indicating an intent or ability to significantly influence the management or operations of the bank or bank holding company.”³⁴ The Change in Bank Control Act (“CIBC Act”) provides similar authority to the Federal Reserve and the other federal regulators with respect to any acquisition of 10% or more of any class of voting securities of a regulated institution that is not subject to Federal Reserve review and approval under the BHC Act. Notably, in order for a foreign bank to make an acquisition in the United States, the BHC Act also requires the Federal Reserve to assess a number of other factors, including the supervision exercised by home country authorities. Foreign entrance into the U.S. market may not be permitted if the Federal Reserve does not determine that home country regulators exercise comprehensive consolidated supervision (“CCS”).

3. Other interested stakeholders

In addition to identifying regulatory compliance issues and assessing what regulatory approvals will be required for foreign M&As, a critical due diligence consideration for certain foreign investments is an assessment of how other interested stakeholders may align on the transaction. This, in part, is an assessment of how controversial a transaction will be — and that is particularly relevant to foreign investors from potentially sensitive countries, like China. Specific considerations may include whether a transaction will be welcomed by the employees of the target; whether there are any highly organized political groups, such as unions, that may be interested in

the transaction and how it may affect their constituencies; whether there are rival bidders who could seek to interfere in the transaction; and what other third parties will be oriented either in favor or against the transaction.

* * *

As figure 1 on page 4 demonstrates, national security considerations overlay each of these fundamental due diligence issues, especially with respect to M&A activity from China: reputation for ongoing compliance matters, such as export control and anti-corruption compliance, can impact the trustworthiness determination of a foreign acquirer for U.S. national security purposes (see section D); prior approval of CFIUS, which assesses the impact on U.S. national security of mergers, acquisitions and investments that result in foreign control, may be the most significant regulatory approval for certain foreign investments (see section B); and if there are national security implications of an investment, the existence of other interested stakeholders and their orientation toward a transaction becomes amplified in importance. In particular, with respect to the last point, because national security considerations can generate political interest in a transaction, they can provide greater leverage to potential opponents to create controversy and, in turn, may require more active outreach to potential supporters to head off such controversy. In turn, the combination of national security with the fundamental due diligence questions — compliance, approvals and stakeholders — that accompany cross-border M&As activity should help determine transaction parties’ ultimate strategy for securing approval within the U.S. regulatory and institutional framework.

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

National security: CFIUS reviews under Exon-Florio/FINSA

Mergers and acquisitions of U.S. businesses that may implicate national security are required to receive closer regulatory scrutiny from CFIUS. Of all potential investors, Chinese M&As are among the most likely to receive the greatest scrutiny. In fact, there have been several potential transactions involving Chinese firms that were abandoned after initial consultations with CFIUS or to avoid a potential negative Presidential decision,³⁵ with the Huawei Technologies’ proposed investment with Bain Capital in 3Com (discussed more fully below) serving as most recent example. In addition, the only divestment of an acquisition ever formally ordered by a President under Exon-Florio involved China — namely, President George H.W. Bush’s order in 1990 requiring China National Aero Tech to divest MAMCO Manufacturing, Inc., an aerospace company based in Washington state.³⁶ Accordingly, as part

³⁴ Scott Alvarez, “Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs” (Apr. 24, 2008).

³⁵ Graham and Marchick, *op. cit.*, p. 102.

³⁶ President Bush’s order is available at <http://www.presidency.ucsb.edu/ws/index.php?pid=18108>.

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of assessing the U.S. regulatory framework for investment from China, this section provides a more detailed discussion of the CFIUS process and the statute that controls the CFIUS process — historically known as the Exon-Florio Amendment.

1. Overview of Exon-Florio

The principal U.S. statute governing regulatory reviews of certain types of FDI is Section 721 of the Defense Production Act of 1950. Section 721 is known as the Exon-Florio Amendment after the original amendment to the Defense Production Act, which was adopted in 1988 amidst concerns over Japanese investment. The Exon-Florio Amendment provided the President with express authority to review the national security effects of foreign acquisitions, mergers and takeovers.³⁷ The law was recently amended by the Foreign Investment and National Security Act of 2007 (“FINSA”).³⁸ FINSA left intact the essential elements of Exon-Florio, while also adopting amendments that provide for greater clarity on process, additional factors related to national security reviews under the statute, greater accountability among the agencies charged with implementing the statute, and enhanced Congressional oversight.

Under the statute as amended by FINSA, CFIUS, as the President’s designee, has authority to review “any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.”³⁹ The purpose of the review is to determine the effects of a transaction on U.S. national security. CFIUS then must investigate any transaction that (1) threatens to impair the national security of the United States, if the threat has not been mitigated during the initial review period; (2) would involve control by a foreign government;⁴⁰ or (3) would result in foreign control of U.S. critical infrastructure, if such control threatens to impair U.S. national security and the threat is not mitigated during the initial review period. The President ultimately has authority to suspend or prohibit any transaction that threatens to impair the national security if, after a full investigation is completed, “there is credible evidence that leads the President to believe that the foreign interest exercising control might take action that threatens to impair the national security,” and other laws except for the International Emergency Economic Powers Act,⁴¹ “do not in the President’s judgment provide adequate and appropriate authority for the President to protect the national security in the matter before the President.”⁴²



The Department of Treasury chairs CFIUS.⁴³ In addition, CFIUS is comprised of eight other voting members (the Departments of Commerce, Defense, Homeland Security, Justice, State, and Energy; the U.S. Trade Representative; and the White House Office of Science and Technology); two permanent non-voting members (the Director of National Intelligence and the Department of Labor); and several other White House offices that act as observers and, on a case-by-case basis, participate in CFIUS reviews.⁴⁴

By statute, CFIUS is authorized to review a transaction either upon a voluntary filing by either party to the transaction, or upon initiation of the Committee. By regulation, CFIUS historically has also provided for any Committee member to issue its own notice to the full Committee requesting a review of a particular transaction.⁴⁵ The Treasury Department, as chair of CFIUS, also has considerable discretion on whether to accept a notice for review. Thus, for example, while the statute and regulations indicate a single party to a transaction may file a voluntary notice, it is extremely rare for the Treasury to deem a

³⁷ Omnibus Trade and Competitiveness Act of 1988, § 5021, Pub. L. 100-418 (1988), codified at 50 U.S.C. App. § 2170. The original authorization was scheduled to expire in 1991, but was made permanent by Section 8 of Defense Production Act Extension and Amendments of 1991, Pub. L. 102-99 (1991).

³⁸ Pub. L. 110-49 (2007) (“FINSA”).

³⁹ Id. § 2(a)(3) (codified at 50 U.S.C. App. § 2170(a)(3)).

⁴⁰ An investigation of such transactions is not required if the Secretary or Deputy Secretary of the Treasury, and an equivalent official at the “lead” CFIUS agency, determine that the proposed transaction will not impair national security. For those acquisitions by state-owned enterprises that reach the investigation stage, the law requires an assessment of the foreign country’s compliance with U.S. and multilateral counter-terrorism, nonproliferation and export control regimes.

⁴¹ 50 U.S.C. §§ 1701–1706.

⁴² FINSA, § 6 (codified at 50 U.S.C. App. § 2170(d)).

