



# Foreign Investment and National Security

*New approaches to national security screening of foreign investments in the United States and China could subject deals to closer scrutiny*

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Both the United States and China have recently produced legislation that is expected to broaden and intensify government scrutiny of foreign direct investment based on national security considerations. The US Congress has overhauled the Exon-Florio amendment on the basis of which the inter-agency Committee on Foreign Investment in the United States (CFIUS) conducts national security screening of acquisitions by, and mergers with, foreign companies. The Foreign Investment and National Security Act of 2007 (FINSA), which took effect

in October 2007, establishes a variety of new statutory requirements for screening by CFIUS. China's new Antimonopoly Law (AML), which will take effect in August 2008, mandates examinations of transactions for national security concerns in addition to competition policy screenings. The AML will build on China's existing national security screening regulations, which were passed in August 2006.

National security screening has already proven to be a significant complication for foreign investment in both

countries. For example, PRC authorities have insisted on radical reductions in the Carlyle Group's proposed investment in China's largest manufacturer of construction machinery, Xugong Group Construction Machinery Co. Ltd. In the United States, China National Offshore Oil Co. (CNOOC) eventually withdrew its 2005 bid to buy Unocal Corp., reportedly for reasons related to national security screening.

How the US and PRC governments implement their respective new laws could significantly affect international investment in and between the United States and China. Particularly intriguing is the impact that implementation of new policies in one country could have in the other. Given the susceptibility of national security screening to action based on commercial and political considerations, it is to be hoped that each country will seek to adhere rigorously to standards that are based on legitimate national security concerns.

## United States

### Exon-Florio

The Exon-Florio amendment to the Defense Production Act of 1950, which was originally enacted in 1988, authorizes the president to block or order divestment of a transaction that gives a foreign entity control over US business operations if there is credible evidence that a foreign entity "might take action that threatens to impair the national security of the United States" and existing provisions of law do not provide "adequate and appropriate" authority to protect national security.

The president has delegated responsibility for Exon-Florio screening to CFIUS, a 13-member inter-agency committee chaired by the Secretary of the Treasury. (Until FINSA took effect, CFIUS agencies included the departments of the Treasury, Commerce, Defense, State, Justice, and Homeland Security; the Office of Management and Budget; the Council of Economic Advisors; the Office of the US Trade Representative; the National Security Council; the National Economic Council; and the Office of Science and Technology Policy. FINSA added the Department of Energy and, on a non-voting basis, the Department of Labor and the intelligence community.)

US law does not require that transactions be screened, but parties often voluntarily submit transactions for examination by CFIUS to avoid adverse action under Exon-Florio. Adverse action can include blocking of transactions in whole or part, or forced divestment of acquired interests.

CFIUS screening is designed to last no longer than 90 days, although informal consultations with CFIUS and other factors can result in delays. For most transactions, CFIUS examinations are completed at the end of an ini-

tial 30-day review period. Relatively few examined transactions are also subjected to a formal 45-day investigation. And CFIUS has referred only a handful of transactions to the president for a decision following an investigation. (FINSA has not changed this process or timing.)

Only once has a US president taken formal action under Exon-Florio. President George H. W. Bush ordered a PRC government buyer to divest its ownership of a US aerospace firm in 1990. But Exon-Florio screening has complicated, delayed, and resulted in changes to many transactions. Transactions are sometimes delayed when parties are induced to withdraw and refile notifications,

thereby "restarting the screening clock." Furthermore, some prospective buyers have dropped acquisition efforts because they thought their proposals would not receive Exon-Florio clearance.

One such aborted effort was CNOOC's bid to acquire Unocal in 2005. CNOOC's bid drew criticism from a US competitor and from many members of Congress. Although it submitted an Exon-Florio notification, CNOOC subsequently withdrew its bid when obtaining CFIUS clearance appeared unlikely. The PRC Ministry of Foreign Affairs strongly criticized the

reception that CNOOC's bid received in Washington, demanding "that the US Congress correct its mistaken ways of politicizing economic and trade issues and stop interfering in the normal commercial exchanges between enterprises of two countries."

