Chinese SOE Investment: An Economic Statecraft

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China’s rising economic preeminence has been stunning, firmly ensconcing China as the second most powerful world economy replacing previously second-ranked Japan. In a remarkably short span, less than 15 years, the US economy has experienced a relatively huge decline vis-à-vis China on a nominal GDP basis.

China’s remarkable economic juggernaut has been fueled by an opening of markets, globalization and booming free trade which has provided immense financial benefit to Chinese companies. The free market open rules trading system “led to the establishment of China as a major global exporter. As China’s economy has boomed, China has looked increasingly abroad for investment opportunities to both employ its cash hoard and provide long-term growth for its citizens.

In China, many large companies are state-owned enterprises (SOEs), and are the most common form of entity that are involved in investment. Chinese SOEs receive preferential treatment in terms of access to capital and obtaining regulatory approvals and are employed in the advancement of Chinese governmental aims “serv[ing] political goals, including fostering indigenous innovation, supporting social stability and crisis response in China, and advancing economic initiatives abroad such as ‘One Belt, One Road.’”

By definition, all SOEs raise concerns because of their connection to their home states. These anxieties over state-owned businesses are not unique to China and relate to all SOEs in general. Investments made by states trigger different regulatory sensitivities compared to considerations raised by private companies because of the possibility that in conducting business government owned or controlled entities may utilize non-profit motivations and substitute political ambitions instead of or in addition to profit-making.

Thus, these concerns are tied to any government-owned business which potentially subjugates (or at a minimum is an additional motivation) private market interests to the political interests of the state. Indeed, such concerns are not entirely new. As an illustration of prior concerns with respect to government-owned businesses and their investment decisions was the opposition over Dubai Ports’ attempt to invest in the U.S. In 2007, the Dubai government-owned Dubai Ports World sought to acquire port terminals located in the U.S. Members of the U.S.

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1 See Wendy Leutert, China’s Reform of State-Owned Enterprises, 21 ASIA POLICY 83, 86 (2016).

2 Id.

Congress, concerned about a foreign government controlling the flow of goods and people into the U.S. voiced strenuous opposition on national security grounds. In this respect, Chinese SOEs are no different than other state-owned businesses.

However, there are additional factors with respect to China's SOEs which increase national security concerns of FDI recipient nations; China's political structure and unique state dominance/control of SOEs presents a different type of investor. China is a communist economic order and the state is purposely directly involved in all critical economic sectors. "The way that the Chinese government exercises ‘state capitalism’ is that it directly or indirectly controls a large number of powerful SOEs, especially in the strategic and key sectors."

The raison d'être of the Chinese SOE is the advancement of the CCP's objectives thus amplifying the general "state-ownership" concerns. China is ruled by one political party, the CCP, and its domination of Chinese SOEs is of critical importance. The CCP wields near total non-financial control over its citizenry; singularly legislates the law of the land and CCP appointed judges rule on the interpretation of law in courts. These facts are not meant as a criticism of China which has expressed no intent of aggressively advancing such goals. Nevertheless, Chinese SOEs may have motivations that align with CCP goals and those aims may not necessarily correlate with other countries' national interests.

While the U.S. government also wishes to advance its geo-political goals, the key distinction is that the U.S. government's pursuit of policies is not part of private U.S. company investment decision making. In evaluating FDI from U.S. companies, the presumption is the decision to invest is 100 percent profit motivated; but the same cannot be said of Chinese SOE investment. It is thus crucial to internalize that Chinese SOEs related investments may very well harbor an agenda to advance strategic goals for the CCP. These concerns can be expected to grow. The CCP is apparently strengthening its control over SOEs.

The potential motivation to further the goals of an alternative vision of global governance by a private entity investing and buying companies is a very different context for review than traditional corporate acquirers. In addition, investments and joint ventures from SOEs may not be an efficient allocation of resources or be a profit-generator. If investments are not based upon pure economic motivations, the investments may prove to be less than stellar performers or at a minimum, fail to

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5 See, e.g., Debt risk for main state-owned enterprises is controllable: China, THE ECONOMIC TIMES (India) (Jan. 27, 2017), http://economictimes.indiatimes.com/articleshow/56806126.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst (While many state companies are bloated and inefficient, China has relied on them more heavily over the past year to generate economic growth in the face of cooling private investment).
achieve the potential return. Crucially, such motivations bring potential economic risk/loss of potential into the calculus for a recipient nation.