⁴³ The fact that the Treasury Department, the most naturally pro-investment of all executive agencies, chairs a national security review process is both a symbolic and practical nod to the importance of foreign investors and the open investment regime of the United States.

⁴⁴ Executive Order 13456, Further Amendment of Executive Order 11858 Concerning Foreign Investment in the United States § 3 (2008) (hereinafter “FINSA Executive Order”). The additional White House offices are the Office of Management and Budget, the Council of Economic Advisers, the Assistant to the President for National Security Affairs, the Assistant to the President for Economic Policy, and the Assistant to the President for Homeland Security and Counterterrorism.

⁴⁵ 31 C.F.R. § 800.401.

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notice containing information and responses from only one party to a transaction sufficient to initiate a review.

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

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

Notwithstanding these statutorily-prescribed timeframes for reviews, there is no statute of limitations on the inherent Presidential authority in Exon-Florio. The President can act at any point, even after a transaction has closed. Moreover, the President’s decision is not subject to judicial review by U.S. courts.⁴⁶ However, once a transaction has undergone a review, it receives a form of safe harbor: FINSA, the implementing Executive Order, and CFIUS’s regulations provide that the Committee can unilaterally initiate another review only if certain limited circumstances are met — such as, the initial review was based on false or materially misleading information, or material omitted information, or if there has been an intentional material breach of a mitigation agreement upon which approval was originally conditioned.⁴⁷ Notably, Exon-Florio law does not provide a mechanism for the Executive Branch to review greenfield investments in the United States.

2. Exon-Florio in practice

CFIUS is a unique regulatory body insofar as it operates by consensus⁴⁸ and includes multiple agencies with viewpoints that reflect their distinct missions and equities. There is an inherent tension between the security agency members of CFIUS, with their focus on defense, homeland security, counterintelligence, and law enforcement, and the economic agencies, which are more focused on trade and investment.⁴⁹ This tension is purposeful: having a consensus-based, confidential process that requires input from cabinet agencies with differing equities is intended to facilitate careful, objective determinations that permit investments where possible but without sacrificing important national security interests.

At the same time, one consequence of having a consensus-based, confidential process that involves so many agencies and with limited information flow to the regulated parties is that the process itself can be opaque. In turn, much in CFIUS practice turns not only on what is set forth in the statute and regulations, but on understanding

which agencies have particular interests in a transaction, who the key decision-makers will be at those agencies, and what questions or considerations are likely to be of principal concern to those decision-makers. Particularly for the hardest cases, understanding the idiosyncrasies of agency interests and perspectives and what issues will matter to the key decision-makers is more a regulatory art than a science. Added to this mix is the fact that prominent transactions, especially those involving FDI from China, can attract media and political attention. (See in this context also the booklet by Timothy Frye and Pablo Pinto in this series.)

Accordingly, investors and U.S. parties alike are well advised to understand and anticipate CFIUS’s analysis and considerations before launching into transactions that might require a CFIUS review. This is particularly true for investments from China, which, for reasons described below, are more likely to raise both strategic and political issues. The critical threshold questions for a CFIUS review are: (i) whether there is foreign control over a U.S. business; (ii) if there is foreign control, whether the transaction may present any significant national security issues; and (iii) if there are national security concerns, whether they can be mitigated through contractual commitments from the transaction parties or other permissible means.⁵⁰

a. Control over U.S. business

The threshold question for any CFIUS review is whether there is a transaction that presents a foreign person⁵¹ with “control” over a U.S. business. Where there is potential foreign government ownership or influence, the control analysis is applied twice: first, in assessing, whether a foreign entity will be controlling a U.S. business and, second, in assessing whether in fact that foreign entity is itself controlled by a foreign government.

The definition of “control” in the CFIUS regulations has historically been quite broad, and that remained true in the revised definition implementing FINSA. “Control” means:

[T]he power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity.⁵²

In practice, “control” is very much a functional definition. The amount of share interests and the right to board seats, for example, are highly relevant to finding control, but they are not necessarily determinative. Rather, CFIUS will take into consideration all relevant factors of a foreign person’s ability to determine, direct or decide important

⁴⁶ FINSA, § 6 (codified at 50 U.S.C. App. § 2170(e)).

⁴⁷ FINSA, § 2 (codified at 50 U.S.C. App. § 2170(b)(1)(D)); FINSA Executive Order § 7(f).

⁴⁸ The drive toward a consensus reflects the desire among CFIUS members to avoid sending a transaction to the President, if at all possible. Thus, there is internal pressure among the CFIUS cabinet membership to form a consensus view on every transaction. In the rare instance when a transaction does proceed all the way to the President for a decision, the reports prepared for the President by the member agencies of CFIUS can reflect differing views.

⁴⁹ Graham and Marchick, *op cit.*, pp. 34–35.

⁵⁰ One common strategy deployed by transaction parties to help manage the various inputs into CFIUS and to alleviate the statutory time pressure on the Committee is to engage in informal consultations with the CFIUS agencies before filing a formal notice. In fact, the final regulations implementing FINSA expressly encourage parties to consult with CFIUS before filing a formal notice. In part as a result of this practice, the majority of CFIUS reviews are concluded in the initial 30-day period. For example, even under the heightened scrutiny applied under FINSA, only about one-eighth of all cases filed in 2008 with CFIUS proceeded to investigation.

⁵¹ “Foreign person” includes any foreign national, foreign government, or entity over which “control” is exercised by a foreign national, foreign government, or another foreign entity. Thus, controlling acquisitions of U.S. businesses by U.S. subsidiaries of foreign companies fall within the jurisdiction of CFIUS if they potentially impact U.S. national security.

⁵² 31 C.F.R. § 800.204(a).

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matters affecting a U.S. business. Among other things that CFIUS will consider are the right to direct or determine certain extraordinary corporate actions such as the sale of all assets or dissolution of an entity, as well as other “matters,” such as approval over major expenditures, closing or relocation of facilities, the appointment or dismissal of managers and officers, and how non-public information is treated.⁵³ At the same time, certain standard minority economic protections — including certain negative rights and anti-dilution rights — may not, by themselves, confer control.⁵⁴

In addition, there must be control over a *U.S. business*. There are two important points with respect to the term “U.S. business.” First, CFIUS’s jurisdiction extends only to the extent that a business undertakes activities in interstate commerce in the United States.⁵⁵ Thus, for example, in the case of a foreign acquisition of a Canadian company that has a sales office in the United States, CFIUS’s jurisdiction would only extend to the sales office and its business in the United States. Second, a transaction does not necessarily have to involve an investment into or acquisition of a legally organized entity to trigger CFIUS’s jurisdiction. For example, the sale of a business unit or of assets in the United States that includes customer lists, intellectual property and employees (i.e., elements of a going concern) could be a covered transaction.⁵⁶

b. National security analysis

FINSA formally requires CFIUS to conduct a risk-based analysis, informed by an analysis performed by the Director of National Intelligence, of the national security risk posed by any transaction.

⁵⁷ This statutory requirement codified CFIUS’s existing practice with respect to how it analyzes transactions.