In early 2006, Dubai Ports World's acquisition of a UK company that held certain US sea port operations created even more controversy. Although CFIUS cleared the transaction, Dubai Ports World agreed to divest its ownership of the port operations when it became evident that Congress would probably pass legislation mandating divestment.

### FINSA

Largely a response to concerns about the CNOOC and Dubai Ports World acquisition efforts, FINSA is a comprehensive re-write of the Exon-Florio amendment. FINSA codifies a variety of changes to Exon-Florio, many of which the current Bush administration had already implemented in response to congressional pressure:

- Mandatory assessment of a transaction's impact on US "critical infrastructure," energy assets, and "critical technologies";
- A requirement that transactions involving state-owned or controlled foreign entities or critical infrastructure be subject to a formal, 45-day investigation;
- Establishment of a clear legal footing for "mitigation agreements" between the government and transaction par-

### Quick Glance

- Regulatory changes in the United States and China could lead to closer scrutiny of foreign investments from a national security perspective.
- How these reviews are conducted in one country could influence the way they are conducted in the other.

ties. The US government can penalize parties for violating these agreements, even by reopening its examination of cleared transactions in some circumstances.

- Mandatory analysis of screened transactions by the US director of National Intelligence; and
- A system of congressional notification to expand congressional oversight of CFIUS screening.

### Considerations for foreign investors in the United States and China

Though the full impact of the statutory changes imposed by FINSA and the AML will become clear as administrative practice and precedent emerge, the new legislation and other changes have several obvious implications for foreign investors in the United States and China.

## Recent practice in China and AML provisions on national security screening suggest that scrutiny of foreign direct investment in China may be increasingly politicized.

### China

Following CNOOC's failed bid for Unocal and domestic controversy over foreign investment in perceived "important" Chinese industries, the PRC government has taken an increasingly restrictive approach to foreign investment.

The US investment fund Carlyle Group, for example, encountered major hurdles when it announced in October 2005 plans to acquire an 85 percent stake in Xugong Group Construction Machinery. The transaction raised concerns that foreign investors were gaining excessive control of a strategic Chinese manufacturing sector. Following more than a year of regulatory delay, the PRC Ministry of Commerce (MOFCOM) has yet to approve the transaction even though Carlyle agreed in March 2007 to reduce its proposed ownership stake in Xugong to a 45 percent minority interest.

Largely in response to calls for greater protection of domestic industries from foreign control, six PRC government agencies jointly issued the Provisions on the Acquisition of Domestic Enterprises by Foreign Investors in August 2006. The regulations require MOFCOM approval of foreign acquisitions of "important" industries that have an effect on "national economic security." The regulations modified previous rules that required MOFCOM approval only for foreign mergers and acquisitions valued at more than \$100 million.

China codified national security screening requirements for the first time in national legislation in August 2007 when it adopted the AML. In addition to competition policy screening, the AML states that foreign mergers with, and acquisitions of, domestic companies "should go through national security checks according to relevant laws and regulations. . . ."

In the United States, CFIUS is treating acquisitions of infrastructure, such as oil refineries and toll roads, which would not have even been notified for screening in the past, as having national security importance. In addition, FINSA formalizes more intensive oversight by Congress, which, in turn, may increase opportunities for competitors to use Exon-Florio examinations to delay and disrupt transactions. Recent practice in China and AML provisions on national security screening, particularly the codification of a "national economic security" standard, suggest that scrutiny of foreign direct investment in China may be increasingly politicized.

Of particular interest is how administration of the law in one country might affect administration of the law in the other. If, for example, US administration of FINSA appears to be driven by commercial rather than security considerations, PRC authorities may exercise more latitude in applying the AML's "national economic security" standard.

The Bush administration has been highlighting limitations on screening established in FINSA, rightly noting that a variety of troubling proposals were omitted from the legislation. At the same time, PRC authorities have made comparisons to US policies in defending AML security-screening provisions. In response to concerns about protectionism, PRC officials have stated in the *China Daily* that AML policies would merely bring China into line with international practice, stating that "[c]hecks on mergers of foreign and domestic firms are practiced by many countries."

In sum, administration of FINSA and the AML merit careful attention not only because of the effects that application of the laws can have on investment in the respective countries but also because of possibilities for reciprocal action by others. 完

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