China has acknowledged the crucial need to reform its inefficient SOEs and doing so would lend confidence to recipient nations and lower concerns. However, economic considerations have not trumped political considerations. Rather than utilizing pure economic factors as the benchmark for SOE reform, political factors are considered which may impinge on the profit-making calculus private sector companies engage in. In terms of enacting reforms to China’s SOEs, economic performance is surely a factor but not the controlling factor as it would be in a private sector business. This demonstrates that SOE investment in other countries may potentially be made based at least in part upon non-economic factors. The fact that some SOEs investments may not have pure economic profit as the driving factor may constitute an inefficient allocation of financial resources and economic potential in addition to raising security concerns.

Although FDI is acknowledged as beneficial and an important enabler of economic vitality, many governments are concerned about national security implications of FDI. Chinese FDI has come under more stringent scrutiny in recent years sparked by political concerns about foreign ownership in Europe and the U.S. Some in the U.S. have urged a complete ban on Chinese SOE investment. It is not only the U.S. that has signaled a reassessment is being considered. The EU has also expressed concerns regarding China’s FDI into the EU and the associated national security risks of OBOR-driven investment. EU diplomats gave expressed “suspicions ran deep over China’s geopolitical intentions in Europe, particularly with its massive trade and infrastructure plan, the ‘Belt and Road Initiative’.

The laws of the U.S. as they relate to foreign investment and national security assume greater importance. The U.S. remains the world’s largest net capital importer, attracting more than half of the total Organization of Economic Co-operation and Development inflows. Changes in the content or application of U.S. laws governing foreign investment could, therefore, not only lead to modeling by other countries but also force significant changes in the flow of FDI worldwide.

The U.S. Treasury Department's Committee on Foreign Investment in the United States (CFIUS) is the primary vetting mechanism. The CFIUS wields power to review a "covered transaction," defined as any merger, acquisition or takeover … by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States. The term "national security" is not strictly

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6 For an excellent discussion of SOE reforms see Wendy Leutert, supra note 1.


defined and CFIUS focuses on certain strategic national security spheres such as energy, defense and technology.\(^9\)

The CFIUS review process consists of four steps: (1) a voluntary filing with CFIUS by one or more parties to the transaction; (2) a 30-day Committee review of the transaction; (3) a potential additional 45-day Committee investigation; and (4) within 15 days of receiving the report, the President has to make a decision to permit, deny the acquisition, or seek divesture after an *ex post facto* review.

For transactions that raise issues, parties may engage in pre-filing consultations and negotiations with the CFIUS or member agencies before making their official notification.\(^10\) Although these discussions are not part of the formal CFIUS process, they often influence the outcome. Parties sometimes may modify their transaction before filing to expedite clearance. In other cases, parties may abandon transactions after it became clear that the CFIUS would not approve them or would not do so on terms acceptable to the parties.

A CFIUS filing is not mandatory for any transaction. Nevertheless, foreign direct investment by a firm controlled directly or indirectly by a foreign government is subject to mandatory review.\(^11\) The focus of review is directed toward the plans for acquired assets and on national origin i.e. foreign government seeking to engage in any merger, acquisition, or takeover. The CFIUS is required to consider whether the acquisition "could affect national security" rather than applying the "threatens to impair national security" level of scrutiny. The lower standard of review, coupled with the mandatory nature of the inquiry, presents the CFIUS with the opportunity to exercise leverage over the acquiring entity or its government.

The 30-day initial review period begins to run once the CFIUS staff gives notice that they are satisfied that the filing contains all of the required information.\(^12\) Although only one party to the transaction need file notice to trigger a review, the CFIUS may delay the beginning of the review period until the required information about other parties is received.\(^13\) Thus, the CFIUS in practice may request a joint filing. During the 30-day initial review, the CFIUS may contact the parties for further information or to discuss steps that would mitigate any national security concerns that the transaction raises.

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9 See https://www.wsg.com/CFIUS/pdf/section-721.pdf (noting the list of factors CFIUS will consider include defense, energy and technology). Note there are calls to expand the list of areas. See https://www.agriculture.senate.gov/newsroom/dem/press/release/senators-stabenow-and-grassley-introduce-bipartisan-legislation-to-protect-american-agricultural-interests-in-foreign-acquisitions (proposal to add food security to list).