Specifically, for every transaction, CFIUS engages in a three-part analysis comprised of: (1) a threat assessment focused on national security issues associated with the buyer; (2) a vulnerability assessment focused on national security issues associated with the U.S. assets and business at issue; and (3) an assessment of the potential consequences, that results from the “interaction between threat and vulnerability.”⁵⁸

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

- Domestic production needed for projected national defense requirements.
- The capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services.

⁵³ *Id.*

⁵⁴ *Id.* at § 800.204(c).

⁵⁵ *Id.* at § 800.226.

⁵⁶ *Id.* at § 800.301(c)(Examples 6 and 7).

⁵⁷ Pub. L. No. 110-049, §§ 2,5, 50 U.S.C. App. §§ 2170(b)(4), (l)(1)(B).

⁵⁸ Department of Treasury, Guidance Concerning the National Security Review Conducted by the Committee on Foreign Investment in the United States, at 8 (Dec. 1, 2008) available at http://www.treas.gov/offices/international-affairs/cfius/docs/GuidanceFinal_12012008.pdf (hereinafter “CFIUS Guidance”).



- The control of domestic industries and commercial activity by foreign citizens as it affects U.S. capability and capacity to meet national security requirements.
- The sales of military goods, equipment or technology to a country that supports terrorism, or proliferates missile technology or chemical and biological weapons.
- U.S. technological leadership in areas affecting U.S. national security.⁵⁹

These criteria reflected Congress’s overriding interest at the time on protecting the defense industrial base and U.S. technological leadership. However, Congress purposely did not adopt an exclusive list of national security considerations, instead indicating that the term “national security” is “to be read in a broad and flexible manner.”⁶⁰ CFIUS, in turn, has never formally defined the term.

FINSA attempted to provide additional indicia of the meaning of “national security” in the CFIUS context — or at least to codify CFIUS’s existing practice with respect to considering those factors. First, the amendments stated that “national security” “shall be construed so as to include those issues relating to homeland security, including its application to critical infrastructure.”⁶¹ This reflects the practice of CFIUS, at least since September 11, 2001, and in particular since the Department of Homeland Security was added to CFIUS in 2003, to examine transactions in sectors that relate to “critical infrastructure.” CFIUS has defined “critical infrastructure” to mean “in the context of a particular transaction, a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset ... over which [foreign] control is acquired ... would have a debilitating impact on national security.”⁶² Under this definition, not every foreign investment occurring in a critical infrastructure sector will be covered by CFIUS. Rather, it is the particular character of the assets and business that matter for CFIUS’s purposes.

⁵⁹ 50 U.S.C. App. § 2170(f).

⁶⁰ Statement of Senator Exon, Congressional Record 134 (April 25, 1988): S 4833.

⁶¹ FINSA § 2, 50 U.S.C. App. § 2170(a)(5).

⁶² 31 C.F.R. § 800.208.

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

- The potential national security-related effects on United States critical infrastructure, including major energy assets.
- The potential national security-related effects on United States critical technologies (which means “critical technology, critical components, or critical technology items essential to national defense,” subject to regulations issued by CFIUS).⁶³
- Whether the covered transaction is a foreign government-controlled transaction.
- For transactions involving foreign government control that result in an investigation, whether the host country adheres to nonproliferation regimes, whether the host country presents any risk of transshipment of export and military-controlled items, and the relationship of the host country to U.S. counterterrorism efforts.
- The long-term projection of United States requirements for sources of energy and other critical resources and material.⁶⁴

Third, FINSA required CFIUS to issue guidance on the types of transactions that the Committee has reviewed and that have presented national security considerations. This includes transactions that may constitute covered transactions that would result in control of critical infrastructure relating to United States national security by a foreign government or an entity controlled by or acting on behalf of a foreign government. However, the guidance issued by CFIUS also was required to preserve the confidentiality of CFIUS reviews. To strike this balance, CFIUS issued guidance that offers a measure of additional clarity in identifying transactions that present “national security considerations,” but also largely repeats the statutory factors for national security and the information CFIUS requests of transaction parties in its regulations.⁶⁵

Beyond the guidance and an enhanced number of information requests in the final regulations under FINSA, there are other unidentified factors that CFIUS will consider in its national security analysis. A more analytical list of factors that CFIUS considers is provided below at table 1. In the next section, this booklet will examine how characteristics of Chinese FDI relate to some of these factors, including the connection of a foreign company to its home country government; its reputation for compliance on regulatory issues related to national security, such as export control laws; the

perception of a military rivalry with the foreign country; and the foreign country’s reputation for commercial and state espionage.

Table 1: Factors considered by CFIUS in national security analysis

Foreign acquirer	U.S. company
<ul style="list-style-type: none"> • The acquirer’s reputation for compliance with laws and regulations, with a particular focus on export control compliance and/or prior commitments to CFIUS. • The reputation of the acquirer’s home country for cooperating on important U.S. national security policy objectives, including non-proliferation and counterterrorism matters. • The reputation of the acquirer’s management, including whether the acquirer’s officers and directors have any past or current connection to the home country’s military or intelligence agencies. • The reputation of the acquirer’s home country for commercial or state espionage. • Whether the acquirer does business in countries subject to U.S. embargoes (e.g., Iran, Democratic People’s Republic of Korea, Sudan, Cuba). 	<ul style="list-style-type: none"> • The assets of the U.S. target company, including whether those assets themselves are part of U.S. critical infrastructure, supply U.S. critical infrastructure, or otherwise could be a threat (e.g., are assets or materials that could be used for terrorist purposes). • Government customers of the U.S. company, including in the first instance defense customers but also including non-defense and intelligence customers. • Access of the U.S. company to government systems. • Access to U.S. government classified information (and, in turn, the existence of a U.S. government approved facility security clearance). • The importance of the U.S. assets to U.S. law enforcement interests. • The importance of the U.S. assets or technology to the defense supply chain.

⁶³ A working group of U.S. government agencies, chaired by the Department of Treasury, has identified 14 sectors in which critical technologies arise: advanced materials and processing; chemicals; advanced manufacturing; information technology; telecommunications; microelectronics; semiconductor fabrication equipment; military-related electronics; biotechnology; professional and scientific instruments; aerospace and surface transportation; energy; space systems; and marine systems. See Report to Congress on Foreign Acquisition of and Espionage Activities Against U.S. Critical Technology Companies (Unclassified) 9–10 (Sept. 2007).

⁶⁴ FINSA § 4; 50 U.S.C. App. § 2170(f)(6)-(10).

⁶⁵ That information focuses on certain obvious national security criteria, including whether the U.S. company has any contracts with U.S. defense or intelligence agencies or defense contractors, whether the U.S. company has technology that is controlled under export control laws, whether a foreign government controls or directs the foreign acquirer, and what the foreign acquirer’s intentions are for the U.S. operations. 31 C.F.R. § 800.402(c).

