Protectionism or Rule of Law? - A Comparison between US and PRC National Security Review Regime

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By Liang Tao

A series of recent news might make people think that the U.S. was intentionally throwing fuel on its increasingly tense economic relationship with China. On September 28, 2012, the U.S. President Barack Obama blocked an acquisition of four wind farms by Ralls Corporation, a Chinese-owned corporation affiliated with Changsha-based Sany Group. Further on October 8, 2012, the U.S. House of Representatives released an investigative report accusing China’s two largest telecom equipment manufacturers, Huawei and ZTE, of posing threat to the U.S. national security. Actually, before the issuance of this report, Huawei had been constantly challenged by the U.S. government due to national security concerns arising from Huawei’s acquisition of the U.S. business.

These days, there are various points of views regarding the national security issue in connection with transpacific mergers and acquisitions. Some people claim that the U.S. national security review of foreign acquisition is just a cover for protectionism. It would make sense if we could put aside the crossfire of finger pointing and run an objective comparison between US and PRC national security review regime.

**Origin and history**

In the U.S., the Committee on Foreign Investment in the United States (“CFIUS”), an inter-agency committee chaired by the Treasury Department, is in charge of reviewing foreign acquisitions of the U.S. businesses to determine whether the acquisitions would impair the U.S. national security. CFIUS was created in 1975 in reaction to investments from the Middle East. In 1988, as a result of Japanese investments, the President was authorized to block foreign investments following CFIUS investigation. In 2007, in the wake of Dubai Ports World’s acquisition of a firm that managed several major U.S. seaports, the CFIUS review process was significantly reformed by the Foreign Investment and National Security Act (“FINSA”), expanding the scope of national security reviews and signaling greater scrutiny.

In China, the notion of “national security” was not introduced in its foreign acquisition review regime until 2006. In that year, the Ministry of Commerce (“MOFCOM”), together with five other government authorities, promulgated the M&A Rules or Circular 10, which, for the first time, requested notification and review of an inbound M&A transaction that might affect China’s “national economic security”. In 2008, the PRC Anti-Monopoly Law was enacted, requiring a broader “national security” review when national security is involved in an undertaking concentration. In February 2011, the General Office of the PRC State Council issued the Notice on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (“Notice”), which formally established the national security review system for inbound M&A transactions by foreign investors. MOFCOM subsequently released implementing provisions (the “Provisions”) in August 2011. Under the Notice and Provisions, an inter-ministerial joint conference (“Joint Conference”) was set up to whom MOFCOM must report any proposed M&A transaction that falls within the scope of the national security review.

**Initiation of security review**

CFIUS process is ostensibly based on a voluntary notification system, permitting parties to a transaction to decide whether to initiate a CFIUS
review. CFIUS does not set any specified deal value or criteria serving as thresholds for notification. However, either CFIUS or the U.S. President is authorized to unilaterally initiate a review of any deal that could result in foreign control of any entity engaged in interstate commerce in the U.S.

A covered transaction that has been notified to CFIUS, without being found any unresolved national security concerns, is eligible for a “safe harbor.” On the contrary, a covered transaction that CFIUS has not reviewed and cleared does not qualify for the safe harbor, and CFIUS has the authority to initiate review of the transaction on its own, even after the transaction has been concluded. That’s exactly what happened in Ralls’s case.

China’s national security review process for acquisition by foreign investors may be initiated by any of the following three ways: (i) the foreign investor can voluntarily file an application for review with MOFCOM; (ii) the local MOFCOM will report the transaction to MOFCOM and mandatorily require the foreign investor to file an application for review with MOFCOM if national security concerns arise; or (iii) concerned government authorities, industrial associations, competitors and upstream and downstream enterprises can submit a request to MOFCOM to conduct a security review if they believe a deal falls within the scope of national security review.

Procedures

CFIUS review process generally starts when the parties to a transaction file a voluntary notice with Treasury Department. After Treasury Department decides that the filing is in good order, it circulates the filing to the other CFIUS members to commence a 30-day review period. After this 30-day period, all CFIUS agencies should either approve the proposed deal or decide that a 45-day investigation is necessary, as any CFIUS agency can separately seek a further investigation.

Upon a 45-day investigation period, if any CFIUS agency still has unaddressed concerns, CFIUS will send a report to the U.S. President who should either permit or block the transaction within 15 days. The entire CFIUS process therefore can take up to 90 days. In the above-mentioned Ralls case, CFIUS submitted the deal to President Obama who subsequently vetoed the deal.

China’s national security review procedure will start upon a voluntary or mandatory filing. The MOFCOM will complete a preliminary review within 15 working days. If the deal falls within the scope of a national security review, the MOFCOM will, within 5 working days, submit the application to the Joint Conference. The Joint Conference then has 5 working days to solicit opinions from the relevant government authorities, which should submit written opinions to the Joint Conference within 20 working days.

If no concern arises, the Joint Conference will notify MOFCOM in writing within 5 working days. On the contrary, if any relevant authority still has any national security concern, the Joint Conference will initiate a special review process, which may take 60 working days, in order to make a decision or further submit this deal to State Council which is not subject to any time limit to make a final decision.

Significance of Ralls Case

Most of CFIUS cases relate to foreign acquisition of the U.S. “critical technology” or “critical infrastructure”, such as Huawei’s acquisition of 3Leaf’s cloud computing technology in 2010 and Dubai Ports World’s acquisition of U.S. seaports in 2006. However, the Ralls case is apparently an exception.

In March 2012, Ralls acquired four Oregon wind farm projects from an U.S. company. For the purpose of this acquisition, Ralls obtained the approval from the U.S. Federal Aviation Administration and the U.S. Navy respectively, though U.S. Navy had mentioned that one of the four wind farms is in the restricted military airspace. Notably, the Ralls acquisition was closed without filing with CFIUS. Thereafter, in June 2012, CFIUS requested Ralls to file a voluntary notification. Per this request, Ralls filed with CFIUS, and consequently received CFIUS’s findings and orders, saying Ralls’s acquisition posed national security risks to the U.S., and shall be frozen and suspended for the President’s review and decision. To challenge such findings and orders, Ralls unprecedentedly filed a lawsuit against CFIUS and then added Obama as a defendant when the President blocked this deal at a later time. This is the first time in 22 years an U.S. President has blocked a foreign investor on national security grounds.

Two lessons we can learn from the Ralls case are (i) the location of an acquired property can be the critical factor in a national security review even if the business itself is entirely irrelevant to any national security issue; and (ii) notwithstanding the CFIUS process is voluntary, less than 10% of all foreign acquisitions is reviewed, and much less deals are blocked, CFIUS may review closed deals unilaterally and retroactively. Additionally, the fact that the President’s veto is not subject to judicial review under the FINSA casts a shadow over the future of Ralls lawsuit.

Observations

According to 2011 CFIUS Annual Report, 6 deals initiated by Chinese investors had been subject to CFIUS review in 2010, while the U.K., Canada and Japan had 26, 9 and 7 deals respectively. It appears that we cannot simply assume that Ralls’s acquisition was reviewed and blocked merely because the purchaser was Chinese, since CFIUS had reviewed more deals initiated by British and Canadian who are traditional allies of the U.S.

However, due to the non-transparency in decision making, recent actions taken by CFIUS and U.S. President might not be purely interpreted as a result of rule of law, especially against the background that Romney and Obama continue arguing over who would be tougher on China immediately before a general election. By the way, can you imagine the responses of the U.S. senators and congressmen if MOFCOM or State Council blocks IBM or Boeing from doing such kind of deal in China?

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