12 Id. §800.502(b).

13 Id. §800.403(b).
At the end of the 30-day initial review period, the CFIUS is required either to clear the transaction based on its initial review or begin an additional 45-day investigation.\(^{14}\) However, the CFIUS may informally request that the parties withdraw the filing before the end of the 30-day initial review period if the CFIUS needs more time or information to fully review the transaction, or the parties have not agreed to mitigating conditions as requested by agencies.\(^{15}\) In practice, all presidential administrations since 1992 have considered the 45-day investigation as a "discretionary" option even in cases where a foreign company is government-owned.\(^{16}\) If the national security concerns raised by a transaction are resolved during the 30-day review, an investigation is not necessary. Therefore, questions arise about what Exon-Florio actually requires, is its intent, and whether the 45–day investigations are mandatory or discretionary.

If CFIUS proceeds with a full investigation of the acquisition, it must conclude its additional review within 45 days.\(^{17}\) At the conclusion of the investigation, it will submit a recommendation to the President. Normally, the CFIUS makes a unanimous recommendation, but if the members are divided they will forward their differing views to the President. The President has 15 days from the date of referral to clear, prohibit, or suspend the acquisition. Action by the President pursuant to the CFIUS is not subject to judicial review. When the process reaches the presidential decision stage, the President must make a mandatory report to Congress.

The statutory language of the CFIUS provides the timeframe for investigations and recommendations. In total, a CFIUS review may last between 30-90 days. However, delays are inherent in the review process. Parties may engage in pre-filing consultations with the CFIUS, make a material change to their filing, or file again for the same transaction. Also, the CFIUS itself can ask the parties for further information or to withdraw. All these issues can result in extensions and delays in the various stages of the CFIUS review process of a proposed transaction. Parties should engage with the CFIUS early in the process to expedite the process and avoid any delays.

Recent amendments to CFIUS expanded its coverage to include real estate transactions, non-controlling investments in critical technology companies, critical infrastructure companies, and companies that maintain or collect sensitive personal data of U.S. citizens.\(^{18}\) Some of these new covered areas (personal data, critical infrastructure, and critical technology) seem to target specifically Chinese investment. The most important aspect of the recent amendments to CFIUS is that they include language specifically designed for China. This seems to be unprecedented that a

\(^{14}\) See 50 U.S.C. app. section 2170(b).

\(^{15}\) See Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, above n 18, §800.507(a).


\(^{17}\) See Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, supra note 12, §800.506(a).

\(^{18}\) Other amendments allow parties to covered transactions to file short-form "declarations" instead of a more detailed notice. The amendment also expands CFIUS’s review period from 30 to 45 days and allows an investigation to be extended for an additional 15-day period under extraordinary circumstances. See Summary of Foreign Investment Risk Review Modernization Act of 2018, available at <https://www.treasury.gov/resource-center/international/Documents/Summary-of-FIRRMA.pdf> (last visited Dec. 19, 2018).
regulation would refer to a specific country. The amendment requires the Secretary of Commerce to submit to Congress and CFIUS a biannual report on foreign direct investment transactions made by Chinese entities in the U.S.\textsuperscript{19}

Global investment through SOEs is beneficial and necessary to bring economic prosperity worldwide. However, foreign acquisitions of companies can pose a significant challenge for governments. The CFIUS enhances the national security when it identifies specific problems which could threaten U.S. security and helps resolve these problems while still allowing U.S. business to receive the investment they need. Viewed from this perspective, the CFIUS has been successful. In every other country, a CFIUS style review mechanism is an option that should be examined as a potential solution to the upcoming challenges of increasing Chinese investment worldwide. Countries should adopt formal and legal security review of foreign investment.

\textsuperscript{19} The report will include the total foreign direct investment from China in the U.S.; a breakdown of such investments by value, investment type and government vs. non-government investments; a list of companies incorporated in the U.S. through Chinese government investment; information regarding U.S. affiliates of entities under Chinese jurisdiction; an analysis of Chinese investment patterns and the extent to which those patterns align with the objectives of China’s Made in China 2025 plan; and other related information. \textit{Id.}