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Foreign acquirer	U.S. company
<ul style="list-style-type: none"> • Whether the transaction could aid the military or intelligence capabilities of a foreign country with interests adverse to those of the United States. • Whether the acquirer is likely to move critical technology or key products offshore. • Whether a foreign government exercises control or influence over the acquirer. • How the acquirer is financing the transaction, and whether the financing would give any other party, including a foreign government, control over the acquirer or the transaction. 	<ul style="list-style-type: none"> • What other assets or businesses are located near the U.S. company. • What existing security procedures the U.S. business has in place. • Whether U.S. management will remain in place, and whether U.S. citizens will occupy important security-related positions after the transaction. • The existence of sensitive technology, including export controlled technology. • The record of the U.S. company on compliance issues, including in particular export control compliance. • The non-government customer base of the U.S. company (i.e., whether the U.S. company supplies a customer base that is critical to homeland or national security). • The level of competition in the applicable marketplace and, in particular, whether the U.S. company occupies a dominant position in a market that involves important strategic products, services or technologies.

c. Mitigation

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

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

In adopting FINSA, the U.S. Congress sought to clarify that mitigation agreements should only be adopted when (i) the transaction causes an incremental increase in the risk to national security; (ii) existing regulatory authority is not adequate to address the incremental risk; and (iii) a “risk-based analysis” of the threat to national security has been performed and approved by the Committee. Specifically, FINSA states that a mitigation agreement “may” be imposed “in order to mitigate any threat to the national security of the United States that *arises as a result of the covered transaction*” and that such an agreement “shall be based on a risk-based analysis ... of the threat to national security of the covered transaction.”⁶⁶

Finally, while CFIUS agencies can bargain for various penalties, including agreed upon damages figures, FINSA also makes clear that CFIUS can re-open a transaction for a material breach of a mitigation agreement if there is a finding of intentional breach by the lead agency *and* a finding by all of CFIUS that no other remedies are available.⁶⁷

While the CFIUS process focuses on a specific class of transactions — i.e., those that may raise legitimate national security issues — it can entail significant costs for FDI in certain types of U.S. businesses, including ongoing compliance costs with mitigation commitments

⁶⁶ FINSA § 5, 50 U.S.C. App. § 2170(l)(1)(A)-(B) (emphasis added).

⁶⁷ FINSA § 2, 50 U.S.C. App. § 2170(b)(1)(D).

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to which investors must agree to receive CFIUS approval.⁶⁸ In the most extreme cases, the Exon-Florio statute, as amended by FINSA, can serve as an absolute bar to certain acquisitions that present national security issues. As evidenced by the experience of Huawei Technologies, the risk of investment screening and the potential costs related to CFIUS is greater for Chinese investors. Accordingly, as part of any due diligence exercise that Chinese companies undertake when considering an acquisition or significant investment in a U.S. business — and, likewise, as part of the U.S. business's consideration of Chinese investment — it would be prudent to assess fully the risks and costs associated with a potential CFIUS review and to plan appropriately for addressing those risks. The concluding section of this booklet sets forth certain strategies and steps that Chinese investors can take to help manage such risks.

The U.S. political landscape for Chinese investment

Apart from CFIUS and other regulatory approvals, the U.S. Congress can take an active interest in FDI and be an important institution for investors to consider and engage in the context of specific transactions. (See also the booklet by Timothy Frye and Pablo Pinto in this series.) This is particularly true for investments that present national security issues. In that regard, Congress's interest and attempted intervention in foreign investments has not been circumscribed to Chinese investment. A Japanese investment in Fairchild and a proposed British takeover of Goodyear Tire & Rubber Company originally led to the adoption of Exon-Florio. In 2000, members of Congress expressed concern over the sale of Silicon Valley Group, a semiconductor equipment manufacturer, to the Dutch company ASML Holding N.V., and in 2006 Congress famously intervened in the sale of U.S. port terminals to the Emirati firm Dubai Ports World.⁶⁹

There is no question, however, that Congress will be a more important institutional consideration for investments from China than it will be for FDI from virtually any other country. Indeed, in 2000, Congress created a bi-partisan committee, the United States-China Economic and Security Review Commission ("USCC"), specifically "to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China."⁷⁰ The USCC must submit an annual report to Congress, which includes recommendations for legislative and administrative action. In 2005, Congress directed the USCC to focus its work and study on proliferation practices, economic transfers, energy, U.S. capital markets, regional economic and security impacts, U.S.-China bilateral

programs, WTO compliance, and the implications of restrictions on speech and access to information in China.⁷¹

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

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

1. COSCO's port operations in Long Beach

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

Rep. Duncan Hunter (R-CA), one of the most vocal critics of the transaction, summarized the arguments of the opponents:

COSCO is not a private enterprise. It is an arm of the Chinese government and an auxiliary to the People's Liberation Army... Chinese control of a 135-acre terminal in Long Beach would pose a number of security threats to the United States. The terminal obviously would become a center for Chinese espionage on the West Coast. And it also would give the Chinese a stable, high-powered listening post for the interception of communications throughout California and beyond. The Chinese would know every move the U.S. military makes and could monitor training exercises as well as operational deployments. Beijing also could develop ways to interrupt, neutralize or mislead the command, control and communications networks upon which our military operations depend.⁷²

However, the Pentagon and at least two members of Congress publicly stated that the deal posed no national security threat. Pentagon Spokesperson Kenneth Bacon said: "There are no national security concerns attendant to expanding COSCO's presence in the United States."⁷³ Representatives Steve Horn and David Dreier wrote

⁶⁸ In addition to the investment review provided by CFIUS, it should be noted that the Department of Defense, U.S. intelligence agencies, the Department of Energy, and the Nuclear Regulatory Commission have independent authority to review and restrict investments into companies that, as contractors to those agencies, possess U.S. government classified information. These authorities are less likely to be relevant to Chinese investors; it would be extremely unlikely for a Chinese company to be permitted to acquire outright — or even to make an investment that would be deemed "controlling" — in a business that is part of the defense industrial base or that possesses any classified contracts with the U.S. government.

⁶⁹ Graham and Marchick, op. cit., pp. 124–125.

⁷⁰ Floyd D. Spence National Defense Authorization Act for 2001 § 1238 (codified at 22 U.S.C. § 7002).

⁷¹ Pub. L. No. 109–108.

⁷² Rep. Duncan Hunter (R-CA), "U.S. turns a blind eye as China hits the beach," *Insight on the News*, April 21, 1997.

⁷³ Otto Kreisler, "Navy sees no national security threat in Cosco lease," *Copley News Service*, April 1, 1997.

in a joint letter to their colleagues that, based on intelligence briefings from the CIA, Office of Naval Intelligence, Coast Guard, and Bureau of Customs, “there is no evidence that the agreement between the City and Port of Long Beach and the China Ocean Shipping Company is a national security issue.”⁷⁴

Nevertheless, Congress incorporated into the Defense Authorization Act for fiscal year 1999 restrictions that prohibited “any funding to be used to enter into or renew a contract with any company owned, or partially owned, by the People’s Republic of China.”⁷⁵ Long Beach and COSCO worked around the restriction by having other port tenants use the new facilities, with COSCO picking up the areas vacated by those tenants.⁷⁶

2. CNOOC’s proposed bid for Unocal

In their 2006 book on U.S. national security and FDI, Graham and Marchick comprehensively reviewed the political firestorm that erupted over CNOOC’s bid for Unocal in 2005. They identified five arguments put forth by opponents to the transaction: (1) the transaction put global energy sources at risk, due to the possibility of CNOOC hoarding Unocal’s reserves for China’s exclusive use, thereby compromising U.S. national security interests that depend on secure supplies of oil and gas; (2) the CNOOC bid was an attempt by the Chinese government to control critical oil and gas supplies, and the control and accompanying revenues would strengthen China’s government; (3) CNOOC’s bid relied upon preferential loans from Chinese state-owned banks and CNOOC’s state-owned parent, which put U.S. companies at a competitive disadvantage; (4) CNOOC’s acquisition of Unocal would have potentially facilitated the transfer of sensitive technologies to China; and (5) because the Chinese would never allow a U.S. company to acquire a major Chinese oil company, based on reciprocity, the United States should not allow the transaction.⁷⁷

Notwithstanding sound counter-arguments from supporters of the transaction, politics carried the day and overwhelmed CNOOC’s bid. Congress’s actions, which were detailed at length in Graham and Marchick, included the following:

- Multiple letters were written by Members of Congress to Cabinet-level officials in the Bush Administration expressing concern over the transaction. More than three dozen Members of Congress wrote to then-Treasury Secretary John Snow asking that the potential transaction “be reviewed immediately to investigate the implications of the acquisition of U.S. energy companies and assets by CNOOC and other government-controlled Chinese energy companies.”⁷⁸ Senators Kent Conrad (D-ND) and Jim Bunning (R-KY) complained



to U.S. Trade Representative Rob Portman and Secretary of Commerce Carlos Gutierrez that CNOOC’s bid was “inconsistent with China’s WTO commitments,” citing the financing terms for CNOOC as evidence that “[t]he proposed acquisition is not being conducted on commercial terms and has little commercial justification.”⁷⁹

- The House of Representatives was active in passing legislation expressing opposition to the CNOOC bid. It overwhelmingly (by a vote of 333 to 92) passed a bill prohibiting the Treasury Department’s use of funds for recommending approval of the sale of Unocal to CNOOC.⁸⁰ It also approved, by a vote of 398 to 15, a nonbinding resolution urging an Exon-Florio review of the bid.⁸¹
- The House Armed Services Committee held a hearing on the CNOOC-Unocal transaction on July 13, 2005.

Ultimately, Congress provided the death knell for CNOOC’s bid by adopting an amendment to an energy bill requiring that the Secretaries of Energy, Defense and Homeland Security conduct a study of China’s growing energy requirements and the implications of “such growth on the political, strategic, economic, or national security of the United States.”⁸² The amendment would have prohibited CFIUS from completing any review of a CNOOC-Unocal transaction for 141 days, which is 51 days longer than the maximum of 90 days established by the Exon-Florio Amendment — thereby greatly increasing the cost of the CNOOC bid. Faced with this pressure, CNOOC withdrew its bid.

⁷⁴ March 25, 1997 Dear Colleague letter quoted in CRS study on “Long Beach: proposed lease by China Ocean,” 97–476 (June 3, 1998).

⁷⁵ Department of Defense Appropriations Act of 1999, Pub. L. 105–262, § 8060, 112 Stat. 2311 (Oct. 17, 1998).

⁷⁶ “The town the Navy left behind: Long Beach reinvents itself as tourist, shipping port of call,” CNN, available at <http://www.cnn.com/SPECIALS/cold.war/experience/the.bomb/route/08.long.beach/> (last visited November 19, 2007).

⁷⁷ Graham and Marchick, op. cit., p. 120.

⁷⁸ Letter to Treasury Secretary John W. Snow from Representative William J. Jefferson et al. (undated).

⁷⁹ Letter to the Honorable Carlos M. Gutierrez and Ambassador Rob Portman from Senators Kent Conrad and Jim Bunning (July 11, 2005), available at conrad.senate.gov.

⁸⁰ H. Amdt. 431 offered to HR 3058 by Rep. Carolyn Kilpatrick of Michigan, approved in roll call vote no. 353, 109th Congress, 1st sess., 151 Congressional Record H5515 (daily ed. June 30, 2005).

⁸¹ “Expressing the Sense of the House of Representatives that a Chinese State-Owned Energy Company Exercising Control of Critical United States Energy Infrastructure and Energy Production Capacity Could Take Action That Would Threaten to Impair the National Security of the United States,” HR 344, 109th Congress, 1st sess., 151 Congressional Record H194 (daily ed. January 25, 2005): § 1, 4. The resolution was offered by Rep. Pombo and approved in roll call vote no. 360.

⁸² Energy Policy Act of 2005, § 1837, Public Law 109–58, U.S. Statutes at Large 119, 594.

3. Huawei's proposed investment in 3Com

The most recent Chinese investment to elicit concern from Congress was Huawei's proposed joint investment with Bain Capital Partners in the telecommunications firm 3Com. According to public filings by 3Com, Bain Capital Partners and Huawei

agreed to purchase 3Com ... for \$2.2 billion. Bain Capital will control 83.5 percent of the voting shares. Bain Capital will appoint 8 of 11 board members. Huawei will acquire a minority interest of 16.5 percent. Huawei will appoint 3 of 11 board members. Huawei can increase its equity by up to 5 percent (but no more), based on certain performance criteria, but cannot gain additional seats on the board or gain any measure of additional operational control.⁸³

The Congressional response included the following actions and statements:

- A small group of principally Republican members of the House of Representatives introduced a proposed resolution opposing the transaction. Reciting a litany of alleged espionage-related activities attributed to China, Huawei's alleged ties to the PLA and other publicly reported concerns over Huawei's business, the proposed resolution specifically stated that the transaction "threatens the national security of the United States" and called on CFIUS to reject the transaction.⁸⁴
- Sen. John Kyl (R-AZ), joined by 13 other Senators, sent a letter to the Treasury Department urging that the transaction be closely reviewed under FINSIA. The letter stated the Senators' belief that "Huawei has built and currently maintains most of the PLA's telecommunications backbone systems and is the Chinese military's preferred provider for a wide variety of telecommunications products." The letter went on to say that, "because of this long-standing and apparently deeply-engrained relationship between Huawei Technologies and the PLA, we are concerned about the national security implications of this acquisition for the United States."
- Senator Chris Bond (R-MO), the ranking Republican on the Senate Select Committee on Intelligence, stated: "It is troubling to me that a foreign military organization with interests in communications might obtain access to our security systems."⁸⁵
- Representatives Peter Hoekstra and Duncan Hunter wrote to Treasury Secretary Paulson formally requesting CFIUS review of the transaction regardless of whether it was submitted for examination by the parties.⁸⁶ The letter stated in part: "This review should be conducted, and a determination made, as to whether this sale will in any way impact the national

security of the United States or increase the vulnerability of U.S. computer networks and telecommunications systems to Chinese intrusion." In an interview, Rep. Hoekstra (R-MI) said: "There is no doubt as to why the Chinese want a partnership with 3Com. They look at this as a key connection to stealing additional secrets from U.S. corporations and from our national security apparatus."⁸⁷

- The House of Representatives Committee on Energy and Commerce, chaired by Representative John Dingell (D-MI) and led on the Republican side by Ranking Member Joe Barton (R-TX), wrote the Treasury Department on January 31, 2008 — in the middle of the investigation by CFIUS — that it intended independently to investigate the transaction, and requested that CFIUS respond to certain questions. The letter cited "growing apprehension" among Members of Congress over the deal and stated that concerns over national security "are more than justifiable, especially in light of recent increases in attacks on government and private networks [by Chinese military hackers]."⁸⁸
- Representative Thaddeus McCotter (R-MI) made repeated statements, including on the House floor, calling on CFIUS to block the investment by Huawei.

3Com, Bain Capital, and Huawei subsequently announced that they had withdrawn the transaction from CFIUS following their failure to reach a mitigation agreement that adequately addressed CFIUS's concerns,⁸⁹ and Bain Capital later announced its intent to terminate the merger agreement with 3Com.⁹⁰

4. The political environment going forward

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

For example, the political reaction to Lenovo's acquisition of IBM's Personal Computer division was relatively mild. In that case, three Republican members of Congress — Henry Hyde, then-Chair of the House International Relations Committee; Don Manzullo, then-Chair of the House Small Business Committee; and Duncan Hunter, then-Chair of the House Armed Services Committee — requested that

⁸³ 3Com 8-K, filed Oct. 11, 2007.

⁸⁴ H. Res. 730, 110th Cong., 1st Sess. (introduced Oct. 10, 2007).

⁸⁵ "GOP urges probe in China firm deal," *The Washington Times*, Oct. 4, 2007.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ "Letter to Secretary of Treasury Henry Paulson from Chairman Dingell, Ranking Member Barton, and Representatives Rush and Whitfield," January 31, 2008, available at http://energycommerce.house.gov/Press_110/110-ltr.013108.DOTreasury.CFIUS.pdf.

⁸⁹ 3Com Press Release, "3Com and Bain Capital Partners announce mutual withdrawal of CFIUS application," February 20, 2008.

⁹⁰ 3Com Press Release, "3Com announces intent to pursue break-up fee from Bain Capital," March 20, 2008.

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CFIUS investigate the national security ramifications of the Lenovo-IBM deal. They warned that the sale could result in corporate assets and technology with military uses being passed to the Chinese, and the Chinese could use its new acquisition to conduct espionage activities in the United States. Representatives Hyde, Manzullo, and Hunter indicated, however, that they were not necessarily opposed to the transaction going forward, so long as a proper review was undertaken. After the extended review by CFIUS that resulted in approval of the transaction, Congressional criticism was muted.

Recent transactions, while eliciting some concern on Capitol Hill, also have been less politicized. Senator Jim Webb (D-VA) expressed concern over CIC's minority investment in the U.S. private equity company Blackstone,⁹¹ but he was relatively isolated in making an issue of that investment. The Congressional reaction to CIC's investment in Morgan Stanley was even more muted. CITIC's proposed investment in the subsequently defunct Bear Stearns likewise caught the attention of Congress at the time, but no Member issued exceptionally critical statements. Even in the case of 3Com-Huawei, the Congressional reaction arguably was milder than prior Chinese transactions, such as CNOOC and COSCO.

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

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

Special considerations of Chinese investment

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

export control compliance record, of Chinese companies; (5) the other markets in which the Chinese company may do business; and (6) a perceived rivalry between the U.S. military and the Chinese military.

1. State ownership and control

As noted, FINSA formalizes a presumption of investigation in the CFIUS process where an acquirer is foreign government-controlled. Given the landscape of the Chinese economy and the strong history of Chinese companies being at least partly owned by the government, this issue of state control, and whether an entity is acting on the basis



of commercial concerns or on behalf of government interests, may result in increased scrutiny when a Chinese company is involved.⁹²

A recent U.S. State Department report noted that the state-owned sector accounts for approximately 40% of China's GDP.⁹³ As of 2008, the ten largest multinational enterprises in China were all SOEs.⁹⁴ Most large publicly traded SOEs remain subject to substantial state control due to restrictions on the transfer of state-owned shares, which constitute a majority of shares issued by listed companies,⁹⁵ as well as state approval over officers in management positions.⁹⁶

⁹¹ "Senator raises China concerns on Blackstone," *Reuters*, June 21, 2007, available at <http://www.nbc.com/id/19322421>.

⁹² Graham and Marchick, *op. cit.*, pp. 105–106.

⁹³ U.S. Department of State, Background Note: China (April 2008), available at <http://www.state.gov/r/pa/ei/bgn/18902.htm>.

⁹⁴ OECD, Directorate for Financial and Enterprise Affairs, "Draft report: China's outward foreign direct investment," DAF/INV/WD(2008) at ¶¶ 33–35 (Feb. 22, 2008) (hereinafter "Draft OECD Report on China OFDI").

⁹⁵ Chi Hung Kwan, "Who Owns China's State-owned Enterprises? Toward Establishment of Effective Corporate Governance," in *China in Transition* (July 28, 2006), available at <http://www.rieti.go.jp/en/china/06072801.html>; Graham and Marchick, *op. cit.*, pp. 106–107.

⁹⁶ Of nearly 1,400 publicly listed Chinese companies at the end of 2005, nearly two-thirds of the outstanding shares were non-tradeable. Randall Morck, Bernard Yeung and Minyuan Zhao, "Perspectives on China's outward foreign direct investment" at 11 (Aug. 2007). More than half of the non-tradeable shares were owned directly by governmental entities, and the remainder were owned principally by other large SOEs or state-managed investment funds. *Id.*

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Many of the largest SOEs are also owned by the State-owned Assets Supervision and Administration Commission (“SASAC”), which has control over the budgets of the SOEs and has ultimate authority over approving M&As.⁹⁷ In addition, publicly listed firms have a parallel structure to their board — the firm’s Party Committee, chaired by the Party Secretary, who reports to the Communist Party of China’s Organizational Department. According to one study, the CEOs of the 53 largest SOEs in China are appointed directly by the Communist Party of China’s Organizational Department.⁹⁸ Local governments or the Communist Party also can exercise control by informally influencing the composition of corporate boards and the corporation’s management team.⁹⁹

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

That even publicly listed Chinese companies can have ownership interests held by the government or be aligned in some way with the government even when there is no apparent state ownership (e.g., if officials are tied to the government) is significant from the perspective of the U.S. regulatory and political environment. SOEs comprise a high share of China’s outward bound FDI. Of the 30 Chinese companies that are the largest outward investors, only one — the Lenovo Group — is not officially state controlled.¹⁰⁰ Indeed, ten of these companies accounted for approximately 84% of all outward FDI from

China between 2004 and 2006.¹⁰¹ With this background, the U.S. officials involved in the CFIUS process may start with the presumption that all Chinese companies seeking to invest in the United States are controlled by the Chinese government — and it will be left to the Chinese company to convince the U.S. government otherwise.

2. State subsidies

As the CNOOC experience with Unocal indicates, the funding that Chinese companies rely upon in making investments in the United States may be an important regulatory and political factor. First, on the regulatory front, such funding can be indicative of state control. As Graham and Marchick noted, one of the factors that CFIUS considers to determine government control is “contractual arrangements” and the “pledge or other transfer of any or all of the principal assets of the entity.” As a contract, a loan agreement likely could be considered to meet these terms if it included a “pledge” of certain of the acquirer’s assets as collateral.¹⁰² Further, if an entity appears to be making an investment on non-market terms, CFIUS may question whether the transaction is purely a commercial transaction or, instead, reflects state-related interests and direction. In this regard, it is significant that four state-controlled banks — the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank, the Agricultural Bank of China — are responsible for a sizeable portion of all commercial loans in China.¹⁰³ Financing from such state-controlled entities may impact CFIUS’s threat assessment of the transaction.

State subsidies also can present policy questions that garner attention from Congress. For example, CNOOC reportedly received two low or no-interest loans totaling \$7 billion from its state-owned parent to make its bid for Unocal.¹⁰⁴ In response, members of Congress, in a joint letter to the President, expressed concern with the appropriateness of states subsidizing investment transactions to acquire scarce natural resources that are in high demand. They observed that, when government subsidies are directed toward such highly demanded and scarce resources, “any ensuing market distortions should be of particular concern ... [because] [s]uch subsidies may facilitate the allocation of scarce resources to inefficient or less-efficient producers.”¹⁰⁵ The OECD has noted that large Chinese SOEs:

have inherent advantages in undertaking large foreign investments since they enjoy formal as well as informal support from the government in the area of finance, networking, information access, and administrative procedures. They can also rely on monopolistic power in their respective subsector in the domestic market which has been protected by the government.¹⁰⁶

More to the point, state subsidies to Chinese companies can easily translate into political concerns over the impact of FDI from China on

⁹⁷ Jim Hemerling, David C. Michael, and Holger Michaelis, “China’s global challengers: the strategic implications of Chinese outbound M&A” (The Boston Consulting Group 2006); Draft OECD Report on China OFDI, op. cit., ¶ 104.

⁹⁸ Morck, Yeung, and Zhao, op. cit. p. 13.

⁹⁹ Graham and Marchick, op. cit., p. 107.

¹⁰⁰ Morck, Yeung, and Zhao, op. cit., at 6 (Aug. 2007).

¹⁰¹ Draft OECD Report on China OFDI, op. cit., ¶ 33 (citing Cheng, L. and Z. Ma, “China’s outward FDI: past and future” (July 2007)).

¹⁰² Graham and Marchick, op. cit., p. 116.

¹⁰³ Morck, Yeung, and Zhao, op. cit., p. 14.

¹⁰⁴ Allan Sloan, “Lending a helping hand: the math behind CNOOC’s rich offer to buy out Unocal,” *Newsweek*, July 18, 2005.

¹⁰⁵ Senators Charles E. Grassley and Max Baucus, “Grassley, Baucus express concern over potential CNOOC-Unocal deal,” press release, July 13, 2005, available at grassley.senate.gov; Graham and Marchick, op. cit., p. 116.

¹⁰⁶ Draft OECD Report on China OFDI, op. cit., ¶ 35.

small and medium-sized U.S. businesses. Indeed, in its 2007 report to Congress, the USCC claimed that subsidies from the Chinese government negatively impact market conditions for U.S. companies, stating that “China’s unfair trade practices, including ... illegal subsidies for Chinese exports,” harm small and medium-sized U.S. manufacturers.¹⁰⁷ In addition, subsidies to SOEs can raise questions — whether fair or not — about the SOE’s ability to make efficient decisions and be a responsible owner of the U.S. target company.

3. Commercial and state espionage

Chinese FDI in certain sectors — in particular defense, aerospace, telecommunications, information technology — also can present regulatory and political challenges because of U.S. concerns over Chinese commercial and state espionage. The U.S. intelligence community has characterized the Chinese intelligence services as “among the most aggressive in collecting against sensitive and protected U.S. targets,”¹⁰⁸ and the Department of Justice “consider[s] China to be one of [its] top counter-intelligence priorities.”¹⁰⁹ The USCC claims “Chinese espionage in the United States ... comprises the single greatest threat to U.S. technology,” and “is straining the U.S. counterintelligence establishment.”¹¹⁰

U.S. officials have publicly claimed that there are over 3,000 Chinese “front companies” operating in the United States whose purpose is to gather intelligence and technology.¹¹¹ While that may have been an exaggerated number, in response to the threat, the FBI reportedly has increased the number of counterespionage agents assigned to China from 150 in 2001 to more than 350.¹¹² One-third of all economic espionage matters being actively pursued by the FBI in 2007 were reportedly tied to China.¹¹³ Since the beginning of 2007, there have been at least a dozen guilty pleas or criminal charges resulting from alleged Chinese espionage activity in the United States.¹¹⁴

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

¹⁰⁷ United States-China Economic and Security Review Commission, Executive Summary: Annual Report to Congress 3 (2007), available at http://www.uscc.gov/annual_report/2007/executive_summary.pdf.

¹⁰⁸ Statement of John Negroponte, Director of National Intelligence, Before the Senate Select Committee on Intelligence, January 11, 2007.

¹⁰⁹ Testimony of Alberto Gonzalez, Attorney General, Before the House Judiciary Committee, April 6, 2006.

¹¹⁰ USCC Executive Summary for 2007 Report, op. cit., p. 6.

¹¹¹ “FBI spy chief asks public for help,” CNN.com, Feb. 10, 2005, available at <http://www.cnn.com/2005/US/02/10/fbi.espionage/index.html>.

¹¹² David J. Lynch, “FBI goes on offensive against China’s tech spies,” USA Today, July 23, 2007, available at http://www.usatoday.com/money/world/2007-07-23-china-spy-2_N.htm (last accessed November 20, 2007).

¹¹³ Id.

¹¹⁴ Joby Warrick and Carrie Johnson, “Chinese spy ‘slept’ in U.S. for 2 decades,” Washington Post, Apr. 3, 2008, at A1.

4. Regulatory compliance

A fourth special consideration for FDI from China is the issue of regulatory compliance by Chinese companies, including in particular with U.S. export control laws. The importance of export controls as an ongoing compliance matter is described in Section A above. However, the issue of export control compliance also may have a broader regulatory and political impact on the ability of Chinese firms to make investments in the first instance. As noted, under FINSIA, CFIUS must formally consider compliance with the U.S. export control regime when investigating a transaction that involves foreign government ownership. Moreover, the U.S. government has adopted stricter licensing requirements for export to China. Specifically, under the so-called “China Rule,” items controlled on the Commerce Control List will generally be denied for export if they would “make a direct and significant contribution to Chinese military capabilities” or otherwise would be destined for “military end-use” in the People’s Republic of China, even if such items would not need an export license in typical circumstances.¹¹⁵ As a result, CFIUS will apply additional scrutiny to transactions involving Chinese investment in U.S. companies possessing export-controlled technology.

Another compliance factor that may impact the regulatory and political environment for Chinese investment is the reputation of both the foreign investor and the U.S. party for compliance with anti-bribery laws.¹¹⁶ First, as a political matter, ties between Chinese firms and the Chinese government and, in turn, any connection with public corruption, whether real or alleged, can be exploited politically by opponents of any particular investment.

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

5. Investments in other markets

Closely related to concerns that U.S. authorities may have over export control risks associated from Chinese investment are concerns over the markets in which a Chinese investor conducts business. In

¹¹⁵ Department of Commerce, Bureau of Industry and Security, Revisions and Clarification of Export and Reexport Controls for the People’s Republic of China (PRC); New Authorization Validated End-User; Revision of Import Certificate and PRC End-User Statement Requirements, 72 Fed. Reg. 33646 (June 19, 2007).

¹¹⁶ As with export controls, ongoing compliance with the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1 et seq., is discussed in Section A.

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science and technology industries, acquisition of advanced foreign weapons, and far reaching reforms of the armed forces.”¹¹⁸ The report stated that, while “China’s ability to sustain military power at a distance remains limited,” China “has the greatest potential to compete militarily with the United States and field disruptive military technologies that could over time offset traditional U.S. military advantages.”¹¹⁹

The Pentagon’s concerns over Chinese military objectives and strategic behavior are important for Chinese FDI for three reasons. First, to the extent Chinese FDI involves a state-owned company or CFIUS has questions about the connection of a Chinese investor to the Chinese government or military, CFIUS will assess the Chinese investment in terms of how it might strengthen the Chinese military or reduce the strategic standing of the United States military. This may well be a significant factor given that many of the largest Chinese SOEs have been involved in the production of military items.¹²⁰ Second, in turn, Chinese investments in the technology sector as well as in the energy or natural resource sectors will receive even greater scrutiny from the Defense Department — and the other CFIUS agencies likely will provide great deference to DOD’s interests in such transactions. Finally, as CNOOC and Huawei Technologies experienced, the perceived threat of the Chinese military is an issue that resonates with Congress, and Chinese investments that arguably might benefit the Chinese military or have some connection to the military — even remotely — stand the greatest likelihood of becoming highly politicized.

particular, U.S. government authorities and Congress are focused on Chinese investment in countries subject to U.S. sanctions, such as Iran, the Sudan, and the Democratic People’s Republic of Korea, as well as other countries where the U.S. has proliferation concerns. Thus, for Chinese investors, CFIUS will consider the potential threat posed by the transaction for controlled materials and technology, including dual use technology relevant to nuclear and missile proliferation, to be transshipped to countries such as Iran, Pakistan, and the Democratic People’s Republic of Korea.

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

6. Military rivalry

Finally, the United States’ view of the Chinese military as an emerging strategic threat impacts the U.S. regulatory and institutional environment for Chinese FDI. The National Defense Authorization Act for Fiscal Year 2000 required the U.S. Department of Defense to issue an annual report to Congress on Chinese military power and strategy.¹¹⁷ In its 2008 annual report, the Pentagon noted an increased “pace and scope of China’s military transformation,” “fueled by continued high rates of investment in its domestic defense and

¹¹⁷ Pub. L. 106-65, § 1202 (2000).

¹¹⁸ U.S. Department of Defense, Annual Report to Congress: Military Power of the People’s Republic of China 2008, p. I.

¹¹⁹ *Id.* (internal quotation and citation omitted).

¹²⁰ Graham and Marchick, *op. cit.*, pp. 114–115.

Conclusions: strategic measures for Chinese FDI

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

First, investors should understand the potential risks associated with any investment and be strategic about the sectors and U.S. businesses in which to invest. The experience of Bain Capital, 3Com and Huawei Technologies reflects the perils of potentially underestimating the risk inherent in Chinese investments in certain sectors. Based upon the public statements of the transaction parties, it would appear from the outside that, to varying degrees, they may have underestimated the degree to which Huawei's proposed 16% interest in 3Com and minority representation in 3Com's Board would strike regulatory and political nerves.¹²¹

This is not to argue that Bain Capital and Huawei Technologies should have refrained from the investment in 3Com, or that the decision by CFIUS to block the transaction was the right result. Outsiders to any transaction cannot know exactly the considerations that factored into the transaction parties' or CFIUS's respective analysis. However, the 3Com case does exemplify the importance for Chinese investors to conduct an informed regulatory and political risk analysis in connection with the due diligence evaluation of potential investments in the United States. In this regard, Chinese investors should be aware that certain U.S. businesses, including those in the defense, aerospace, telecommunications, information



¹²¹ In a supplemental to a proxy statement issued by 3Com in February 2008, the company disclosed: "The Board of Directors considered Huawei's participation in the proposed transaction as a factor in their recommendation of the Merger. The Board believed that Huawei's participation increased deal certainty." 3Com Corporation, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Feb. 19, 2008).

technology, and, to a lesser degree, energy sectors, will present considerable regulatory and/or political risk and may not be realistic transaction targets. Other assets may still be subject to CFIUS review but potentially will be less sensitive, such as chemicals and certain infrastructure (e.g., sea ports). Even with these assets, however, political risk may remain high. And still other assets, such as real estate and manufacturers of consumer retail products, may present minimal regulatory and political hurdles even for Chinese investors. In each asset class, though, the same lesson remains: be smart about the investment and conduct a full risk analysis before proceeding.

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

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

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

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

Sixth, in certain transactions, the Chinese investor may wish to join with a well-known and reputable U.S. partner to pursue an investment or to defer to the U.S. party on the opposite side of a transaction to take the lead in public statements and political strategy. Having a U.S. partner obviously will not equate to a successful and quiet investment in all circumstances — after all, Huawei Technologies was the minority partner to Bain Capital’s predominant position in the failed 3Com transaction. However, U.S. parties often will be able to deliver political supporters, and involving U.S. citizens in a transaction, in turn, may be prudent politically. The IBM-Lenovo transaction is one that demonstrates the potential import of having a strong U.S. party to a given transaction. In that case, IBM, with its virtually unparalleled reputation both in the Executive Branch and in Congress, provided a strong voice to the rationale for the transaction. Lenovo, to its credit, exercised discipline and enabled IBM to take the higher profile publicly in the transaction. By comparison, executives from CNOOC and Huawei each made public comments that hurt their cause and contributed to political controversy. Huawei’s chief marketing officer famously called U.S. concerns over the transaction “bullshit.”¹²²

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

Eighth, and finally, Chinese firms potentially contemplating major acquisitions in the United States may wish to develop a comprehensive strategy — well before any investment is made — to help manage political risk, especially in Washington. Such a “Washington strategy” might include a communications effort intended to help lay the groundwork for future investment and improve the investor’s reputation among key Washington institutions; efforts to make the Chinese investor more transparent publicly as well

as to key agencies and members of Congress, including by providing briefings to these audiences; and establishing a framework of third-party validators — i.e., well-respected third parties who, when asked to comment about the Chinese firm, will be favorably inclined. Such a “Washington strategy” may also involve participating in the larger Washington policy-related environment outside the context of any particular transaction — such as by participating in events hosted by trade organizations and think tanks and potentially even seeking opportunities to participate in certain industry organizations.

* * *

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

Nevertheless, the United States maintains an official policy of welcoming investment. The challenge for Chinese investors, therefore, is to find the right transactions that enable them to invest in the U.S. market without incurring regulatory or political trouble. This is the aim of the foregoing recommendations — namely, to help provide Chinese investors with a broad roadmap to lessen regulatory and political risk and avail themselves of the open investment environment in the United States.

¹²² Andrew Parker and Paul Taylor, “Huawei rails at 3Com deal security concerns,” *Financial Times*, Feb. 12, 2008.

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